2005

HSBC Bank plc

Annual Report and Accounts

The world's local bank

HSBC

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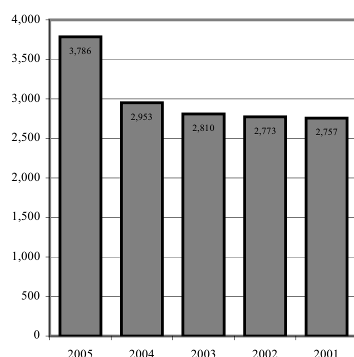
Presentation of Information

This document comprises the *Annual Report and Accounts 2005* for HSBC Bank plc ('the bank') and its subsidiary undertakings (together 'the group'). It contains the Directors' Report and Accounts, together with the Auditors' report, as required by the UK Companies Act 1985.

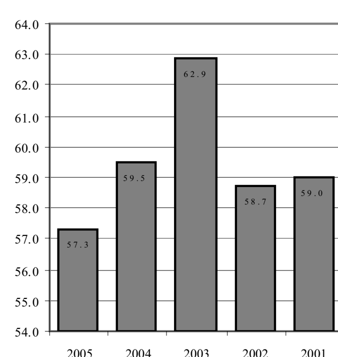
Financial Highlights

	2005	2004	2003	2002	2001
	£m	£m	£m	£m	£m
For the year [1,2]					
Profit on ordinary activities before tax	**3,786**	2,953	2,810	2,773	2,757
Profit attributable to shareholders of the parent company	**2,897**	2,057	2,046	1,867	1,937
At year-end					
Shareholders' funds of the parent company	**19,091**	16,828	17,064	16,455	15,648
Capital resources	**19,677**	16,424	14,603	12,768	12,209
Customer accounts and deposits by banks	**239,673**	193,664	175,390	155,234	147,665
Total assets	**386,422**	292,481	246,104	218,378	202,309
Ratios (%)					
Return on average shareholders' funds (equity) of the parent company	**16.7**	12.7	8.5	8.5	9.3
Capital ratios					
— total capital	**10.8**	10.5	10.7	10.3	10.7
— tier 1 capital	**6.9**	7.4	7.4	7.1	6.8
Cost:income ratio	**57.3**	59.5	62.9	58.7	59.0
Cost:income ratio including net insurance claims	**58.5**	64.2	–	–	–

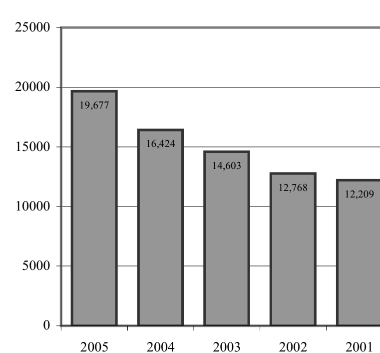
Profit on ordinary activities before tax (£m)



Cost:income ratio (%)



Capital resources (£m)



1 *The 2004 and 2005 financial highlights are prepared in accordance with IFRSs as endorsed by the EU.*

2 *2004 financial highlights excludes IAS 32, IAS 39 and IFRS 4. The 2001, 2002 and 2003 financial highlights are UK GAAP as previously reported.*

3 *The profit on ordinary activities before tax and the profit attributable to shareholders for the years 2001 – 2003 exclude goodwill amortisation.*

The financial highlights are influenced by changes in the group structure over the five years. The most significant acquisitions are as follows: in 2001, HSBC Investment Bank Asia Limited, Banque Hervet, Demirbank TAS, HSBC Guyerzeller Bank AG; in 2002, HSBC Trinkaus & Burkhardt KGaA, HSBC Republic Bank (UK) Limited and activities of HSBC Investment Bank plc; in 2004, Marks and Spencer Retail Financial Services Holdings Limited.

Business Highlights

Summary

- Net operating income before loan impairment charges up £1,518 million, 16 per cent
- Profit before tax up £833 million, 28 per cent

UK Personal Financial Services ("PFS") – profit up £161 million, or 24 per cent

- A range of UK marketing campaigns, including the first ever 'January Sale' by a high street bank, heightened brand awareness and increased market share in most product lines
- Successful integration of Marks and Spencer Retail Financial Services Holdings Limited ("M&S Money")
- Strong growth in mortgages and credit cards*
  - 22 per cent rise in mortgage balances, enhanced by widening spreads
  - market share of gross UK mortgage advances increased, despite overall market contraction
  - credit card advances increased 18 per cent driven by competitive pricing and marketing
- Strong growth in current, savings and deposit account balances*
  - sales of new savings accounts grew significantly, driven by competitive pricing and the launch of new products, with substantial growth in online products, particularly in First Direct
  - growth in savings balances was more than offset by reduced spreads

UK Commercial Banking – profit up £136 million, or 20 per cent

- Continued growth in customer base; 20,000 customers switched their banking relationship from other financial institutions, the largest share of any UK retail bank customers switching their banking relationship from other financial institutions
- Strong growth in lending with a 23 per cent increase in balances, and an increase in market share
- Customers increased 6 per cent
- Current account customers increased to over 700,000 and balances rose 12 per cent
- Deposit balances increased 11 per cent driven by marketing and competitive pricing

UK Corporate, Investment Banking and Markets ("CIBM") – profit down £115 million, or 23 per cent

- Balance sheet management revenue declined due to a flattening yield curve limiting reinvestment opportunities, and rising costs of funds
- Customer balance growth drove 14 per cent rise in Global Transaction Banking revenues
- Significant restructuring expenditure on IT systems and people, although expense growth slowed in the second half of the year

International Banking – profit up £324 million, or 102 per cent

- Turkey profit before tax increased 97 per cent, due largely to growth in credit card balances

France – profit up £92 million, or 25 per cent

- Marketing related to the rebranding of five subsidiaries assisted in a 54 per cent increase in mortgage sales
- Increase in loan impairment releases following several corporate restructurings
- Gains on disposals of £106 million, reflecting private equity and investment portfolio disposals

Private Banking – profit up £162 million, or 46 per cent

- Strong balance sheet growth in the UK and Switzerland
- New Wealth Management team in Germany, successful in generating £13.1 billion of net new money

Total operating expenses – up by £352 million, or 6 per cent

- Lower operating expenses in UK PFS and Commercial Banking
- £254 million of additional costs, primarily for the expansion of CIBM capabilities
- Staff costs increased 9 per cent in France
- Costs in Private Banking increased, reflecting front office recruitment and higher performance-related bonuses in line with revenue growth

Loan impairment charges – up £405 million, or 109 per cent

- Asset growth in UK PFS and Commercial Banking combined with declining credit quality in UK personal lending
- Releases and recoveries in CIBM in 2005 were slightly lower than prior year

** Balances quoted exclude the impact of the acquisition of M&S Money*

Financial Review

Summary of Financial Performance

Consolidated Income Statement

	2005 £m	2004 £m
Net interest income	**4,042**	4,480
Net fee income	**3,355**	3,032
Other income	**3,633**	2,511
Operating income	**11,030**	10,023
Net insurance claims incurred and movement in policyholders' liabilities	**(230)**	(741)
Loan impairment charges	**(776)**	(371)
Net operating income	**10,024**	8,911
Total operating expenses	**(6,315)**	(5,963)
Operating profit	**3,709**	2,948
Share of operating profit in joint ventures and associates	**77**	5
Profit on ordinary activities before tax	**3,786**	2,953
Tax on profit on ordinary activities	**(827)**	(723)
Profit on ordinary activities after tax	**2,959**	2,230
Attributable to shareholders of the parent company	**2,897**	2,057

Profit on ordinary activities before tax

	2005 £m	2004 £m
UK Personal Financial Services	**832**	671
UK Commercial Banking	**812**	676
UK Corporate, Investment Banking and Markets	**393**	508
International Banking	**641**	317
France	**460**	368
Private Banking	**516**	354
HSBC Trinkaus & Burkhardt	**132**	59
	3,786	2,953

Growth in the **UK** economy remained subdued during 2005 at 1.8 per cent, the lowest rate since 1992. Consumer spending and housing activity slowed sharply during the first nine months of the year, staging a minor recovery in the final quarter. Doubts remained over the strength of consumer spending, given the rise in unemployment in ten consecutive months and reduced confidence in the housing market. The boost to the economy from government spending in recent years was also not expected to be significant. The recovery in exports was maintained, helped in large part by the strength of the global economy, though the industrial sector continued to struggle. Industrial output contracted in 2005 for the fourth time in the past five years. Companies were reluctant to invest despite a general profit recovery, stronger balance sheets and a strong equity market performance. Although commodity prices rose sharply, inflation remained well contained at around 2 per cent and wage growth eased. In response to weaker economic activity, the Bank of England cut interest rates in August to 4.5 per cent.

The **euro zone** experienced lacklustre economic growth in 2005, of nearly 1.3 per cent, although momentum accelerated during the course of the year. With consumer spending growth remaining subdued, the strongest areas were exports and fixed investment. There was, as usual, considerable divergence between countries: Italy and Portugal saw hardly any economic growth, while Spain, Greece and Ireland grew by over 3 per cent. Growth in France slowed from 2.1 per cent in 2004 to 1.4 per cent in 2005 but both investment and consumer spending revived a little in the second half of the year. Weak domestic demand continued to

Financial Review (continued)

constrain German GDP growth which slowed from 1.1 per cent in 2004 to 0.9 per cent in 2005, despite growth in exports, particularly capital goods. Euro zone inflation averaged at a little over 2 per cent in 2005, with higher energy prices boosting inflation by around 0.5 per cent. The European Central Bank raised interest rates from 2 per cent to 2.25 per cent in early December, the first increase for almost five years.

The performance of the **Turkish** economy in 2005 remained very positive. GDP grew by approximately 5.7 per cent, while inflation continued to fall, to 7.7 per cent in December from 9.7 per cent a year earlier. Economic policy remained anchored by the government's agreement with the IMF. Turkey's current account deficit, which reached £13.4 billion, or approximately 6.3 per cent of GDP in 2005, is increasingly being financed by longer-term direct investment into the country, which would help reduce Turkey's vulnerability to a sudden reversal in short-term capital flows.

Profit before tax increased by £833 million or 28 per cent compared with last year. Excluding the contribution from the acquisition of M&S Money, profit before tax increased by 27 per cent driven by strong demand for credit in a stable to declining interest rate environment. There was an offsetting deterioration in credit quality in the UK personal and commercial sectors.

Net interest income decreased by 10 per cent to £4,042 million. Excluding the impact of M&S Money, net interest income declined by 12 per cent. The interest rate and trading environment in 2005 presented significant challenges to the money markets and balance sheet management businesses in CIBM Global Markets. The related fall in net interest income was largely driven by a decline in earnings from maturing higher-yielding money market assets, combined with a flat yield curve limiting reinvestment opportunities. Strong growth in the volume of personal and commercial lending during the year was facilitated by several innovative marketing campaigns to raise product awareness, in addition to the establishment of dedicated commercial centres and the recruitment of further sales staff. Higher income from retail balance growth mitigated the effects of declining net interest income from Treasury operations.

UK PFS net interest income grew by 10 per cent and UK Commercial by 26 per cent. Mortgage net interest income in UK PFS grew by 37 per cent reflecting balance growth of 22 per cent and improvements in retention. In a declining market, the bank increased its market share of gross advances, helped by successful pricing and marketing strategies. Widening spreads were largely the result of presentational changes to fees as part of accounting for effective interest rates under IFRS. The bank's credit card businesses benefited from the ongoing strength of consumer expenditure on plastic which, combined with competitive pricing, marketing and cross-sales, contributed to growth of 18 per cent in average balances to £3,579 billion. HSBC branded cards increased market share of new cards issued. Spreads improved on the back of '0 per cent' balances that had been gained in campaigns in 2004 rolling over to higher rates. Unsecured personal lending net interest income in the UK increased 3 per cent in 2005. Preferential lending rate offers to low risk customers contributed to a 13 per cent increase in loan balances and also to an increase in market share from 10.7 to 11.7 per cent. Furthermore, focused marketing and, initiatives such as the 'January Sale', plus improved focus on sales, including the development of daily sales management information and new sales management processes, also contributed to growth. Balance growth was partly offset by narrower spreads as a result of the preferential rates.

The bank's current account proposition was re-launched in 2005. Brand awareness and marketing, assisted by a 6 per cent growth in average current account balances led to a 5 per cent growth in net interest income. Savings also exhibited strong balance growth on the back of new products available on-line including a new First Direct e-saving product, which grew average balances by £0.6 billion. Competitive pricing improved brand awareness. Spreads were also negatively impacted by the non-recurrence of last year's base rate rise. The overall decline in spreads offset the balance growth and net interest income on savings declined by 5 per cent.

UK Commercial lending and overdraft balances increased by 23 per cent and the bank increased its market share. Growth was particularly strong in the property, distribution and service sectors. Invoice financing net interest income increased 10 per cent, driven by a 12 per cent increase in customer numbers supported by a sales force realignment. Commercial deposit savings balances rose 11 per cent assisted by competitive pricing. A similar rise in current account balances of 12 per cent was the result of customers switching business to the bank on the back of marketing and advertising campaigns during the year.

In France, net interest income was broadly in line with 2004. In the personal sector, net interest income was broadly flat. This disguised higher volumes driven by marketing related to the rebranding, offset by lower margins as a consequence of competitive pricing. In the commercial segment, a programme to align the bank's most experienced relationship managers to its 350 largest Middle Market Enterprises ('MMEs'), led to a 10 per cent increase in medium term loan balances.

Private Banking net interest income grew by 27 per cent due to strong balance sheet growth in the UK, Switzerland and, to a lesser extent, Germany as clients borrowed in the low interest rate environment to make alternative investments.

Increased net interest income in International Banking was driven mainly by balance growth in Turkey. A credit card campaign in Turkey was a significant engine of growth, contributing to a 93 per cent increase in lending.

Net fee income increased by 11 per cent to £3,355 million. Excluding the acquisition of M&S Money, net fee income increased by 9 per cent. Growth in UK PFS fees mirrored the growth in personal loan sales noted above. A similar trend was seen in UK Commercial Banking with increased new business volumes driving loan and overdraft fee income, coupled with higher card acquiring income, driven by higher transaction volumes in part from the acquisition of new merchant relationships.

Private Banking fees in Germany, Switzerland, the UK and Monaco benefited from a significant inflow of net new money. This was due to the new Wealth Management team in Germany, the recruitment of relationship managers in Switzerland, effective cross referral strategies in the UK, and an enhancement of the onshore business in Monaco. Core fees and commissions were augmented by a favourable change in product mix towards discretionary managed funds attracting high fees.

In Turkey, fee income benefited from increased lending activity.

In UK CIBM, net fees rose by 7 per cent, partly due to higher income from an increase in the equity capital markets business, which benefited from significant deals. The asset backed securities product also generated higher fees with several notable transactions closing in 2005.

Other income increased by £1,122 million or 45 per cent, largely driven by a 208 per cent rise in trading income to £1,830 million. This was due to the reclassification of net interest income to trading income and positive revenue trends on products within Global Markets reflecting the successful investment made in client facing trading capabilities. Gains from sales of financial investments increased significantly to £248 million, as the private equity business experienced a strong flow of profitable realisations.

Operating expenses increased by £352 million, or 6 per cent. Excluding the impact of M&S money, operating expenses increased by 4 per cent. UK PFS expenses were broadly in line with 2004 and Commercial Banking expenses declined by 10 per cent. Costs of branch refurbishment and marketing increased, but this was offset by the ongoing benefits of a cost reduction programme in 2004. In UK CIBM operating expenses increased by 8 per cent, reflecting the first full year of additional headcount recruited to support the expansion of the business. CIBM staff costs increased by 7 per cent overall, and there was limited selective hiring in 2005. Additional infrastructure and technology investment to support the CIBM business expansion added to the growth in expenses. In France, operating expenses increased by 7 per cent driven by recruitment of additional sales staff and the rebranding of CCF to HSBC France. Cost growth of 27 per cent in Turkey was in support of the expansion of the business.

Loan impairment charges were £776 million, a rise of £405 million on 2004. Excluding M&S money, the charge increased 92 per cent. Although strong loan growth contributed to some of the increase, the deterioration in delinquency in the UK unsecured personal loan and credit card portfolios was the principal driver. Levels of personal indebtedness reached historic highs in the UK which, together with changes in legislation, were reflected in the increasing number of personal bankruptcies. Slower economic growth and rising unemployment combined with these factors to raise the rate of delinquency across the personal sector. Actions were taken in the personal portfolio to improve collections activity and to tighten underwriting controls and change the product mix towards lower risk customers. There was evidence in the second half of the year that the credit quality of the more recent vintages had improved as a result. In addition, some weakness has been seen in the commercial portfolio in the fourth quarter, requiring a small number of individually significant provisions. Overall credit quality remains relatively sound, however charges grew at a faster rate than assets in the last three months of 2005. The larger corporate book remained subdued.

Share of profit in associates and joint ventures rose by £72 million to £77 million. This was due to the disposal of a company held by an associate.

Capital Management

(audited information except where stated)

Capital measurement and allocation

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

Under the European Union's Banking Consolidation and Amending Directive (Directive 98/31/EC) to the Capital Adequacy Directive (CAD2), the FSA requires each bank and banking group to maintain an individually prescribed ratio of total capital

to risk-weighted assets. Under the EU's Amending Directive the FSA allows banks to calculate capital requirements for market risk in the trading book using VAR techniques.

Capital adequacy is measured by the ratio of capital to risk-weighted assets, taking into account balance sheet assets and off-balance-sheet transactions, calculated for both the bank and the group on a consolidated basis.

The group's capital is divided into two tiers: tier 1 capital comprises shareholders' funds, innovative tier 1 securities and minority interests in tier 1 capital after adjusting for items reflected in shareholders' funds which are treated differently for the purposes of capital adequacy. The book values of goodwill and intangible assets are deducted in arriving at tier 1 capital. Tier 2 capital comprises collective impairment provisions (previously general provisions), reserves arising from revaluation of property, qualifying subordinated loan capital and minority and other interests in tier 2 capital and unrealised gains arising on the fair valuation of equity instruments held as available-for-sale. The amount of innovative tier 1 securities cannot exceed 15 per cent of overall tier 1 capital, qualifying tier 2 capital cannot exceed tier 1 capital, and term subordinated loan capital may not exceed 50 per cent of tier 1 capital. There are also limitations on the amount of collective impairment allowances which may be included in tier 2 capital. Total capital is calculated by deducting the book values of unconsolidated investments, investments in the capital of banks, and certain regulatory items from the total of tier 1 and tier 2 capital.

In October 2004, the FSA published a consultation paper CP04/17 'Implications of a changing accounting framework'. This was followed in April 2005 with a policy statement with the same title, PS05/5. These papers set out the FSA's approach to assessing banks' capital adequacy after implementation of IFRSs. PS05/5 took effect on publication.

Under the new policy, there have been changes to the measurement of banks' capital adequacy, the most significant of which for the group are set out below.

- The capital treatment for collective impairment allowances is the same as previously applied to general provisions, i.e. they are included in tier 2 capital. This had a positive impact on the group's total capital ratio as the amount of collective impairment allowances exceeds the amount of the previous general provisions.
- The effect of recognising defined benefit pension plan deficits on the balance sheet will be reversed for regulatory reporting. However, whereas previously banks deducted from capital prepayments to pension plans, they must now deduct from capital their best estimate of the additional funding that they expect to pay into the plans over the following five years to reduce the defined benefit liability. This estimate is arrived at in conjunction with the plans' actuaries and/or trustees.
- Under IFRSs, dividends are not recognised as a liability on the balance sheet until they are declared. This gives rise to an increase in shareholders' funds at the reporting date compared with the previous accounting, which is reversed when the relevant dividend is subsequently declared. Banks reflect the benefit of this increase in their regulatory capital until the dividend declaration, in line with the accounting treatment.
- Unrealised gains on available-for-sale equities held are included as part of tier 2 capital; previously these were not recognised.

The FSA plan to review certain elements of this policy in mid-2007. In addition, in January 2006, the FSA published a consultation paper, CP06/1, which set out proposed amendments to the handbook on which comments are due in March 2006. These proposals are not expected to have a significant impact for the group.

Capital management

The group's capital resources policy is to maintain its capital base through the diversification of its sources of capital and the efficient allocation of capital. It seeks to maintain at all times a prudent relationship between its total capital, as measured according to the criteria used by the FSA for supervisory purposes, and the varied risks of its business.

Regulatory capital position *(unaudited information)*

The table below sets out the analysis of regulatory capital.

Composition of capital	2005 £m	2004 £m
Tier 1:		
Shareholders' funds of the parent company	**19,091**	17,961
Minority interests and preference shares	**985**	451
Innovative tier 1 securities	**1,641**	1,635
Less: goodwill capitalised and intangible assets	**(9,156)**	(8,331)
Other regulatory adjustments	**63**	(134)
Total qualifying tier 1 capital	**12,624**	11,582
Tier 2:		
Reserves arising from revaluation of property and unrealised gains on available-for-sale equities	**570**	134
Collective impairment allowances	**972**	–
General provisions	**–**	380
Perpetual subordinated loan	**1,296**	1,177
Term subordinated loan	**4,525**	3,717
Minority and other interests in tier 2 capital	**737**	711
Total qualifying tier 2 capital	**8,100**	6,119
Unconsolidated investments	**(635)**	(1,023)
Investments in other banks and other financial institutions	**(316)**	(225)
Other deductions	**(96)**	(29)
Total capital	**19,677**	16,424
Total risk-weighted assets	**182,566**	156,972
Capital ratios:	**%**	%
Total capital	**10.8**	10.5
Tier 1 capital	**6.9**	7.4

The above figures were computed in accordance with the EU Banking Consolidation Directive and the FSA policy statement PS05/5. The comparative figures at 31 December 2004 have not been restated to reflect the implementation of IFRSs and PS05/5. The group complied with the FSA's capital adequacy requirements throughout 2005 and 2004.

Tier 1

The increase of £1.0 billion in tier 1 capital was largely due to retained profits of £1.5 billion and capital issues of £1.5 billion. These increases were partly offset by the impact of the pension scheme cash injection and other movements including the effect of implementation of IFRSs.

Tier 2

The increase of £2.0 billion in tier 2 capital in 2005 largely reflects the proceeds of capital issues, net of redemptions and regulatory amortisation. The inclusion of unrealised gains on available-for-sale equities and collective impairment allowances under IFRSs also contributed to the increase.

Board of Directors and Senior Management

Directors

S K Green, Chairman

Age 57. Chairman from January 2005 and a Director since 1995. Deputy Chairman from 2003 to December 2004. Group Chief Executive of HSBC Holdings plc since 2003 and Group Chairman designate. Joined HSBC in 1982. Executive Director, Corporate, Investment Banking and Markets from 1998 to 2003. Group Treasurer of HSBC Holdings plc from 1992 to 1998. Chairman of HSBC Bank USA, N.A., HSBC Bank Middle East Limited, HSBC Group Investment Businesses Limited, HSBC Private Banking Holdings (Suisse) S.A. and HSBC USA Inc. A Director of The Bank of Bermuda Limited, HSBC France, The Hongkong and Shanghai Banking Corporation Limited, Grupo Financiero HSBC, S.A. de C.V., HSBC North America Holdings Inc. and HSBC Trinkaus & Burkhardt KGaA.

M F Geoghegan, CBE, Deputy Chairman

Age 52. Deputy Chairman from 6 March 2006 and a Director since 2004. Chief Executive from 2004 to 6 March 2006. An executive Director of HSBC Holdings plc since 2004 and Group Chief Executive designate. Joined HSBC in 1973. President of HSBC Bank Brasil S.A. – Banco Múltiplo from 1997 to 2003 and responsible for all of HSBC's business throughout South America from 2000 to 2003. A Director of HSBC France and HSBC Private Banking Holdings (Suisse) S.A. A non-executive Director and Chairman of Young Enterprise.

D D J John, Chief Executive

Age 55. Chief Executive from 6 March 2006 and a Director since 2003. Deputy Chief Executive from May 2005 to 6 March 2006 and Chief Operating Officer from 2003 to May 2005. A Group Managing Director from 6 March 2006. A Group General Manager from 2000 to 6 March 2006. Joined HSBC Bank plc in 1971. Deputy Chairman and Chief Executive Officer, HSBC Bank Malaysia Berhad from 1999 to 2002. Chief Executive Officer, The Hongkong and Shanghai Banking Corporation Limited in India from 1997 to 1999. General Manager for Wales from 1993 to 1997.

D C Budd, Chief Operating Officer

Age 52. Chief Operating Officer and a Director since May 2005. A Group General Manager from 9 May 2005. Joined HSBC in 1972. President and Chief Executive Officer, HSBC Bank Argentina S.A. from 2003 to 2005. Chairman of HSBC Bank A.S. and a Director of HFC Bank Limited, HSBC Bank Malta p.l.c. and Marks and Spencer Financial Services plc.

C-H Filippi

Age 53. A Director since 2000. Chairman and Chief Executive Officer of HSBC France. Joined HSBC France in 1987 having previously held senior appointments in the French civil service. A Group Managing Director since 2004. A Group General Manager from 2001 to 2004. Global Head of Corporate and Institutional Banking from 2001 to 2004.

J D Fishburn*

Age 59. A Director since 2003. Chairman of HFC Bank Limited and Independent non-executive Director of HSBC Finance Corporation.

C M S Jones*

Age 62. A Director since 2001. Formerly Chairman and Managing Director, James Beattie PLC.

R E S Martin*

Age 45. A Director since April 2005. General Counsel and Company Secretary of Reuters Group PLC.

A R D Monro-Davies*

Age 65. A Director since 2004. Formerly Chief Executive Officer, Fitch Ratings.

P M Shawyer*

Age 55. A Director since 2004. Formerly a Managing Partner of Deloitte.

J Singh*

Age 54. A Director since 2001. Chairman and Chief Executive Officer of Edwardian Group Limited. Member of the Board of Warwick Business School.

J F Trueman*

Age 63. A Director since 2004. Formerly Deputy Chairman of S G Warburg & Co. Ltd.

* *Independent non-executive Director*

Secretary

J H McKenzie

Age 52. Joined HSBC in 1987.

Registered Office: 8 Canada Square, London E14 5HQ

Senior Executives

M P Brewer

Age 46. General Manager, Strategic Development. Joined HSBC in 1977.

B M Cannon

Age 50. General Manager and Head of Credit and Risk. Joined HSBC in 1982.

R P Contractor

Age 49. Chief Information Officer. Joined HSBC in 1987.

I M Dorner

Age 51. General Manager and Head of Premier and Wealth. Joined HSBC in 1986.

J D Garner

Age 36. General Manager, Personal Financial Services and Direct Businesses. Joined HSBC in 2004.

J E Harding

Age 53. Head of Human Resources. Joined HSBC in 1981.

A M Keir

Age 47. General Manager, Commercial Banking. Joined HSBC in 1981.

C G F Laughton-Scott

Age 49. Deputy Head of Global Banking. Joined HSBC in 1986.

A M Mahoney

Age 43. General Manager and Head of the Network. Joined HSBC in 1983.

R K McGregor

Age 57. Chief Financial Officer. Joined HSBC in 1977.

C M Meares

Age 48. Chief Executive Officer, HSBC Private Bank UK, Channel Islands and Luxembourg. Joined HSBC in 1980.

M J Powell

Age 44. Head of Global Markets. Joined HSBC in 1984.

R G Spence

Age 46. General Manager and Head of Special Projects. Joined HSBC in 1978.

S G Troop

Age 49. General Manager and Head of Insurance. Joined HSBC in 1979.

Report of the Directors

Results for 2005

The consolidated profit for the year attributable to the shareholders of the bank was £2,897 million.

An interim dividend of £700 million was paid on the ordinary share capital during the year.

Further information about the results is given in the consolidated income statement on page 20.

Principal activities and business review

The group provides a comprehensive range of banking and related financial services.

The bank divides its activities into the following business segments: UK Personal Financial Services; UK Commercial Banking; UK Corporate, Investment Banking and Markets; International Banking; HSBC France; Private Banking; and HSBC Trinkaus & Burkhardt.

UK Personal Financial Services provides current accounts, savings, personal loans, mortgages, cards, wealth management and general insurance to UK personal customers through a variety of distribution channels under the HSBC, First Direct, M&S Money and partnership cards brands.

UK Commercial Banking provides products and services to a broad range of commercial organisations from sole proprietors to major companies.

Corporate, Investment Banking and Markets provides tailored financial solutions to major government, corporate and institutional clients worldwide. Products and services offered include Global Markets, Global Transaction Banking, Corporate and Institutional Banking, Global Investment Banking and the Group’s Investment Business.

International Banking provides a range of retail financial services, primarily across Europe, to local and expatriate customers and wholesale banking to corporate and institutional clients.

HSBC France offers a wide range of retail, commercial and asset management products to individuals, companies and institutional customers through a network of regional banks in France.

Private Banking offers an array of client services to high net worth customers, including advisory portfolio management, discretionary asset management, tax, trust and estate planning, mutual funds and currency and securities transactions.

HSBC Trinkaus & Burkhardt, based in Düsseldorf, Germany, offers a comprehensive range of services to wealthy private clients, larger companies, institutional investors, public corporations and financial institutions.

As at 31 December 2005, the bank had 1,528 branches in the United Kingdom, including 13 branches in the Isle of Man and the Channel Islands. Outside the United Kingdom, it has branches in Australia, Belgium, Cyprus, the Czech Republic, France, Greece, the Hong Kong Special Administrative Region, Ireland, Israel, Italy, the Netherlands, Slovakia, South Africa, Spain and Sweden; it has a representative office in Venezuela; and its subsidiaries have offices in Armenia, the Channel Islands, France, Germany, Greece, Israel, Kazakhstan, Luxembourg, Malta, Poland, Russia, South Africa, Switzerland, Turkey and the United Arab Emirates. Through these undertakings, the bank provides a comprehensive range of banking and related financial services.

In November 2005, the vehicle leasing and fleet management operations of HSBC Vehicle Finance (UK) Limited, a wholly owned subsidiary of the bank, were transferred to Lex Vehicle Leasing Limited. The bank continues to manage customer relationships, while Lex Vehicle Leasing Limited provides vehicle support services.

The Financial Review is given on pages 3 to 7.

Share capital

In August 2005, HSBC Holdings plc subscribed £500 million for one additional ordinary share of £1 credited as fully paid in the ordinary share capital of the bank. During December 2005, HSBC Holdings plc subscribed for two further ordinary shares for £300 million and £700 million, respectively.

Save for these, there have been no other changes to the authorised or issued share capital of the bank in the year ended 31 December 2005.

Valuation of freehold and leasehold land and buildings

The group’s freehold and long leasehold properties were valued in 2005. The value of these properties was £260 million in excess of their carrying amount in the consolidated balance sheet. The group no longer revalues freehold and long leasehold properties under IFRSs.

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 under the leadership of the Chief Executive.

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 8.

H A Rose retired as a non-executive Director on 25 May 2005.

S K Green was appointed as Chairman on 1 January 2005. R E S Martin was appointed as a non-executive Director on 29 April 2005. D D J John was appointed as Deputy Chief Executive on 9 May 2005 and on the same date D C Budd succeeded him as Chief Operating Officer and was appointed as an executive Director.

D D J John has been appointed Chief Executive of the bank with effect from 6 March 2006, succeeding M F Geoghegan who has been appointed Group Chief Executive, HSBC Holdings plc, with effect from 26 May 2006. M F Geoghegan will remain as a Director of the bank, and has been appointed Deputy Chairman with effect from 6 March 2006.

Non-executive Directors are appointed for three year terms, subject to their re-election by shareholders at the subsequent Annual General Meeting. Independent non-executive Directors have no service contract and are not eligible to participate in the HSBC Group's share plans.

C-H Filippi, J D Fishburn, M F Geoghegan and A R D Monro-Davies will retire by rotation at the forthcoming Annual General Meeting and they will offer themselves for re-election. None of the Directors had, during the year or at the end of the year, a material interest, directly or indirectly, in any contract of significance with the bank or any of its subsidiary undertakings.

Board committees

The Board has appointed a number of committees consisting of certain Directors and senior executives. The following are the principal committees:

Executive Committee

The Executive Committee meets regularly and operates as a general management committee under the direct authority of the Board.

The members of the Executive Committee are D D J John (Chairman), D C Budd, both of whom are executive Directors and B M Cannon, J D Garner, A M Keir, C G F Laughton-Scott, A M Mahoney, R K McGregor, C M Meares and M J Powell, all of whom are senior executives.

Audit Committee

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

The members of the Audit Committee are A R D Monro-Davies (Chairman), P M Shawyer and J F Trueman. H A Rose retired as a Director and Chairman of the Audit Committee on 25 May 2005 and was suceeded as Chairman of the Audit Committee by A R D Monro-Davies. All of the members of the Audit Committee who served during 2005 are, or were during the term of their appointment, independent non-executive Directors.

Remuneration Committee

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

Internal control

The Directors are responsible for internal control in the group and for reviewing its effectiveness. Procedures have been designed for safeguarding assets against unauthorised use or disposition; for maintaining proper accounting records; and for the reliability 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 errors, losses or fraud. The procedures also enable the bank to discharge its obligations under the Handbook of Rules and

Guidance issued by the FSA, 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 Guidance for Directors on the Combined Code issued by the Institute of Chartered Accountants in England and Wales. Such procedures have been in place throughout the year and up to 6 March 2006, the date of approval of the *Annual Report and Accounts*. In the case of companies acquired during the year, the internal controls in place are being reviewed against the group's benchmarks and they are being integrated into the group's systems. The group's key internal control procedures include the following:

- Authority to operate the bank is delegated to the Chief Executive who has responsibility for overseeing the establishment and maintenance of appropriate systems and controls and has authority to delegate such duties and responsibilities as he deems fit among the Directors and senior management. The appointment of executives to the most senior positions within the group requires the approval of the Board of Directors.
- Functional, operating, financial reporting and certain management reporting standards are established by HSBC Holdings' management for application across the whole HSBC Group. These are supplemented by operating standards set by the bank's management, as required.
- Systems and procedures are in place in the group to identify, control and report on the major risks including credit, changes in the market prices of financial instruments, liquidity, operational error, unauthorised activities and fraud. Exposure to these risks is monitored by the bank's or major subsidiaries' executive committees, risk management committees and the asset and liability management committees.
- Processes to identify new risks from changes in market practices or customer behaviours which could expose the group to heightened risk of loss or reputational damage.
- Comprehensive annual financial plans are prepared, reviewed and approved by the Board of Directors. Results are monitored regularly and reports on progress as compared with the related plan are prepared monthly.
- Centralised functional control is exercised over all computer system developments and operations. Common systems are employed where possible for similar business processes. Credit and market risks are measured and reported on in the bank and major subsidiaries and aggregated for review of risk concentrations on an HSBC Group-wide basis.
- Responsibilities for financial performance against plans and for capital expenditure, credit exposures and market risk exposures are delegated with limits to line management. In addition, functional management in HSBC Holdings has been given responsibility to set policies, procedures and standards in the areas of finance; legal and regulatory compliance; internal audit; human resources; credit; market risk; operational risk; computer systems and operations; property management; and for certain global product lines.
- Policies and procedures have been established to guide the bank, subsidiary companies and management at all levels in the conduct of business to avoid reputational risk which can arise from social, ethical or environmental issues, or as a consequence of operational risk events. As a banking group, HSBC's good reputation depends upon the way in which it conducts its business but it can also be affected by the way in which clients, to which it provides financial services, conduct their business.
- The internal audit function, which is centrally controlled, monitors compliance with policies and standards and the effectiveness of internal control structures across the group. The work of the internal audit function is focused on areas of greatest risk to the group as determined by a risk management approach. The head of this function reports to the Chairman and the Audit Committee.
- Management is responsible for ensuring that recommendations made by the internal audit function are implemented within an appropriate and agreed timetable. Confirmation to this effect must be provided to internal audit. Management must also confirm annually to internal audit that offices under their control have taken or are in the process of taking the appropriate actions to deal with all significant recommendations made by external auditors in management letters or by regulators following regulatory inspections.

The Audit Committee has kept under review the effectiveness of this system of internal control and has reported regularly to the Board of Directors. The key processes used by the Committee in carrying out its reviews include regular reports from the heads of key risk functions; the production and regular

updating of summaries of key controls measured against group benchmarks which cover all internal controls, both financial and non-financial; annual confirmations from senior executives that there have been no material losses, contingencies or uncertainties caused by weaknesses in internal controls; internal audit reports; external audit reports; prudential reviews; and regulatory reports.

The Directors, through the Audit Committee, have conducted an annual review of the effectiveness of the bank's system of internal control covering all controls, including financial, operational, compliance and risk management.

Risk management

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

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

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

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

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

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.

Health and safety policies and HSBC Holdings plc standards and procedures are set by the group's Fire and Safety Department and are implemented by Coordinators based in each country in which the group operates.

The group faces a range of threats from terrorists and criminals across the world. In particular, over recent years, the threat from international terrorism has become signficant in a number of areas where the group operates. This threat has mainly manifested itself in bomb attacks such as the one in Istanbul in 2003 in which HSBC's Turkish headquarters building was attacked. Despite suffering tragic loss of life and major damage, existing security measures and well-managed contingency procedures enabled the business to be up and running again the following day.

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 the group.

Group staff, buildings, assets and information are appropriate for the level of threat.

Directors' emoluments

Details on the emoluments of the Directors of the bank for 2005, disclosed in accordance with the Companies Act, are shown in Note 8(e) 'Directors' emoluments' in the Notes on the Financial statements.

Directors' interests

Interests in shares

According to the register of Directors' interests maintained by the bank pursuant to section 325 of the Companies Act 1985, the Directors of the bank at the year-end had the following beneficial interests in the shares and loan capital of HSBC Holdings plc. As Directors of HSBC Holdings plc, the interests of S K Green and M F Geoghegan are disclosed within the financial statements of that company.

HSBC Holdings plc Ordinary shares of US$0.50

	At 1 January 2005	At 31 December 2005
D C Budd	94,450[1]	146,085[2]
C-H Filippi	326,000	265,000
J D Fishburn	19,732[3]	19,732[3]
D D J John	145,172[4]	186,869[5]
P M Shawyer	2,404	2,404

1 *Interest as at date of appointment, 9 May 2005, includes an interest in 48,280 shares held under The HSBC Holdings plc Restricted Share Plan 2000 long-term incentive plan in which Mr Budd is beneficially interested but have yet to vest.*
2 *Includes an interest in 49,126 shares held under The HSBC Holdings plc Restricted Share Plan 2000 and 24,151 shares held under The HSBC Share Plan long-term incentive plans in which Mr Budd is beneficially interested but have yet to vest.*
3 *Includes 4,054 shares held in the Deferred Phantom Stock Plan operated by Household International, Inc. and will be released to J D Fishburn when he retires as a Director of that company, which will be no later than May 2017.*
4 *Includes an interest in 139,290 shares held under The HSBC Holdings plc Restricted Share Plan 2000 long-term incentive plan in which Mr John is beneficially interested but have yet to vest.*
5 *Includes an interest in 130,586 shares held under The HSBC Holdings plc Restricted Share Plan 2000 and 50,401 shares held under The HSBC Share Plan long-term incentive plans in which Mr John is beneficially interested but have yet to vest.*

Following the acquisition of HSBC France in 2000, HSBC France shares issued following the exercise of options over HSBC France shares became exchangeable for HSBC Holdings plc ordinary shares of US$0.50 each in the same ratio as the exchange offer for HSBC France (13 HSBC Holdings plc ordinary shares for each HSBC France share). HSBC Holdings plc ordinary shares, which may be used to satisfy the exchange of HSBC France shares following exercise of these options, were purchased by The HSBC Holdings Employee Benefit Trust 2001 (No.1). As at 1 January 2005, the Trust held 26,787,515 HSBC Holdings plc ordinary shares. As a potential beneficiary of the Trust, C-H Filippi was deemed to have a technical interest in all the HSBC Holdings plc ordinary shares held by the Trust until 11 August 2005. On 11 August 2005, deeds were entered into to appoint 559,000 HSBC Holdings plc ordinary shares of US$0.50 each into a sub-trust in respect solely of C-H Filippi's options. As a result, on 11 August 2005, C-H Filippi also ceased to have an interest in 22,534,513 HSBC Holdings plc ordinary shares held by and remaining in the Trust at that date, but retained an interest in 559,000 HSBC Holdings plc ordinary shares held by the sub-Trust. As at 31 December 2005, Mr Filippi had an interest in 559,000 HSBC Holdings plc ordinary shares held by the sub-Trust.

In addition to the interests in the ordinary share capital of HSBC Holdings plc disclosed above, the Directors had the following interests in shares or debentures of subsidiary undertakings of HSBC Holdings plc.

As Directors of HSBC France, C-H Filippi and P M Shawyer each had a beneficial interest in one share of €5 in that company, which Mr Filippi held throughout the year and Mr Shawyer acquired during the year on his appointment as a Director of HSBC France. The Directors have waived their rights to receive dividends on these shares and have undertaken to transfer these shares to the bank on ceasing to be Directors of HSBC France.

As a Director of other French subsidiaries C-H Filippi holds a number of Director's qualification shares, as is legal practice in France. These are as follows: HSBC Asset Management Holding (1 share of €16.00) and HSBC Private Bank France (1 share of €2.00). Mr Filippi has waived his rights to receive dividends on these shares and has undertaken to transfer these shares to the respective company on ceasing to be a Director.

Save as stated above, none of the Directors had an interest in any shares or debentures of HSBC Holdings plc or any of its subsidiary undertakings at the beginning or at the end of the year and none of the Directors, or members of their immediate families, was awarded or exercised any right to subscribe for any shares or debentures during the year.

Share options

At 31 December 2005, the undernamed Directors held options to acquire the number of HSBC Holdings ordinary shares of US$0.50 each set against their respective names. The options were awarded for nil consideration at exercise prices equivalent to the market value at the date of award, except that options awarded under the HSBC Holdings savings-related share option plans before 2001 are exercisable at a 15 per cent discount to the market value at the date of award and those awarded since 2001 at a 20 per cent discount. Except as otherwise indicated, no options were exercised or lapsed during the year and there are no remaining performance criteria conditional upon which the outstanding options are exercisable.

Options over HSBC Holdings plc ordinary shares of US$0.50 each

	Options held at 1 January 2005	Options awarded during year	Options exercised during year	Options held at 31 December 2005
Executive Directors				
D C Budd	16,119[1]	–	16,119[2]	–
D D J John	23,628	567[3]	1,119[4]	23,076
Non-executive Directors				
C-H Filippi	808,000	103,071[5]	–	911,071

1 *Interest as at date of appointment, 9 May 2005.*
2 *Exercise of 15,000 shares granted under the HSBC Holdings plc Executive Share Option Scheme on 15 June 2005 and 1,119 shares granted under the HSBC Holdings plc savings-related share option plan on 22 September 2005.*
3 *Grant of option under the HSBC Holdings plc savings-related share option plan on 24 May 2005.*
4 *Exercise of 1,119 shares granted under the HSBC Holdings plc savings-related share option plan on 1 August 2005.*
5 *Grant of option under the HSBC Share Plan on 21 June 2005*

At 31 December 2005, C-H Filippi held the following options to acquire HSBC France shares of €5 each. On exercise of these options, each HSBC France share will be exchanged for 13 HSBC Holdings plc ordinary shares of US$0.50 each. The options were granted by HSBC France for nil consideration at a 5 per cent discount to the market value at the date of award. There are no remaining performance criteria conditional upon which the outstanding options are exercisable. No options over HSBC France shares of €5 each were awarded to or exercised by C-H Filippi during the year, except as otherwise indicated.

Options over HSBC France shares of €5 each

	Options held at 1 January 2005	Equivalent HSBC Holdings ordinary shares of US$0.50 each at 1 January 2005	Options exercised during the year	Equivalent HSBC Holdings ordinary shares of US$0.50	Options held at 31 December 2005	Equivalent HSBC Holdings ordinary shares of US$0.50 each at 31 December 2005
C-H Filippi	46,000	598,000	3,000[1]	39,000	43,000	559,000

1 *Part exercise of option over 3,000 HSBC France shares on 14 June 2005 subsequently exchanged for 39,000 HSBC Holdings plc ordinary shares.*

Save as stated above, none of the Directors or members of their immediate families were awarded or exercised any right to subscribe for any shares or debentures during the year.

Employee involvement

HSBC continues to regard communication with its employees as a key aspect of its policies. Information is given to employees about employment matters and about the financial and economic factors affecting the group's performance through management channels, intranet sites, in-house magazines and by way of attendance at

internal seminars and training programmes. Employees are encouraged to discuss operational and strategic issues with their line management and to make suggestions aimed at improving performance. The involvement of employees in the performance of the bank is further encouraged through participation in bonus and share option plans.

Diversity policy: employees with disabilities

The group continues to be committed to providing equal opportunities to employees. The employment of disabled persons is included in this commitment and the recruitment, training, career development and promotion of disabled persons is based on the aptitudes and abilities of the individual. Should employees become disabled during employment, every effort is made to continue their employment and, if necessary, appropriate training is provided.

Community involvement and donations

During the year, the bank made charitable donations totalling £5 million.

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

During 2005, the bank gave £4 million in charitable donations to support community activities in the UK. The donations were used to fund a wide variety of initiatives, as described below, with a particular focus on education, particularly for under-privileged primary and secondary school students, and the environment. The bank also sharply increased its focus on employee-led charitable initiatives.

Education

The HSBC Education Trust directly supports educational initiatives; for example, it helps schools achieve specialist status as business and enterprise, sports and language colleges. HSBC also provides scholarships and fellowships nationally and internationally.

Environment

The group's employees are involved in a variety of projects related to environmental sustainability. Many employees have participated in HSBC's global *Investing in Nature* programme, launched in 2002, involving three partners: WWF, Earthwatch and Botanic Gardens Conservation International (BGCI).

Community

While some of our charitable activities are managed centrally, as the world's local bank we want to stay close to the communities in which we operate. This desire led us to expand our local community activities in 2005, with many initiatives driven by our employees.

For example, we introduced a new scheme to allow employees to nominate local community causes to benefit from financial support. Over 270 employee-led projects were initiated through this scheme, with financial support approaching £2 million. In addition, over £400,000 was donated to charities to match funds raised, or time given, by employees. We have increased the amount of funds we will match from £100 to £500, per employee each year.

Our employees and customers in the UK also raised substantial funds for national appeals. We raised more than £500,000 for the BBC Children in Need appeal, making HSBC one of the largest corporate donors. We also introduced a new service to allow customers to donate money to Children in Need through our ATMs in 2005; this was a first for a UK bank and we plan to extend the scheme to include other charities in the future.

Employees raised a further £92,000 for The Children's Heart Federation with sponsored walks. And in December, the bank's branches and offices across the UK collected Christmas gifts for local needy people through the 'Neighbours in Need' scheme. Over 13,000 gifts were donated through some 500 charitable organisations.

Finally, the group joined with British Airways in their *Change For Good* campaign, with branches collecting unwanted foreign coins and notes in aid of Unicef. The funds raised through this initiative are directly helping Unicef's work in those areas affected by the Boxing Day 2004 Tsunami. Over £320,000 was raised through this scheme.

No political donations were made during the year.

At the HSBC Holdings plc Annual General Meeting in 2003 shareholders gave authority for the bank to make EU political donations and incur EU political expenditure up to a maximum aggregate sum of £50,000 over a four-year period as a precautionary measure in light of the wide definitions in The Political Parties, Elections and

Referendums Act 2000. This authority has not been used.

Supplier payment policy

The bank subscribes to the Better Payment Practice Code for all suppliers, the four principles of which are: to agree payment terms at the outset and stick to them; to explain payment procedures to suppliers; to pay bills in accordance with any contract agreed with the supplier or as required by law; and to tell suppliers without delay when an invoice is contested and settle disputes quickly.

Copies of, and information about, the Code are available from The Department of Trade and Industry, 1 Victoria Street, London SW1H 0ET and on the internet, www.payontime.co.uk.

The amount due to the bank's trade creditors at 31 December 2005 represented 22 days' average daily purchases of goods and services received from those creditors, calculated in accordance with the Companies Act 1985, as amended by Statutory Instrument 1997/571.

Future accounting developments
(audited information)

At 31 December 2005, HSBC Bank plc had adopted all IFRSs or interpretations that had been issued by the International Accounting Standards Board ('IASB') and endorsed by the EU with the exception of the '*Amendment to IAS 39 & IFRS 4 – Financial Guarantee Contracts*'.

Financial guarantee contracts are currently accounted for under IAS 37 '*Provisions, Contingent Liabilities and Contingent Assets*' as contingent liabilities and are as such disclosed as off-balance-sheet items. Under the amendment the issuer of a financial guarantee should classify such contracts as a financial instrument liability in accordance with IAS 39 '*Financial Instruments: Recognition and Measurement*'. An exception is made for issuers of guarantees deemed to be insurance contracts who, subject to certain conditions, may irrevocably elect to account for such contracts as financial liabilities under IAS 39 or as insurance contract liabilities under IFRS 4 '*Insurance Contracts*'.

HSBC Bank plc is required to adopt this amendment for the year ending 31 December 2006 and is currently assessing the impact this will have both in the group and bank.

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.

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

6 March 2006

Statement of Directors' Responsibilities in Relation to the Director's Report and the Financial Statements

The following statement, which should be read in conjunction with the Auditors' 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 ensuring that the Director's report and the consolidated financial statements of HSBC Bank plc and its subsidiaries (the 'group') and parent company financial statements for HSBC Bank plc (the 'bank') are prepared 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 have elected to prepare these group financial statements in accordance with International Financial Reporting Standards as adopted by the EU ('IFRSs') and have elected to prepare the bank financial statements on the same basis.

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

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

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

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 the going concern basis.

The Directors have responsibility for ensuring that sufficient accounting records are kept that disclose with reasonable accuracy at any time the financial position of the bank and enable them to ensure that its financial statements comply with the Companies Act 1985.

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

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

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

6 March 2006

Independent Auditors' Report to the Member of HSBC Bank plc

We have audited the group and bank financial statements (the 'financial statements') of HSBC Bank plc for the year ended 31 December 2005 which comprise the group Income Statement, the group and bank Balance Sheets, the group and bank Cash Flow Statements, the group and bank Statements of Recognised Income and Expense, and the related notes. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the bank's member, in accordance with section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the bank's member those matters we are required to state to them in an Auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the bank and the bank's member as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and Auditors

The Directors' responsibilities for preparing the Annual Report and Accounts in accordance with applicable law and International Financial Reporting Standards as adopted by the EU (IFRSs) are set out in the Statement of Directors' Responsibilities on page 18.

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

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation. We also report to you if, in our opinion, the Directors' Report is not consistent with the financial statements, if the bank has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding Directors' remuneration and other transactions is not disclosed.

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

Basis of audit opinion

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

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

Opinion

In our opinion:

- the group's financial statements give a true and fair view, in accordance with IFRSs, of the state of the group's affairs as at 31 December 2005 and of its profit for the year then ended;
- the bank's financial statements give a true and fair view, in accordance with IFRSs as applied in accordance with the provisions of the Companies Act 1985, of the state of the bank's affairs as at 31 December 2005; and
- the financial statements have been properly prepared in accordance with the Companies Act 1985 and Article 4 of the IAS Regulation.

KPMG Audit Plc
Chartered Accountants
Registered Auditor
London

6 March 2006

Financial Statements

Consolidated income statement for the year ended 31 December 2005

	Notes	2005 £m	2004 £m
Interest income		**11,056**	9,715
Interest expense		**(7,014)**	(5,235)
Net interest income		**4,042**	4,480
Fee income		**4,249**	3,900
Fee expense		**(894)**	(868)
Net fee income		**3,355**	3,032
Trading income excluding net interest income		**794**	594
Net interest income on trading activities		**1,036**	–
Net trading income		**1,830**	594
Net income from financial instruments designated at fair value	*4*	**170**	–
Net investment income on assets backing policyholders' liabilities		**–**	311
Gains less losses from financial investments		**248**	79
Dividend income		**28**	318
Net earned insurance premiums	*5*	**438**	714
Other operating income		**919**	495
Total operating income		**11,030**	10,023
Net insurance claims incurred and movement in policyholders' liabilities	*6*	**(230)**	(741)
Net operating income before loan impairment charges		**10,800**	9,282
Loan impairment charges		**(776)**	(371)
Net operating income		**10,024**	8,911
Employee compensation and benefits	*8*	**(3,624)**	(3,345)
General and administrative expenses	*9*	**(2,090)**	(1,966)
Depreciation of property, plant and equipment		**(483)**	(583)
Amortisation of intangible assets and impairment of goodwill		**(118)**	(69)
Total operating expenses		**(6,315)**	(5,963)
Operating profit		**3,709**	2,948
Share of profit in associates and joint ventures		**77**	5
Profit before tax		**3,786**	2,953
Tax expense	*11*	**(827)**	(723)
Profit for the year		**2,959**	2,230
Profit attributable to shareholders of the parent company		**2,897**	2,057
Profit attributable to minority interests		**62**	173

Consolidated balance sheet at 31 December 2005

	Notes	2005 £m	2004 £m
ASSETS			
Cash and balances at central banks		**1,711**	1,275
Items in the course of collection from other banks		**3,595**	1,495
Trading assets	*15*	**48,510**	40,754
Trading assets which may be repledged or resold by counterparties	*15*	**21,611**	–
Financial assets designated at fair value	*16*	**5,345**	–
Derivatives	*17*	**26,077**	13,285
Loans and advances to banks	*31*	**31,578**	34,970
Loans and advances to customers	*31*	**182,629**	141,527
Financial investments	*18*	**41,517**	37,594
Financial investments which may be repledged or resold by counterparties	*18*	**1,965**	–
Interests in associates and joint ventures	*20*	**845**	224
Goodwill and intangible assets	*21*	**9,618**	8,821
Property, plant and equipment	*23*	**4,319**	4,695
Other assets	*25*	**3,896**	4,246
Deferred taxation	*29*	**195**	154
Prepayments and accrued income		**3,011**	3,441
Total assets		**386,422**	292,481
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	*31*	**34,198**	32,595
Customer accounts	*31*	**205,475**	161,069
Items in the course of transmission to other banks		**2,268**	907
Trading liabilities		**45,133**	14,982
Financial liabilities designated at fair value	*26*	**8,185**	–
Derivatives	*17*	**26,636**	13,391
Debt securities in issue	*31*	**26,801**	26,785
Retirement benefit liabilities		**2,218**	2,935
Other liabilities	*27*	**4,788**	5,379
Current taxation		**345**	462
Liabilities under insurance contracts issued	*28*	**1,978**	–
Liabilities to policyholders under long-term assurance business		**–**	4,513
Accruals and deferred income		**3,448**	3,816
Provisions:	*29*		
– deferred taxation		**139**	328
– other provisions		**384**	434
Subordinated liabilities	*30*	**4,792**	5,370
Total liabilities		**366,788**	272,966
Equity			
Called up share capital	*35*	**797**	797
Share premium account	*36*	**13,883**	12,820
Other reserves	*36*	**556**	17
Retained earnings	*36*	**3,855**	3,194
Total equity attributable to shareholders of the parent company		**19,091**	16,828
Minority interests	*36*	**543**	2,687
Total equity		**19,634**	19,515
Total equity and liabilities		**386,422**	292,481

S K Green, *Chairman*
M F Geoghegan, *Deputy Chairman*
D D J John, *Chief Executive*
J H McKenzie, *Secretary*

6 March 2006

Financial Statements (continued)

Consolidated statement of recognised income and expense for the year ended 31 December 2005

	2005 £m	2004 £m
Available-for-sale investments:		
– valuation gains taken to equity	**49**	–
– transferred to income statement on disposal or impairment	**(194)**	–
Cash flow hedges:		
– gains taken to equity	**35**	–
– transferred to income statement	**(180)**	–
Exchange differences arising on net investments in foreign operations	**(83)**	(83)
Other reserves:		
– gains taken to equity	**42**	
Actuarial losses on post–employment benefits	**(302)**	(277)
	(633)	(360)
Net deferred taxation on items taken directly to equity	**161**	92
Total net expense taken directly to equity during the year	**(472)**	(268)
Profit for the year	**2,959**	2,230
Total recognised income and expense for the year	**2,487**	1,962
Effect of change in accounting policy		
IFRSs transition adjustment at 1 January 2005		
– share premium reserve	**(437)**	–
– available-for-sale fair value reserve	**553**	–
– cash flow hedging reserve	**177**	–
– retained earnings	**(606)**	–
– minority interests	**(2,307)**	–
	(2,620)	–
	(133)	1,962
Total recognised income and expense for the year attributable to:		
– shareholders of the parent company	**2,433**	1,794
– minority interests	**54**	168

Consolidated cash flow statement for the year ended 31 December 2005

	Notes	2005 £m	2004 £m
Cash flows from operating activities			
Profit before tax		**3,786**	2,953
Adjustments for:			
– non-cash items included in net profit	*37*	**(42)**	446
– change in operating assets	*37*	**(44,993)**	(17,904)
– change in operating liabilities	*37*	**49,604**	31,893
– elimination of exchange differences and other adjustments		**(3,690)**	1,177
– net gain from investing activities		**(248)**	(138)
– share of profits in associates and joint ventures		**(77)**	(5)
– dividends received from associates		**64**	6
– tax paid		**(767)**	(707)
Net cash from operating activities		**3,637**	17,721
Cash flows used in investing activities			
Purchase of financial investments		**(58,223)**	(39,424)
Proceeds from the sale of financial investments		**51,820**	29,363
Purchase of property, plant and equipment		**(745)**	(833)
Proceeds from the sale of property, plant and equipment		**186**	118
Purchase of goodwill and intangible assets		**(413)**	(261)
Net cash outflow from acquisition of and increase in stake of subsidiaries		**(25)**	(550)
Net cash inflow from disposal of subsidiaries		**–**	2
Net cash outflow from acquisition of and increase in stake of associates		**(170)**	(75)
Proceeds from disposal of associates		**256**	16
Net cash used in investing activities		**(7,314)**	(11,644)
Cash flows from/(used in) financing activities			
Issue of ordinary share capital		**1,500**	700
HSBC shares released on vesting of share awards and exercise of options		**53**	40
Increase in non-equity minority interests		**–**	300
Subordinated loan capital issued		**523**	853
Subordinated loan capital repaid		**(635)**	(736)
Dividends paid to shareholders		**(1,400)**	(1,436)
Dividends paid to minority interests:			
– equity		**(14)**	(9)
– non-equity		**–**	(41)
Net cash from/(used in) financing activities		**27**	(329)
Net (decrease)/increase in cash and cash equivalents		**(3,650)**	5,748
Cash and cash equivalents at 1 January		**33,677**	28,321
Effect of exchange rate changes on cash and cash equivalents		**488**	(392)
Cash and cash equivalents at 31 December	*37*	**30,515**	33,677

Financial Statements (continued)

HSBC Bank plc balance sheet at 31 December 2005

	Notes	2005 £m	2004 £m
ASSETS			
Cash and balances at central banks		**689**	587
Items in the course of collection from other banks		**2,125**	1,327
Trading assets	*15*	**34,733**	20,598
Trading assets which may be repledged or resold by counterparties	*15*	**3,950**	–
Financial assets designated at fair value	*16*	**16**	–
Derivatives	*17*	**17,570**	10,696
Loans and advances to banks	*31*	**19,196**	22,983
Loans and advances to customers	*31*	**134,819**	101,233
Financial investments	*18*	**15,383**	14,648
Financial investments which may be repledged or resold by counterparties	*18*	**2**	–
Interests in associates and joint ventures	*20*	**230**	113
Investments in subsidiary undertakings	*24*	**14,468**	14,628
Goodwill and intangible assets	*21*	**567**	229
Property, plant and equipment	*23*	**1,469**	1,482
Other assets	*25*	**1,469**	590
Deferred taxation	*29*	**1,007**	934
Prepayments and accrued income		**1,490**	1,785
Total assets		**249,183**	191,833
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	*31*	**27,999**	26,982
Customer accounts	*31*	**141,761**	104,183
Items in the course of transmission to other banks		**805**	781
Trading liabilities		**21,303**	6,852
Financial liabilities designated at fair value	*26*	**4,321**	–
Derivatives	*17*	**17,251**	10,949
Debt securities in issue	*31*	**8,212**	13,646
Retirement benefit liabilities		**2,003**	2,656
Other liabilities	*27*	**2,846**	861
Current taxation		**95**	238
Accruals and deferred income		**1,851**	2,087
Provisions:	*29*		
– deferred taxation		**12**	4
– other provisions		**124**	176
Subordinated liabilities	*30*	**4,479**	7,278
Total liabilities		**233,062**	176,693
Equity			
Called up share capital	*35*	**797**	797
Share premium account	*36*	**13,883**	12,820
Other reserves	*36*	**82**	29
Retained earnings	*36*	**1,359**	1,494
Total equity		**16,121**	15,140
Total equity and liabilities		**249,183**	191,833

S K Green, *Chairman*
M F Geoghegan, *Deputy Chairman*
D D J John, *Chief Executive*
J H McKenzie, *Secretary*

6 March 2006

HSBC Bank plc statement of recognised income and expense for the year ended 31 December 2005

	2005 £m	2004 £m
Available-for-sale investments:		
– valuation gains/(losses) taken to equity	–	–
– transferred to income statement on disposal or impairment	(1)	–
Cash flow hedges:		
– losses taken to equity	(31)	–
– transferred to income statement		–
Exchange differences arising on net investments in foreign operations	7	(45)
Actuarial losses on post–employment benefits	(240)	(247)
	(265)	(292)
Net deferred taxation on items taken directly to equity	73	74
Total net expense taken directly to equity during the year	(192)	(218)
Profit for the year	1,678	1,594
Total recognised income and expense for the year	1,486	1,376
Effect of change in accounting policy		
IFRSs transition adjustment at 1 January 2005		
– Share premium reserve	(437)	–
– available-for-sale fair value reserve	34	–
– retained earnings	(234)	–
	(637)	–
	849	1,376
Total recognised income and expense for the year attributable to shareholders of the parent company	1,486	1,376

Financial Statements (continued)

HSBC Bank plc cash flow statement for the year ended 31 December 2005

	Notes	2005 £m	2004 £m
Cash flows from operating activities			
Profit before tax		**2,038**	1,958
Adjustments for:			
– non-cash items included in net profit	37	**(256)**	205
– change in operating assets	37	**(42,649)**	(15,183)
– change in operating liabilities	37	**38,578**	24,646
– elimination of exchange differences and other adjustments		**(2,957)**	331
– net gain from investing activities		**(49)**	(35)
– tax paid		**(394)**	(417)
Net cash (used in)/from operating activities		**(5,689)**	11,505
Cash flows used in investing activities			
Purchase of financial investments		**(28,886)**	(19,014)
Proceeds from the sale of financial investments		**26,975**	13,702
Purchase of property, plant and equipment		**(236)**	(184)
Proceeds from the sale of property, plant and equipment		**25**	24
Purchase of goodwill and intangible assets		**(396)**	(75)
Net cash outflow from acquisition of and increase in stake of subsidiaries		**–**	(546)
Net cash outflow from acquisition/increase stake in associates		**(103)**	(75)
Proceeds from disposal of associates		**–**	9
Net cash used in investing activities		**(2,621)**	(6,159)
Cash flows from/(used in) financing activities			
Issue of ordinary share capital		**1,500**	700
HSBC shares released on vesting of share awards and exercise of options		**32**	26
Subordinated loan capital issued		**500**	1046
Subordinated loan capital repaid		**(506)**	(431)
Dividends paid		**(1,400)**	(1,436)
Net cash from/(used in) financing activities		**126**	(95)
Net (decrease)/increase in cash and cash equivalents		**(8,184)**	5,251
Cash and cash equivalents at 1 January		**21,748**	16,824
Effect of exchange rate changes on cash and cash equivalents		**489**	(327)
Cash and cash equivalents at 31 December	37	**14,053**	21,748

Notes on the Financial Statements

1 Basis of preparation

(a) For all reporting periods up to and including the year ended 31 December 2004, HSBC Bank plc ('the bank') and its subsidiary undertakings (together 'the group') prepared its consolidated and parent company financial statements in accordance with UK Generally Accepted Accounting Principles ('UK GAAP'). From 1 January 2005, the group has prepared its consolidated and parent company financial statements in accordance with International Financial Reporting Standards as endorsed by the EU ('IFRSs') and effective for the group's reporting for the year ended 31 December 2005. IFRSs comprise accounting standards issued by the International Accounting Standards Board ('IASB') and its predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee ('IFRIC') and its predecessor body.

In preparing these consolidated and parent company financial statements, the group has elected to take advantage of certain transitional provisions within IFRS 1 'First-time Adoption of International Financial Reporting Standards' ('IFRS 1') which offer exemption from presenting comparative information or applying IFRSs retrospectively. The most significant of these provisions is the exemption from presenting comparative information in accordance with IFRSs in the following areas:

- IAS 32 'Financial Instruments: Presentation' ('IAS 32');
- IAS 39 'Financial Instruments: Recognition and Measurement' ('IAS 39');
- IFRS 4 'Insurance Contracts' ('IFRS 4'); and
- In addition, the group has elected not to present comparative information for disclosures required under IFRS 7 'Financial Instruments: Disclosure' ('IFRS 7') as permitted for entities applying the standard for annual periods beginning before 1 January 2006.

Where comparative information for financial instruments and insurance contracts has been prepared on the basis of HSBC Bank plc's previous accounting policies, the accounting policies applied to 2004 are disclosed separately in Note 44(e).

The group has adopted the 'Amendment to IAS 39: The Fair Value Option' (Note 2(h)), the 'Amendment to IAS 19 Employee Benefits: Actuarial Gains and Losses, Group Plans and Disclosures' (Note 2(s)), the 'Amendment to IAS 1 Presentation of Financial Statements: Capital Disclosures', IFRIC 4 'Determining whether an Arrangement contains a Lease' (Note 2(q)) and IFRS 7 with effect from 1 January 2005, ahead of their effective dates. IFRSs as endorsed by the EU are identical in all respects to the published IFRSs except for the EU's amendment to IAS 39 under which certain conditions required for the application of hedge accounting were deleted. The group has not taken advantage of the EU amendment to IAS 39, and applies the more restrictive requirements of IAS 39.

The balance sheets and income statements in this document are presented in accordance with IAS 1 'Presentation of Financial Statements'.

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

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

(b) The consolidated financial statements of HSBC Bank plc comprise the financial statements of the bank and its subsidiaries made up to 31 December. Entities that are controlled by the group are consolidated until the date that control ceases. Newly acquired subsidiaries are consolidated from the date that control is transferred to the group.

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

liabilities and contingent liabilities of the business acquired, the difference is recognised immediately in the income statement.

In accordance with IFRS 1, the group has chosen not to restate business combinations that took place prior to 1 January 2004, the date of transition to IFRSs.

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.

2 Principal accounting policies

(a) Interest income and expense

Interest income and expense for all interest-bearing financial instruments except for those classified as held-for-trading or designated at fair value (other than debt issued by the group and related derivatives) are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest rates of the financial assets or financial liabilities to which they relate.

The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments earned or paid on a financial asset or financial liability through its expected life or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the group estimates cash flows considering all contractual terms of the financial instrument but not future credit losses. The calculation includes all amounts paid or received by the group that are an integral part of the effective interest rate, including transaction costs and all other premiums or discounts.

Interest on impaired financial assets is calculated by applying the original effective interest rate of the financial asset to the carrying amount as reduced by any allowance for impairment.

(b) Non interest income

Fee income

The group earns fee income from a diverse range of services provided to its customers. Fee income is accounted for as follows:

- income earned on the execution of a discrete act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement for the acquisition of shares or other securities);
- income earned from the provision of services is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
- income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, loan commitment fees) and recorded in 'Interest income' (Note 2(a)).

Dividend income

Dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for equity securities.

Net income from financial instruments designated at fair value

'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, except for debt securities in issue and derivatives managed in conjunction with debt securities in issue. Interest on these instruments is shown in 'Net interest income'.

Net trading income

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.

(c) Segment reporting

The group is organised into three geographical regions, the United Kingdom, Continental Europe and Rest of the World and manages its business through seven business segments: UK Personal Financial Services; UK Commercial Banking; UK Corporate, Investment Banking and Markets; International Banking; France; Private Banking and HSBC Trinkaus & Burkhardt. Segment income and expenses include transfers between geographical regions and transfers between business segments. These transfers are conducted at arm's length.

(d) Determination of fair value

All financial instruments are recognised initially at fair value. The fair value of a financial instrument on initial recognition is normally the transaction price, i.e. the fair value of the consideration given or received. In certain circumstances, however, the initial fair value may 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.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value that are quoted in active markets are based on bid prices for assets held or liabilities to be issued and offer prices for assets to be acquired or liabilities held at the time. When independent prices are not available, fair values are determined by using valuation techniques which refer to observable market data. These include comparison with similar instruments where market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

For certain derivatives, fair values may be determined in whole or in part using valuation techniques based on assumptions that are not supported by prices from current market transactions or observable market data.

A number of factors such as bid-offer spread, credit profile, servicing costs of portfolios and model uncertainty are taken into account, as appropriate, when values are calculated using valuation techniques.

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

(e) Loans and advances to banks and customers

Loans and advances to banks and customers include loans and advances originated by the group which are not intended to be sold in the short term and have not been classified either as held for trading or designated at fair value through profit and loss. Loans and advances are recognised when cash is advanced to borrowers and are derecognised when either borrowers repay their obligations, or the loans are sold or written off. 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.

(f) Loan impairment

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 loans assessed collectively. Losses expected from future events, no matter how likely, are not recognised.

Individually assessed loans

At each balance sheet date, the group assesses on a case-by-case basis whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining impairment losses on these loans, the following factors are considered:

– 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 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 value. Any loss is charged in the income statement. The carrying amount of impaired loans on the balance sheet is reduced through the use of an allowance account.

Collectively assessed loans

Impairment is assessed on a collective basis in two different scenarios:

– for loans subject to individual assessment, to cover losses which have been incurred but have not yet been identified; and

– for homogeneous groups of loans that are not considered individually significant, where there is objective evidence of impairment.

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of loss has been identified are grouped together according to their credit risk characteristics for the purpose of calculating an estimated collective loss. This arises from impairment at the balance sheet date which will only be individually identified in the future.

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 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

For homogeneous groups of loans that are not considered individually significant, two alternative methods are used to calculate allowances on a portfolio basis:

- When appropriate empirical information is available, the group utilises roll rate methodology. This methodology employs a statistical analysis of historical trends of the probability of default and the amount of consequential loss, assessed at each time period for which the customer's contractual payments are overdue. 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 value of the portfolio. Other historical data and current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. In certain highly developed markets, sophisticated models also take into account behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.
- In other cases, when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll rate methodology, the group adopts a formulaic approach which allocates progressively higher percentage loss rates in line with the period of time for which a customer's loan is overdue. Loss rates are calculated from the discounted expected future cash flows from a portfolio.

Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

Loan write-offs

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from realising the security have been received.

Reversals of impairment

If the amount of an impairment loss decreases in a subsequent period, and the decrease can be related objectively to an event occurring after the impairment was recognised, the excess is written back by reducing the loan impairment allowance account accordingly. The reversal is recognised in the income statement.

Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans in order to achieve an orderly realisation are recorded as assets held for sale and reported in 'Other assets'. The asset acquired is recorded at the lower of its fair value (less costs to sell) and the carrying amount of the loan (net of impairment allowance) at the date of exchange. No depreciation is provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included in the income statement. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative impairment loss, is recognised in the income statement.

Renegotiated loans

Personal loans, which are generally subject to collective impairment assessment, whose terms have been renegotiated, are no longer considered to be past due or impaired but are treated as new loans only after the minimum required number of payments under the new arrangements have been received.

Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or are considered to be past due.

(g) Trading assets and trading liabilities

Treasury bills, debt securities, equity shares 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 securities, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently, their fair values are remeasured, and all gains and losses from changes therein, are recognised in the income statement in 'Net trading income' as they arise.

(h) Financial instruments designated at fair value

Financial instruments, other than those held for trading, are classified in this category if they meet one or more of the criteria set out below, and are so designated by management. The group may designate financial instruments at fair value when the designation:

– eliminates or significantly reduces valuation 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 securities – The interest payable on certain fixed rate long-term debt securities in issue and subordinated liabilities has been matched with receive/pay variable interest rate swaps as part of a documented interest rate risk management strategy. An accounting mismatch would arise if the debt securities in issue were accounted for at amortised cost, because the related derivatives are measured at fair value with movements in the fair value taken through the income statement. By designating the long-term debt at fair value, the movement in the fair value of the long-term debt will be recorded in the income statement.

  Financial assets and financial liabilities under investment contracts – These are managed on a fair value basis and management information is also prepared on this basis. Liabilities to customers under linked contracts are determined based on the fair value of the assets held in the linked funds, with changes shown in the income statement. Liabilities to customers under other types of investment contracts would be shown at amortised cost. If no designation was made for the assets relating to the customer liabilities they would be reclassified as available-for-sale and the changes in fair value would be recorded directly in equity. Designation at fair value of the financial assets and liabilities under investment contracts allows the fair value movements in fair values to be recorded in the income statements 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 mitigated 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 on trade date, when the group enters into contractual arrangements with counterparties to purchase or sell securities, 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, except for interest payable on debt securities in issue designated at fair value, gains and losses from changes therein are recognised in 'Net income from financial instruments designated at fair value'.

Gains and losses arising from changes in the fair value of derivatives that are managed in conjunction with designated financial assets or financial liabilities are also included in 'Net income from financial instruments designated at fair value'. Interest on these derivatives is also included in this line, except for interest on derivatives managed with debt securities in issue designated at fair value, which is included in net interest income. The amount of change during the period, and cumulatively, in the fair value of designated financial liabilities and loans and receivables that is attributable to changes in their credit risk, is determined as the amount of change in fair value that is not attributable to changes in market conditions.

(i) Financial investments

Treasury bills, debt securities and equity shares intended to be held on a continuing basis, other than those designated at fair value (Note 2(h)), 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 transactions are sold or the borrowers repay their obligations.

(i) Available-for-sale securities are initially measured at fair value plus direct and incremental transaction costs. They are subsequently remeasured at fair value, and changes therein are recognised in equity in the 'Available-for-sale reserve' until the securities are either sold or impaired. When available-for-sale securities are sold, cumulative gains or losses previously recognised in equity are recognised in the income statement as 'Gains less losses from financial investments'.

Interest income is recognised on available-for-sale securities using the effective interest rate method, calculated over the asset's expected life. Premiums and/or discounts arising on the purchase of dated investment securities are included in the calculation of their effective interest rates. Dividends are recognised in the income statement when the right to receive payment has been established. Financial investments are recognised using trade date accounting.

At each balance sheet date an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset or group of assets. This usually arises when circumstances are such that an adverse effect on future cash flows from the asset or group of assets can be reliably estimated. If an available-for-sale security is impaired, the cumulative loss (measured as the difference between the asset's acquisition cost and its current fair value, less any impairment loss on that asset previously recognised in the income statement) is removed from equity and recognised in the income statement. Reversals of impairment losses are subject to contrasting treatments depending on the nature of the instrument concerned:

– if the fair value of a debt instrument classified as available-for-sale 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;

– impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

(ii) Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the group positively intends, and is able, to hold until maturity. Held-to-maturity investments are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest rate method, less any impairment losses.

(j) Sale and repurchase agreements (including stock lending and borrowing)

When securities are sold subject to a commitment to repurchase them at a predetermined price ('repos'), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities 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 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, unless they are sold to third parties, in which case the 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'.

For repos and security lending, if the counterparty has the right to sell or repledge the securities transferred, the securities are presented separately on the balance sheet from assets that may not be repledged or resold by a counterparty.

(k) Derivatives and hedge accounting

Derivatives are recognised initially, and are subsequently remeasured, at fair value. Fair values of exchange-traded derivatives are obtained from quoted market prices. Fair values of over-the-counter ('OTC') derivatives are obtained using valuation techniques, including discounted cash flow models and option pricing models.

In the normal course of business, the fair value of a derivative on initial recognition is the transaction price (i.e. 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 profit or loss on inception of the derivative. When unobservable market data have a significant impact on the valuation of derivatives, the entire initial charge in fair value indicated by the valuation model is not recognised immediately in the income statement. It is instead recognised over the life of the transaction on an appropriate basis, or is recognised in the income statement when the inputs become observable, or when the transaction matures or is closed out.

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 are the same as those of a stand-alone derivative; and the combined contract is not held for trading or designated at fair value through profit and loss. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

Derivatives are classed as assets when their fair value is positive, or as liabilities when their fair value is negative. Derivative assets and liabilities arising from different transactions are only offset if the transactions are with the same counterparty, a legal right of offset exists, and the parties intend to settle the cash flows on a net basis.

The method of recognising fair value gains or losses depends on whether derivatives are held for trading or are designated as hedging instruments, and if the latter, the nature of the risks being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. When derivatives are designated as hedges, the group classifies them as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedges'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedges'); or (iii) hedges of net investments in a foreign operation ('net investment hedges'). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value, cash flow or net investment hedge provided certain criteria are met.

Hedge accounting

At the inception of a hedging relationship, the group documents the relationship between the hedging instruments and hedged items, its risk management objective and its strategy for undertaking the hedge. The group also requires a documented assessment, both at hedge inception and on an ongoing basis, of whether or not the 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 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 hedge item has been derecognised whereby 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 are recognised in equity within the cash flow hedging reserve. Any gain or loss in fair value relating to an ineffective portion is recognised immediately in the income statement.

Amounts accumulated in equity are recycled to the income statement in the periods in which the hedged item will affect profit or loss. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously deferred in equity are transferred from equity and included in the initial measurement of the cost of the asset or liability.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity until the forecast transaction is eventually recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

Net investment hedge

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in equity; the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement on the disposal of the foreign operation.

Hedge effectiveness testing

To qualify for hedge accounting, IAS 39 requires that at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness). Actual effectiveness (retrospective effectiveness) must also be demonstrated on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method a group entity adopts for assessing hedge effectiveness will depend on its risk management strategy.

For prospective effectiveness, the hedging instrument must be expected to be highly effective in achieving 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, the changes in fair value or cash flows must offset each other in the range of 80 per cent to 125 per cent for the hedge to be deemed effective.

Hedge effectiveness 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 any 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 related to debt issued by the group), in which case gains and losses are reported in 'Net income from financial instruments designated at fair value'.

(l) Derecognition of financial assets and liabilities

Financial assets are derecognised when the 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 substantially all

the risks and rewards of ownership; or where control is not retained. Financial liabilities are derecognised when they are extinguished, i.e. when the obligation is discharged, cancelled or expires.

(m) Offsetting financial assets and financial liabilities

Financial assets and financial liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

(n) Subsidiaries, associates and joint ventures

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

Investments in associates and interests in joint ventures are recognised using the equity method, initially stated at cost, including attributable goodwill, and are adjusted thereafter for the post-acquisition change in the group's share of net assets.

Unrealised gains 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. Unrealised 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.

(o) Goodwill and intangible assets

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

Intangible assets are recognised separately from goodwill when they are separable or arise from contractual or other legal rights, and their fair value can be measured reliably.

Goodwill is allocated to cash-generating units for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Impairment testing is performed annually by comparing the present value of the expected future cash flows from a business with the carrying value of its net assets, including attributable goodwill. Goodwill is stated at cost less accumulated impairment losses which are charged to the income statement.

Goodwill on acquisitions of joint ventures or associates is included in 'Interests in associates and joint ventures'.

At the date of disposal of a business, attributable goodwill is included in the group's share of net assets in the calculation of the gain or loss on disposal.

(ii) Intangible assets include the value of in-force long-term assurance business, computer software, trade names, customer lists, core deposit relationships, credit card customer relationships and merchant or other loan relationships. Intangible assets are subject to impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable.

- Intangible assets that have an indefinite useful life, or are not yet ready for use, are tested for impairment annually. This impairment test may be performed at any time during the year, provided it is performed at the same time every year. An intangible asset recognised during the current period is tested before the end of the current year.

- Intangible assets that have a finite useful life, except for the 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 economic life.

For the accounting policy followed in respect of the value of the in-force long-term insurance businesses see Note 2(w).

Intangible assets are amortised over their finite useful lives as follows:

Trade names	over 10 years
Purchased software	over 5 years
Internally generated software	over 5 years
Customer/merchant relationships	between 3 and 10 years
Other	over 10 years

(p) Property, plant and equipment

Land and buildings are stated at historical cost, or fair value at the date of transition to IFRSs ('deemed cost'), less any impairment losses and depreciation calculated to write off the assets over their estimated useful lives as follows:

- freehold land is not depreciated; and
- buildings are depreciated at the greater of two per cent per annum on a straight-line basis or, if leasehold, over the unexpired terms of the leases, or over their remaining useful lives.

Equipment, fixtures and fittings (including equipment on operating leases where the group is the lessor) are stated at cost less any impairment losses and depreciation calculated on a straight-line basis to write off the assets over their accumulated useful lives, which run to a maximum of 35 years but are generally between five years and 20 years.

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.

Property, plant and equipment is subject to an impairment review if there are events or changes in circumstance which indicate that the carrying amount may not be recoverable.

(q) Finance and operating leases

Agreements which transfer to counterparties substantially all the risks and rewards incidental to the ownership of assets, but not necessarily legal title, are classified as finance leases. When the group is a lessor under finance leases the amounts due under the leases, after deduction of unearned charges, are included in 'Loans and advances to banks' or 'Loans and advances to customers' as appropriate. Finance income receivable is recognised 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 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 equipment 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.

Notes on the Financial Statements (continued)

(r) Income tax

Income tax on the profit or loss for the year comprises current tax and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in shareholders' equity, in which case it is recognised in shareholders' equity.

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantially enacted by the balance sheet date, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are offset when the group intends to settle on a net basis and the legal right to set-off 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 it is probable that future taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when a legal right to set off exists in the entity.

Deferred tax relating to actuarial gains and losses on post-employment benefits is recognised directly in equity. From 1 January 2005, deferred tax relating to fair value remeasurement of available-for-sale investments and cash flow hedges which are charged or credited directly to equity, is also credited or charged directly to equity and is subsequently recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

(s) Pension and other post-employment benefits

The group operates a number of pension and other post-employment benefit plans throughout the world. These plans include both defined benefit and defined contribution plans and various other post-employment benefits such as post-employment health-care.

Payments to defined contribution plans and state-managed retirement benefit plans, when the group's obligations under the plans are equivalent to a defined contribution plan, are charged as an expense as they fall due.

The costs recognised for funding defined benefit plans are determined using the Projected Unit Credit Method, with annual actuarial valuations performed on each plan. Actuarial differences that arise are recognised in shareholders' equity and presented in the 'Statement of recognised income and expense' in the period in which they arise. All cumulative actuarial gains and losses on defined benefit plans as at 1 January 2004 were recognised in equity at the date of transition to IFRSs. Past service costs are recognised immediately 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. Current service costs and any past service costs, together unwinding of the discount on plan liabilities less the expected return on plan assets, are charged to operating expenses.

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 limited to unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan.

The costs of providing other post-employment benefits such as post-employment health-care are accounted for on the same basis as defined benefit plans.

(t) Equity compensation plans

Shares in HSBC Holdings plc awarded to an employee on joining the group that are made available immediately, with no vesting period attached to the award, are expensed immediately. When an inducement is awarded to an employee on commencement of employment with the group, and the employee must complete a specified period of service before the inducement vests, the expense is spread over the period to vesting. As these awards are made by the group a liability for the shares is recognised on balance sheet over the vesting period, at fair value.

Share option awards are granted by HSBC Holdings to group employees and are satisfied by HSBC Holdings transferring shares to the employees.

The compensation expense of share options charged to the income statement is credited to the share-based payment reserve over the vesting period. Compensation expense is determined by reference to the fair value of the options on grant date, and the effect of any non-market vesting conditions such as option lapses. An option may lapse if, for example, an employee ceases to be employed by the group before the end of the vesting period. Estimates of future such employee departures are taken into account when accruing the cost during the service period.

The cost of bonuses awarded in respect of past service, by which an employee is required to complete a specified period of future service to be entitled to the award, is spread over the period of service rendered to the vesting date.

(u) Foreign currencies

Items included in the financial statements of each of the group's entities are measured using the currency of the primary economic environment in which the entity operates ('the functional currency'). The consolidated financial statements of HSBC Bank plc are presented in sterling, which is the group's presentation 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 in terms of historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction, except for goodwill and fair value adjustments arising on consolidation, which are translated into the functional currency using the rate of exchange ruling at the balance sheet date. 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.

The results of branches, subsidiaries, joint ventures and associates not reporting in 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 accounted for in a separate foreign exchange reserve. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate subsidiary financial statements. In consolidated financial statements these exchange differences are recognised in the foreign exchange reserve in shareholders' equity. In accordance with IFRS 1, the group has set the cumulative exchange differences for all foreign operations to zero at the date of transition to IFRSs. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in reserves are recognised in the income statement.

(v) Provisions

Provisions are recognised when it is probable that an outflow of economic benefits will be required to settle a current legal or constructive obligation as a result of past events, and a reliable estimate can be made of the amount of the obligation.

(w) 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.

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 attributable to the risks borne during the accounting period. The unearned premium or 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 business where premiums are accounted for when liabilities are established.

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

Claims and reinsurance recoveries

Gross insurance claims for non-life insurance business include paid claims and movements in outstanding claims reserves. The outstanding claims reserves are based on the estimated ultimate cost of all claims made 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. Reserves for claims incurred but not reported are made on an estimated basis, using appropriate statistical techniques.

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. The liabilities under non-linked life insurance contracts (long-term business provision) are calculated by each life insurance operation based on local actuarial principles. The 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.

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

Present value of in-force long-term insurance business

A value is placed on insurance contracts that are classified as long-term insurance business and are in force at the balance sheet date.

The present value of in-force long-term insurance business is determined by discounting future earnings expected to emerge from business currently in force using appropriate assumptions in assessing factors such as recent experience and general economic conditions. Movements in the value of in-force long-term insurance business are included in ‘Other operating income’ on a gross of tax basis.

(x) Investment contracts

Customer liabilities under non-linked and unit-linked investment contracts and the linked financial assets are measured at fair value, and the movements in fair value are recognised in the income statement in ‘Net income from financial investments 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.

Investment management fees receivable are recognised in the income statement over the period of the provision of the investment management services.

The incremental costs directly related to the acquisition of new investment contracts or renewing existing investment contracts are capitalised and amortised over the period during which the investment management services are provided.

(y) Debt securities in issue and subordinated liabilities

Debt securities in issue are initially measured at fair value, which is normally the consideration received net of directly attributable transaction costs incurred. Subsequent measurement is at amortised cost, using the effective interest rate method to amortise the difference between proceeds net of directly attributable transaction costs and the redemption amount over the expected life of the debt, unless the securities are designated at fair value (Note 2(h)).

(z) Share capital

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.

(aa) Cash and cash equivalents

For the purpose of the cash flow statement, cash and cash equivalents include highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments are normally those with less than three months' maturity from the date of acquisition, and include cash and balances at central banks, treasury bills and other eligible bills, loans and advances to banks, and certificates of deposit.

3 Use of assumptions and estimates

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 IFRSs 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 and estimation, are:

Impairment of loans

The group's accounting policy for losses in relation to the impairment of customer loans and advances is described in Note 2(f). Impairment is calculated on the basis of discounted estimated future cash flows.

Goodwill impairment

The group's accounting policy for goodwill is described in Note 2(o). This is discussed in further detail in Note 22 'Impairment of assets other than financial instruments'.

Valuation of financial instruments

The group's accounting policy for valuation of financial instruments is included in Note 2 and is discussed further within Note 17 'Derivatives' and Note 31 'Fair value of financial instruments'.

Pensions

The assumptions used are disclosed in Note 8 'Employee compensation and benefits'.

Share-based payments

The assumptions used are disclosed in Note 10 'Share-based payments'.

Notes on the Financial Statements (continued)

4 Net income from financial instruments designated at fair value

Net income from financial instruments designated at fair value includes:

- all gains and losses from changes in the fair value of financial assets and liabilities designated at fair value, including liabilities under investment contracts;
- all gains and losses from changes in the fair value of derivatives that are managed in conjunction with financial assets and liabilities designated at fair value; and
- interest income, expense and dividend income of financial assets and liabilities designated at fair value, liabilities under investment contracts and derivatives managed in conjunction with them, except for interest arising on the group's debt securities in issue and subordinated liabilities, together with the interest on derivatives managed in conjunction with them, which is recognised in 'Interest expense'.

	2005 £m
Net income arising on:	
– financial assets held to meet liabilities under insurance and investment contracts	783
– other financial assets designated at fair value[1]	9
– derivatives managed in conjunction with financial assets designated at fair value[1]	(4)
	788
– financial liabilities under investment contracts	(500)
– own debt securities in issue and subordinated liabilities[2]	(60)
– other financial liabilities designated at fair value	(61)
– derivatives managed in conjunction with financial liabilities designated at fair value	3
	(618)
Net income arising on financial instruments designated at fair value	170

1 *The group has designated certain loans and advances at fair value.*
2 *Gains and losses from changes in the fair value of own debt securities in issue and subordinated liabilities may arise from changes in own credit risk. In 2005, the group recognised a £22 million loss on changes in the fair value of these instruments arising from changes in own credit risk.*

5 Net earned insurance premiums

	2005			
	Non-life insurance £m	Life insurance (non-linked) £m	Life insurance (linked) £m	Total £m
Gross written premiums	200	381	92	673
Movement in unearned premiums	(12)	(14)	–	(26)
Gross earned premiums	188	367	92	647
Gross written premiums ceded to reinsurers	(56)	(145)	(7)	(208)
Reinsurers' share of movement in unearned premiums	(1)	–	–	(1)
Reinsurers' share of gross earned premiums	(57)	(145)	(7)	(209)
Net earned premiums	131	222	85	438

6 Net insurance claims incurred and movement in policyholders' liabilities

	2005			
	Non-life insurance £m	Life insurance (non-linked) £m	Life insurance (linked) £m	Total £m
Claims, benefits and surrenders paid	79	92	134	305
Movement in provisions	(3)	(129)	42	(90)
Gross claims incurred and movement in policyholder liabilities	76	(37)	176	215
Reinsurers' share of claims, benefits and surrenders paid	(35)	(56)	(6)	(97)
Reinsurers' share of movement in provisions	5	111	(4)	112
Reinsurers' share of claims incurred and movement in policyholder liabilities	(30)	55	(10)	15
Net insurance claims incurred and movement in policyholder liabilities	46	18	166	230

7 Net operating income

Net operating income for the year ended 31 December 2005 is stated after the following items of income, expense, gains and losses:

	2005 £m
Income	
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	11,056
Interest recognised on impaired financial assets	6
Fees earned on financial assets that are not held for trading or designated at fair value and that are not included in their effective interest rates	2,457
Fees earned on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	836
Gains on sale of subsidiaries, associates and joint ventures	487
Expense	
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	7,014
Fees payable on financial assets or liabilities that are not held for trading or designated at fair value and that are not included in their effective interest rates	275
Fees payable relating to trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	80
Gains/(losses)	
Gain/(loss) on disposal or settlement of loans and advances	11
Impairment losses on:	
– loans and advances	807
– available-for-sale financial investments	8

Notes on the Financial Statements (continued)

8 Employee compensation and benefits

The group

	2005	2004
	£m	£m
Wages and salaries	**2,909**	2,576
Social security costs	**382**	361
Post-employment benefits	**333**	408
	3,624	3,345

The bank

	2005	2004
	£m	£m
Wages and salaries	**1,710**	1,563
Social security costs	**170**	163
Post-employment benefits	**261**	351
	2,141	2,077

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

	2005	2004
UK PFS, CIBM and Commercial Banking	**48,615**	47,856
International Banking	**8,149**	6,801
France	**14,183**	14,066
Private Banking	**3,581**	3,858
HSBC Trinkaus & Burkhardt	**1,749**	1,643
Total	**76,277**	74,224

(a) Post-employment benefit plans

(i) Pension plans

The group's total pension cost was £325 million (2004: £402 million), of which £252 million (2004: £339 million) relates to defined benefit plans.

Progressively the group has been moving to defined contribution plans for all new employees. The pension cost of defined contribution plans was £73 million (2004: £63 million).

The extant plans are funded defined benefit plans, with assets, held in trust or similar funds separate from the group. The plans are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the defined benefit obligations and related current service cost vary according to the economic conditions of the countries in which they are situated.

(ii) Healthcare benefits plans

The group also provides post-employment healthcare benefits under plans in the United Kingdom and France, which are unfunded. Post-employment healthcare benefits plans are accounted for in the same manner as defined benefit pension plans. The plans are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the defined benefit obligations 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 was £8 million (2004: £6 million).

(b) Post-employment defined benefit plan principal actuarial assumptions

The principal actuarial financial assumptions used to calculate the defined benefit pension plans and post-employment healthcare benefits at 31 December 2005, which will form the basis for measuring the 2006 periodic costs, were:

	Discount rate %	Inflation assumption %	Rate of increase for pensions in payment and deferred pension %	Rate of pay increase %	Healthcare cost trend rates %
At 31 December 2005					
UK	**4.75**	**2.70**	**2.70**	**3.20**	**6.70**
France	**4.10**	**2.00**	**2.00**	**3.00**	**6.00**
Germany	**4.00**	**2.00**	**2.00**	**3.00**	**n/a**
Switzerland	**2.25**	**1.50**	**n/a**	**2.25**	**n/a**

The group determines discount rates in consultation with its actuary based upon the current average yield of high quality (AA rated) debt instruments, with maturities consistent with that of the pension obligation. The expected rate of return on plan assets is determined in consultation with the group's actuaries, based on historical market returns, adjusted for additional factors such as the current rate of inflation and interest rates.

The principal actuarial financial assumptions used to calculate the defined benefit pension plans and post employment healthcare benefits at 31 December 2004, which formed the basis for measuring the 2005 periodic costs, were as follows:

	Discount rate %	Inflation assumption %	Rate of increase for pensions in payment and deferred pension %	Rate of pay increase %	Healthcare cost trend rates %
At 31 December 2004					
UK	5.30	2.70	2.70	3.20	7.70
France	4.50	2.00	2.00	3.50	6.00
Germany	4.50	1.50	1.50	2.50	n/a
Switzerland	3.25	1.50	n/a	2.25	n/a

The mortality tables and average life expectancy at 65 used at 31 December 2005 were as follows:

	Mortality table	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
		Aged 65	**Aged 45**	**Aged 65**	**Aged 45**
UK	PA92U2005	**19.53**	**20.89**	**22.57**	**23.86**
France	TPG93	**23.02**	**25.32**	**23.02**	**25.32**
Switzerland	EVK2000 (3% loading)	**18.30**	**18.30**	**21.21**	**21.21**
Germany	Heubeck 2005 G	**18.06**	**20.84**	**22.20**	**24.85**

Notes on the Financial Statements (continued)

The mortality tables and average life expectancy at 65 used at 31 December 2004 were as follows:

	Mortality table	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
		Aged 65	Aged 45	Aged 65	Aged 45
UK	PA92U2002	19.26	20.72	22.31	23.71
France	TPG93	23.02	25.32	23.02	25.32
Switzerland	EVK2000 (3% loading)	18.30	18.30	21.21	21.21
Germany	Heubeck Richttafeln	17.67	17.67	21.19	21.19

(c) Defined benefit pension plans

Value recognised in the balance sheet

	At 31 December 2005			
	HSBC Bank (UK) Pension Scheme		Other plans	
	Expected rate of return %	Value £m	Expected rate of return %	Value £m
Equities	**8.0**	**4,753**	**6.6**	**119**
Bonds	**4.3**	**3,041**	**4.7**	**120**
Property	**6.5**	**895**	**6.0**	**1**
Other	**3.6**	**1,418**	**4.5**	**164**
Fair value of plan assets		**10,107**		**404**
Present value of funded obligations		**(11,961)**		**(597)**
Present value of unfunded obligations		**–**		**(4)**
Defined benefit obligation		**(11,961)**		**(601)**
Unrecognised past service cost		**–**		**1**
Net liability		**(1,854)**		**(196)**

	At 31 December 2004			
	HSBC Bank (UK) Pension Scheme		Other plans	
	Expected rate of return %	Value £m	Expected rate of return %	Value £m
Equities	8.1	4,508	7.0	77
Bonds	4.7	2,120	4.3	116
Property	6.5	794	6.0	5
Other	3.6	388	2.4	42
Fair value of plan assets		7,810		240
Present value of funded obligations		(10,335)		(381)
Present value of unfunded obligations		–		(124)
Defined benefit obligation		(10,335)		(505)
Unrecognised past service cost		–		–
Net liability		(2,525)		(265)

Changes in the present value of the defined benefit obligation

	2005		2004	
	HSBC Bank (UK) Pension Plan £m	**Other plans £m**	HSBC Bank (UK) Pension Plan £m	Other plans £m
At 1 January	**10,335**	**505**	9,308	465
Current service cost	**211**	**23**	190	17
Interest cost	**540**	**20**	503	20
Contributions by employees	–	**–**	–	1
Actuarial losses	**1,126**	**68**	522	9
Benefits paid	**(297)**	**(22)**	(321)	(21)
Past service cost – vested immediately	–	**(2)**	–	(6)
Past service cost – unvested benefits	–	**2**	–	–
Acquisitions	**46**	**10**	–	–
Curtailments	–	**(2)**	133	(2)
Exchange and other movements	–	**(1)**	–	22
At 31 December	**11,961**	**601**	10,335	505

Changes in the fair value of plan assets

	2005		2004	
	HSBC Bank (UK) Pension Plan £m	**Other plans £m**	HSBC Bank (UK) Pension Plan £m	Other plans £m
At 1 January	**7,810**	**240**	7,190	225
Expected return	**525**	**15**	506	10
Contributions by the group	**1,132**	**131**	158	8
Contributions by employees	–	**5**	–	4
Experience gains/(losses)	**905**	**9**	276	(20)
Benefits paid	**(297)**	**(6)**	(320)	(6)
Acquisitions	**32**	**11**	–	–
Exchange and other movements	–	**(1)**	–	19
At 31 December	**10,107**	**404**	7,810	240

The actual return on plan assets for the year-ended 31 December 2005 was £1,454 million (2004: £772 million). The group expects to make £150 million of contributions to defined benefit pension plans during 2006.

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

	2005		2004	
	HSBC Bank (UK) Pension Plan £m	**Other plans £m**	HSBC Bank (UK) Pension Plan £m	Other plans £m
Current service cost	**211**	**23**	190	17
Interest cost	**540**	**20**	503	20
Expected return on plan assets	**(525)**	**(15)**	(506)	(10)
Past service cost	–	**(2)**	–	(6)
(Gains)/losses on curtailments and settlements	–	–	133	(2)
Total net expense	**226**	**26**	320	19

Notes on the Financial Statements (continued)

Summary

	2005		2004	
	HSBC Bank (UK) Pension Plan £m	**Other plans £m**	HSBC Bank (UK) Pension Plan £m	Other plans £m
Defined benefit obligation	**(11,961)**	**(601)**	(10,335)	(505)
Plan assets	**10,107**	**404**	7,810	240
Net deficit	**(1,854)**	**(197)**	(2,525)	(265)
Experience gains on plan liabilities	**40**	**3**	219	0
Experience gains/(losses) on plan assets	**905**	**9**	276	(20)
Gains/(losses) from changes in actuarial assumptions	**(1,166)**	**(71)**	(741)	(9)
Total net actuarial losses	**(221)**	**(59)**	(246)	(29)

Total net actuarial losses recognised in equity to date are £555 million.

(d) Post-employment healthcare benefits plans

Value recognised in the balance sheet

	2005 £m	2004 £m
Present value of unfunded obligations	**(168)**	(145)
Net liability	**(168)**	(145)

Changes in the present value of the defined benefit obligation

	2005 £m	2004 £m
At 1 January	**145**	144
Current service cost	**1**	–
Interest cost	**7**	6
Actuarial losses	**22**	2
Benefits paid	**(7)**	(6)
Exchange and other movements	**–**	(1)
At 31 December	**168**	145

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

	2005 £m	2004 £m
Current service cost	1	–
Interest cost	7	6
Total expense	8	6

Summary

	Year ended 31 December	
	2005 £m	2004 £m
Defined benefit obligation	**(168)**	(145)
Net deficit	**(168)**	(145)
Experience losses on plan liabilities	**–**	(1)
Losses from changes in actuarial assumptions	**(22)**	(1)
Total net actuarial losses	**(22)**	(2)

Total net actuarial losses recognised in equity to date are £24 million.

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 2005:

	1% increase	**1% decrease**
	£m	**£m**
Increase/ (decrease) on the aggregate of the current service cost and interest cost	**2**	**(1)**
Increase/ (decrease) on defined benefit obligation	**30**	**(24)**

Bank

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

(e) Directors' emoluments

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

	2005	2004
	£000	£000
Fees	**384**	320
Salaries and other emoluments	**1,603**	1,330
Bonuses[1]	**2,518**	2,882
	4,505	4,532
Gains on the exercise of share options	**222**	8
Vesting of Restricted Share Plan awards	**410**	455

1 *In return for the prior waiver of bonus, the employer contribution into the pension schemes of two Directors has been increased by the amount of £2.024 million (2004: £1.459 million).*

In aggregate, awards of £3,650,000 (2004: £8,925,000) will be made to four Directors under long-term incentive plans in respect of 2005.

Retirement benefits accrue to five Directors under defined benefit schemes and to two Directors under money purchase schemes.

In addition, there were payments under retirement benefit agreements with former Directors of £677,661 (2004: £595,539), including payments in respect of unfunded pension obligations to former Directors of £394,716 (2004: £367,000). The provision as at 31 December 2005 in respect of unfunded pension obligations to former Directors amounted to £3,848,000 (2004: £4,134,000). During the year, aggregate contributions to pension schemes in respect of Directors were £2,311,172 (2004: £2,623,000), including £2,023,782 (2004: £1,459,000) arising from Directors' waivers of bonuses.

Discretionary bonuses for Directors are based on a combination of individual and corporate performance and are determined by the Remuneration Committee of the bank's parent company, HSBC Holdings plc. The cost of the conditional awards under the HSBC Holdings Restricted Share Plan 2000 is recognised through an annual charge based on the original cost and the likely level of vesting of shares, apportioned over the period of service to which the award relates.

Notes on the Financial Statements (continued)

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

	2005 £000
Fees	–
Salaries and other emoluments[1]	671
Bonuses	–

1 *In return for the prior waiver of bonus, an employer contribution of £1,818,750 has been made into a defined benefit pension arrangement.*

The gain on vesting of long-term incentive awards under the HSBC Holdings plc Restricted Share Plan 2000 attributable to the highest paid Director was £290,220. The highest paid Director did not exercise any share options during the year.

Contributions of £1,818,750 arising from the Director's prior waiver of bonus, into a defined contribution pension and £145,000 into a defined benefit arrangement were made by the bank in respect of service by the highest paid Director during the year. In addition, the highest paid Director, as a member of a defined benefit pension arrangement, was entitled to an accrued pension of £218,000 per annum with an accrued transfer value of £4,903,000 as at 31 December 2005.

The Remuneration Committee of the bank's parent company, HSBC Holdings plc, is proposing that the highest paid Director should receive a conditional award of HSBC Holdings plc ordinary shares with a face value of £2 million under The HSBC Share Plan in respect of services as a Director during the year. Details of The HSBC Share Plan and performance conditions are contained within the Directors' Remuneration Report of HSBC Holdings plc.

9 General and administrative expenses

Auditors' remuneration

Auditors' remuneration in relation to statutory audit amounted to £8.8 million (2004: £7.7 million). The following remuneration was paid by group companies to the group's principal auditor, KPMG Audit Plc and its affiliated firms ('KPMG'):

	2005 **£m**	2004 £m
Audit services:		
– statutory audit	**8.0**	7.1
– audit-related regulatory reporting	**4.1**	2.2
Total audit services	**12.1**	9.3
Further assurance services	**1.3**	1.2
Tax services	**0.5**	0.3
Other services:		
– other services	**0.8**	0.6
Total fees paid to KPMG	**14.7**	11.4

The following is a description of the type of services included within the categories listed above:

– Audit-related regulatory reporting services include services for assurance and other services that are reasonably related to the performance of the audit or review of financial statements, including comfort letters and interim reviews.

– Further assurance services include services for advice on accounting matters, reporting on internal controls not connected with the financial statements, due diligence work and environmental audits.

– Tax services include services for tax advice.

– Other services include other assurance and advisory services such as translation services, review of financial models and advice on IT security.

10 Share-based payments

The group has no specific share-based payment arrangements of its own and participates in HSBC Holdings plans consisting of share-option awards and share awards.

Share option awards are granted by HSBC Holdings to group employees and are satisfied by HSBC Holdings transferring shares to the employees on exercise.

Where an award of HSBC Holdings shares is made to a group employee by a group entity, the employing entity has an obligation to transfer HSBC Holdings shares to the employee if the vesting conditions of the award are satisfied. The employing entity incurs a liability in respect of the share awards recognised at fair value, remeasured at each reporting date over the vesting period and at the date of settlement.

During 2005, £59 million was charged to the income statement in respect of equity-settled and £78 million cash-settled share-based payment transactions (2004: £39 million and £43 million respectively). This expense was based on the fair value of the share-based payment transactions when contracted. All of the expense arose under employee share awards made within the group's reward structures.

Calculation of fair values

Fair values of share options/awards, measured at the date of grant of the option/award, are calculated using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model. When modelling options/awards with vesting dependent on the Group's Total Shareholder Return over a period, these 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 consistent with historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

The significant weighted average assumptions used to estimate the fair value of the options granted in 2005 were as follows:

	Group Share Option Plan	3-year Savings-Related Share Option Schemes	5-year Savings-Related Share Option Schemes	The HSBC Share Plan
Risk-free interest rate[1] (%)	**4.6**	**4.3**	**4.3**	**4.3**
Expected life[2] (years)	**7.8**	**3**	**5**	**5**
Expected volatility[3] (%)	**20**	**20**	**20**	**20**

1 *The risk-free rate was determined from the UK gilts yield curve for Group Share Option Plan awards and UK Savings-Related Share Option Schemes. A similar yield curve was used for the Overseas Savings-Related Share Option Schemes.*
2 *Expected life is not a single input parameter but a function of various behavioural assumptions.*
3 *Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options.*

Expected dividend yield was determined, denominated in US Dollars, to be 12 per cent for the first year and 8 per cent thereafter, consistent with consensus analyst forecasts.

The average share price for 2005 was £8.89. The high mid-market price for the year was £9.50 and the low mid-market price was £8.25 (2004: £9.54 and £7.84 respectively).

HSBC Share Plan

The HSBC Share Plan was adopted by the Group in 2005. This Plan comprises Performance share awards, Restricted share awards and Achievement share awards. The aim of the HSBC Share Plan is to align the interests of executives to the creation of shareholder value and recognise individual performance and potential. Awards are also made under this plan for recruitment and retention purposes.

Performance share awards

Performance share awards are made to senior executives taking into account individual performance in the prior year. Performance share awards are divided into two equal parts for testing attainment against pre-determined benchmarking. One half is subject to a Total Shareholder Return 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

Notes on the Financial Statements (continued)

element of the award, shares would be released to the employee according to a sliding scale from 30 to 100 per cent of the award, dependent upon the scale of achievement against the benchmarks and provided that a threshold has been passed. If the threshold is not passed, 0 per cent will vest for that part of the award. Shares will be released after three years to the extent that the performance conditions are satisfied. These awards are forfeited in total if the Group performance fails to meet the minimum criteria.

	2005 Number (000)
Additions during the year	492
Forfeited in the year	–
Outstanding at 31 December [1]	492

1 *All the above awards relate to executives of HSBC Bank plc.*

The weighted average fair value of shares awarded by the group for Performance Share Awards in 2005 was £4.93.

Restricted Share awards

Restricted Share awards are made to eligible employees for recruitment and retention purposes or as part of deferral of annual bonus. The awards vest between one and three years from date of award.

	2005 Number (000)
Additions during the year	226
Forfeited in the year	(12)
Outstanding at 31 December	214

1 *The above table includes the bank employee options of 224,018,000 granted during the year and 212,046 options outstanding at 31 December 2005*

The weighted average fair value of shares awarded by the group for Restricted Share Awards in 2005 was £4.93.

Share options

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

	2005	
	Number (000)	Weighted average exercise price £
Granted in the year	628	8.84
Forfeited in the year	–	–
Outstanding at 31 December	628	8.84

The fair value of options granted in the year as at the date of grant was £1.25. The remaining contractual life of options outstanding at the balance sheet date is 4 years. None of these options are exercisable at the balance sheet date.

Savings-related share option plans

The 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 plan is to align the interests of all employees to the creation of shareholder value. The options are exercisable within six months following either the third or the fifth anniversary of the commencement of the savings contract depending on conditions set at grant. The

exercise price is set at a 20 per cent (2004: 20 per cent) discount to the market value at the date of grant.

	2005		2004	
	Number (000)	**Weighted average exercise price £**	Number (000)	Weighted average exercise price £
Outstanding at 1 January	**30,859**	**5.72**	22,670	5.35
Granted in the year	**10,228**	**6.67**	10,765	6.47
Exercised in the year	**(641)**	**5.55**	(152)	5.37
Transferred in the year	**(165)**	**5.38**	(14)	4.62
Expired in the year	**(3,117)**	**5.89**	(2,410)	5.57
Outstanding at 31 December[1,2]	**37,164**	**5.98**	30,859	5.72

1 *The above table includes the bank employee options of 29,908,022 outstanding at 1 January 2005 (2004: 21,960,687), 9,846,316 options granted in the year (2004:10,484,110) and 36,005,997 options outstanding at 31 December 2005 (2004: 29,908,022)*

2 *The weighted average exercise price for bank employees at 1 January 2005 was £5.73 (2004: £5.35) and at 31 December 2005 was £5.97.*

The weighted average fair value of options granted in the year as at the date of grant was £2.06 (2004: £2.27). 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

	2005	2004
Exercise price range (£)	**£5.35-£6.75**	£5.35-£6.75
Number (000)	**37,164**	30,859
Weighted average exercise price (£)	**5.98**	5.72
Weighted average remaining contractual life (years)	**2.31**	2.87

The bank

	2005	2004
Exercise price range (£)	**£5.35-£6.75**	£5.35-£6.75
Number (000)	**36,006**	29,908
Weighted average exercise price (£)	**5.97**	5.73
Weighted average remaining contractual life (years)	**2.32**	2.89

Restricted Share Plan 2000

Performance Share awards made under the HSBC Holdings Restricted Share Plan 2000

Performance Share awards under the Restricted Share Plan were granted to Senior Executives from 1996 to 2004. The aim of the plan was to align the interests of executives to the creation of shareholder value. This was achieved by setting certain Total Shareholder Return targets against a peer group of major banks which must normally be attained in order for the awards to vest. No further awards will be made under this Plan following adoption of the HSBC Share Plan in 2005.

	2005 Number (000)	2004 Number (000)
Outstanding at 1 January	**561**	253
Additionally during the year	**25**	308
Released in the year	**–**	–
Transferred in the year	**28**	–
Outstanding at 31 December[1]	**614**	561

1 *All the above awards relate to executives of HSBC Bank plc*

Notes on the Financial Statements (continued)

The fair value of the shares at 31 December 2005 was £9.33 (2004: £8.79).

The weighted average remaining vesting period as at 31 December 2005 was 9 months (2004: 1.78 years).

Restricted share awards made under the HSBC Holdings Restricted Share Plan 2000 (‘Achievement Shares’)

Achievement shares are utilised to promote widespread interest in HSBC Holdings shares among employees and to help foster employee engagement. They are awarded to eligible employees after taking into account the employee’s performance in the prior year. Shares are awarded without corporate performance conditions and are released to employees after three years providing the employees have remained continuously employed by the Group for this period.

	Number of shares (000)
Additions during the year[1]	**1,870**
Forfeited in the year	**(2)**
Outstanding at 31 December[2]	**1,868**

1 *Additions during the year include reinvested scrip dividends.*
2 *1,858,883 of the above awards relate to executives of HSBC Bank plc.*

The weighted average fair value of shares awarded by the group for Achievement Share Awards in 2005 was £4.93.

Other awards made under the Restricted Share Plan

Other awards were made under the HSBC Holdings Restricted Share Plan 2000 as part deferral of annual bonus. Awards were also made for recruitment and retention purposes. The awards generally vest from one to three years from the date of award. Awards made under this plan ceased in May 2005. Awards of restricted shares on or after 27 May 2005 were made under the Rules of the HSBC Share Plan.

	2005 Number (000)	2004 Number (000)
Outstanding at 1 January	**34,520**	–
Additionally during the year	**1,489**	34,520
Released in the year	**(10,284)**	–
Transferred in the year	**–**	–
Outstanding at 31 December [1]	**25,725**	34,520

1 *The above table includes bank employee shares of 32,207,000 outstanding at 1 January 2005 (2004: nil), 1,489,000 shares granted in the year (2004: 31,986,000) and 25,333,000 outstanding at 31 December 2005.*

The weighted average fair value of shares awarded by the group for HSBC Holdings Restricted Share Plan 2000 in 2005 was £8.60.

Group Share Option Plan

The Group Share Option Plan was a long-term incentive plan available to certain group employees between 2000 and 2005. The aim of the plan was to align the interests of those higher performing employees to the creation of shareholder value. This was achieved by setting certain Total Shareholder Return targets which must normally 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.

	2005		2004	
	Number (000)	**Weighted average exercise price £**	Number (000)	Weighted average exercise price £
Outstanding at 1 January	**60,783**	**7.61**	30,978	6.93
Granted in the year	**7,991**	**8.39**	31,142	8.29
Exercised in the year	**(110)**	**7.69**	(12)	6.91
Transferred in the year	**164**	**7.71**	–	–
Expired in the year	**(1,438)**	**6.01**	(1,325)	7.44
Outstanding at 31 December[1,2]	**67,390**	**7.74**	60,783	7.61

1 *The above includes the bank employee awards of 34,661,292 options outstanding at 1 January 2005 (2004: 17,681,056), 36,265 options granted in the year (2004: 18,077,283) and 33,341,930 options outstanding at 31 December 2005 (2004:34,661,292).*

2 *The weighted average exercise price for bank employees at 1 January 2005 was £7.62 (2004: £6.93) and at 31 December 2005 was £7.61.*

The weighted average fair value of options granted in the year as at the date of grant was £1.56 (2004: £1.59). 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

	2005		2004	
Exercise price range (£)	**£6.00-£8.00**	**£8.01-£10.00**	£6.00-£8.00	£8.01-£10.00
Number (000)	**29,378**	**38,012**	29,769	31,014
Weighted average exercise price (£)	**6.91**	**8.31**	6.91	8.28
Weighted average remaining contractual life (years)	**0.33**	**1.54**	1.33	2.33

The bank

	2005		2004	
Exercise price range (£)	**£6.00-£8.00**	**£8.01-£10.00**	£6.00-£8.00	£8.01-£10.00
Number (000)	**16,354**	**16,988**	16,775	17,887
Weighted average exercise price (£)	**6.91**	**8.28**	6.91	8.28
Weighted average remaining contractual life (years)	**0.33**	**1.32**	1.33	2.32

HSBC France and subsidiary company plans

HSBC France granted share purchase and subscription offers to certain executives of HSBC France, directors and officers, as well as to certain senior executives of subsidiaries.

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

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

Notes on the Financial Statements (continued)

	2005		2004	
	Number (000)	**Weighted average exercise price €**	Number (000)	Weighted average exercise price €
Outstanding at 1 January	**860**	**142.5**	862	142.5
Exercised in the year	**(94)**	**142.5**	(2)	142.5
Outstanding at 31 December	**766**	**142.5**	860	142.5

The weighted average remaining contractual life for options outstanding at the balance sheet date was 6 years.

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 shares exchangeable under such arrangements was 821,466 shares during the year.

Detailed below are the share-based payments issued before the date of application of IFRS 2 on 7 November 2002 and therefore, are not accounted for within the balance sheet or income statement.

The Group Share Option Plan

	2005		2004	
	Number (000)	**Weighted average exercise price £**	Number (000)	Weighted average exercise price £
Outstanding at 1 January	**75,475**	**8.08**	85,716	7.95
Exercised in the year	**(11,058)**	**7.55**	(8,424)	6.80
Transferred in the year	**(283)**	**3.61**	–	–
Expired in the year	**(972)**	**8.29**	(1,817)	8.21
Outstanding at 31 December[1,2]	**63,162**	**8.18**	75,475	8.08

1 *The above includes the bank employee awards of 48,869,935 options outstanding at 1 January 2005 (2004: 58,443,507), and 37,062,754 options outstanding at 31 December 2005 (2004: 48,869,935).*

2 *The weighted average exercise price for bank employees was £7.85 at 1 January 2005 (2004: £7.71) and £7.96 at 31 December 2005 (2004: £7.85)*

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

	2005		2004	
Exercise price range (£)	**£6.38-£7.46**	**£7.47-£9.64**	£6.38-£7.46	£7.47-£9.64
Number (000)	**13,622**	**49,540**	20,595	54,880
Weighted average exercise price (£)	**6.84**	**8.55**	6.81	8.55
Weighted average remaining contractual life (years)	**–**	–	0.22	0.11
Of which exercisable:				
– number (000)	**13,622**	**49,540**	20,228	25,701
– weighted average exercise price (£)	**6.84**	**8.55**	6.80	8.72

The bank

	2005		2004	
Exercise price range (£)	**£6.38-£7.46**	**£7.47-£9.64**	£6.38-£7.46	£7.47-£9.64
Number (000)	**12,780**	**24,282**	19,654	29,215
Weighted average exercise price (£)	**6.82**	**8.56**	6.80	8.55
Weighted average remaining contractual life (years)	**–**	–	0.67	0.33
Of which exercisable:				
– number (000)	**12,752**	**11,769**	19,625	13,568
– weighted average exercise price (£)	**6.82**	**8.73**	6.80	8.72

Savings Relating Share Option Plan

	2005		2004	
	Number (000)	**Weighted average exercise price £**	Number (000)	Weighted average exercise price £
Outstanding at 1 January	**20,401**	**6.24**	34,920	6.02
Exercised in the year	**(12,145)**	**6.07**	(12,693)	5.64
Transferred in the year	**(54)**	**6.60**	(20)	6.13
Expired in the year	**(855)**	**6.34**	(1,806)	6.25
Outstanding at 31 December[1,2]	**7,347**	**6.51**	20,401	6.24

1 *The above table includes the bank employee options of 19,908,899 outstanding at 1 January 2005 (2004:34,112,875) and 7,246,942 options outstanding at 31 December 2005 (2004:19,908,899).*

2 *The weighted average exercise price for bank employees was £6.24 at 1 January 2005 (2004: £6.02) and £6.51 at 31 December 2005 (2004: £6.24).*

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

	2005		2004	
Exercise price range (£)	**£5.40-£6.03**	**£6.04-£6.75**	£5.40-£6.03	£6.04-£6.75
Number (000)	**175**	**7,172**	10,751	9,650
Weighted average exercise price (£)	**6.01**	**6.52**	6.02	6.49
Weighted average remaining contractual life (years)	–	**0.31**	0.25	1.56
Of which exercisable:				
– number (000)	**175**	**67**	192	81
– weighted average exercise price (£)	**6.01**	**6.53**	5.40	6.75

The bank

	2005		2004	
Exercise price range (£)	**£5.40-£6.03**	**£6.04-£6.75**	£5.40-£6.03	£6.04-£6.75
Number (000)	**172**	**7,075**	10,428	9,479
Weighted average exercise price (£)	**6.01**	**6.52**	6.02	6.50
Weighted average remaining contractual life (years)	–	**0.83**	0.33	1.60
Of which exercisable:				
– number (000)	**172**	**33**	189	79
– weighted average exercise price (£)	**6.01**	**6.32**	5.40	6.75

Notes on the Financial Statements (continued)

11 Tax expense

	2005 £m	2004 £m
Current taxation		
United Kingdom corporation tax charge – current year	**(455)**	(407)
United Kingdom corporation tax charge – adjustment in respect of prior years	**53**	34
Overseas tax – current year	**(349)**	(239)
Overseas tax – adjustment in respect of prior years	**2**	(2)
	(749)	(614)
Deferred taxation		
Origination and reversal of temporary differences	**(99)**	(127)
Adjustment in respect of previous periods	**21**	18
	(78)	(109)
Tax expense	**(827)**	(723)

The bank and its subsidiary undertakings in the United Kingdom provided for UK corporation tax at 30 per cent (2004: 30 per cent). Other overseas subsidiary undertakings and overseas branches provided for taxation at the appropriate rates in the countries in which they operate.

	2005		2004	
	£m	**Percentage of overall tax charge %**	£m	Percentage of overall tax charge %
Analysis of overall tax charge				
Taxation at UK corporate tax rate of 30 per cent (2004: 30 per cent)	**1,136**	**30.0**	886	30.0
Impact of overseas profits in principal locations taxed at different rates	**(26)**	**(0.7)**	(61)	(2.1)
Tax-free gains	**(158)**	**(4.2)**	(12)	(0.4)
Impact of profits in associates and joint ventures	**(23)**	**(0.6)**	–	–
Adjustments in respect of prior period liabilities	**(74)**	**(1.9)**	(86)	(2.9)
Other items	**(28)**	**(0.7)**	(4)	(0.1)
Overall tax charge	**827**	**21.9**	723	24.5

In addition to the amount charged to the income statement the aggregate amount of deferred taxation, relating to items that are charged directly to equity, was £161 million (2004: £92 million).

The group is subject to income taxes in many jurisdictions and significant judgement is required in estimating the group's provision for income taxes. There are many transactions and interpretations of tax law for which the final outcome will not be established until some time later. The group recognises liabilities for taxation based on estimates of whether additional taxes will be payable. The estimation process includes seeking expert advice where appropriate. Where the final liability for taxation is different from the amounts that were initially recorded, these differences will affect the income tax and deferred taxation provisions in the period in which the estimate is revised or the final liability is established.

12 Dividends

	2005		2004	
	£ per share	**£m**	£ per share	£m
Second interim dividend for previous year	**0.88**	**700**	0.88	700
First interim dividend for current year	**0.88**	**700**	0.88	700
	1.76	**1,400**	1.76	1,400

13 Segment analysis

The allocation of earnings reflects the benefit of shareholders' funds to the extent that these costs are actually allocated to businesses in the segment by way of intra-group capital and funding structures.

By geographical region

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

	United Kingdom £m	Continental Europe £m	Rest of the world £m	Intra-group £m	Total £m
2005					
Total operating income					
Net interest income	**2,899**	**1,097**	**46**	**–**	**4,042**
Dividend income	**5**	**23**	**–**	**–**	**28**
Net fee income	**2,107**	**1,164**	**84**	**–**	**3,355**
Net trading income	**1,081**	**599**	**150**	**–**	**1,830**
Net income from financial instruments designated at fair value	**151**	**19**	**–**	**–**	**170**
Net investment income on assets backing policyholders' liabilities	**–**	**–**	**–**	**–**	**–**
Gains less losses from financial investments	**123**	**115**	**10**	**–**	**248**
Net earned insurance premiums	**269**	**169**	**–**	**–**	**438**
Other operating income	**723**	**187**	**9**	**–**	**919**
Total operating income	**7,358**	**3,373**	**299**	**–**	**11,030**
Profit before tax	**2,408**	**1,195**	**183**	**–**	**3,786**
Profit attributable to shareholders	**1,891**	**843**	**163**	**–**	**2,897**
Depreciation and amortisation	**(485)**	**(114)**	**(2)**	**–**	**(601)**
Loan impairment charges	**(811)**	**30**	**5**	**–**	**(776)**
Cost to acquire property, plant and equipment	**(658)**	**(85)**	**(2)**	**–**	**(745)**
Cost to acquire intangibles	**(162)**	**(21)**	**(1)**	**–**	**(184)**
Total assets	**251,370**	**140,747**	**12,684**	**(18,379)**	**386,422**
Total liabilities	**243,062**	**129,377**	**12,572**	**(18,223)**	**366,788**
2004					
Total operating income					
Net interest income	3,265	1,138	77	–	4,480
Dividend income	303	15	–	–	318
Net fee income	1,951	998	83	–	3,032
Net trading income	251	250	93	–	594
Net income from financial instruments designated at fair value	–	–	–	–	–
Net investment income on assets backing policyholders' liabilities	285	26	–	–	311
Gains less losses from financial investments	48	31	–	–	79
Net earned insurance premiums	503	211	–	–	714
Other operating income	433	56	6	–	495
Total operating income	7,039	2,725	259	–	10,023
Profit before tax	1,979	859	115	–	2,953
Profit attributable to shareholders	1,340	620	97	–	2,057
Depreciation and amortisation	(502)	(148)	(2)	–	(652)
Loan impairment charges	(376)	2	3	–	(371)
Cost to acquire property, plant and equipment	(709)	(122)	(2)	–	(833)
Cost to acquire intangibles	(259)	(4)	–	–	(263)
Total assets	185,765	105,864	12,277	(11,425)	292,481
Total liabilities	169,381	103,180	11,833	(11,428)	272,966

Notes on the Financial Statements (continued)

By class of business

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

	2005 £m	2004 £m
Net operating income before loan impairment charges		
UK Personal Financial Services	**3,187**	2,664
UK Commercial Banking	**1,855**	1,713
UK Corporate, Investment Banking and Markets	**1,640**	1,629
International Banking	**1,123**	735
France	**1,622**	1,500
Private Banking	**1,051**	800
HSBC Trinkaus & Burkhardt	**322**	241
	10,800	9,282
Profit/(loss) on ordinary activities before tax		
UK Personal Financial Services	**832**	671
UK Commercial Banking	**812**	676
UK Corporate, Investment Banking and Markets	**393**	508
International Banking	**641**	317
France	**460**	368
Private Banking	**516**	354
HSBC Trinkaus & Burkhardt	**132**	59
	3,786	2,953
Total assets		
UK Personal Financial Services	**63,980**	55,132
UK Commercial Banking	**31,422**	26,338
UK Corporate, Investment Banking and Markets	**138,579**	93,240
International Banking	**18,429**	16,169
France	**90,707**	64,922
Private Banking	**32,651**	27,765
HSBC Trinkaus & Burkhardt	**10,654**	8,915
	386,422	292,481
Cost to acquire property, plant and equipment		
UK Personal Financial Services	**125**	77
UK Commercial Banking	**74**	123
UK Corporate, Investment Banking and Markets	**459**	504
International Banking	**22**	22
France	**50**	77
Private Banking	**9**	18
HSBC Trinkaus & Burkhardt	**6**	12
	745	833
Cost to acquire intangibles		
UK Personal Financial Services	**86**	222
UK Commercial Banking	**25**	20
UK Corporate, Investment Banking and Markets	**31**	16
International Banking	**22**	1
France	**14**	1
Private Banking	**2**	3
HSBC Trinkaus & Burkhardt	**4**	–
	184	263

14 Analysis of financial assets and liabilities by measurement basis

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The principal accounting policies in Note 2 describe how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the financial assets and liabilities in the balance sheet by the class of financial instrument to which they are assigned, and therefore by the measurement basis:

The group

	Held for trading £m	Designated at fair value[1] £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
ASSETS									
Cash and balances at central banks						1,711			1,711
Items in the course of collection from other banks						3,595			3,595
Trading assets	48,510								48,510
Trading assets which may be repledged or resold by counterparties	21,611								21,611
Financial assets designated at fair value		5,345							5,345
Derivatives	24,836	379					64	798	26,077
Loans and advances to banks				31,578					31,578
Loans and advances to customers				182,629					182,629
Financial investments			207		41,310				41,517
Financial investments which may be repledged or resold by counterparties						1,965			1,965
Other assets (including deferred tax)						4,091			4,091
Prepayments and accrued income						3,011			3,011
Total financial assets	94,957	5,724	207	214,207	41,310	14,373	64	798	371,640
Total non-financial assets									14,782
Total assets									386,422
LIABILITIES									
Deposits by banks						34,198			34,198
Customer accounts						205,475			205,475
Items in the course of transmission to other banks						2,268			2,268
Trading liabilities	45,133								45,133
Financial liabilities designated at fair value		8,185							8,185
Derivatives	25,453	567					96	520	26,636
Debt securities in issue						26,801			26,801
Other liabilities (including current taxation)						5,133			5,133
Subordinated liabilities						4,792			4,792
Total financial liabilities	70,586	8,752	–	–	–	278,667	96	520	358,621
Total non-financial liabilities									8,167
Total liabilities									366,788

1 *The derivatives included under 'Designated at fair value' are trading derivatives used to economically hedge the corresponding assets and liabilities designated at fair value.*

Notes on the Financial Statements (continued)

The bank

	Held for trading £m	Designated at fair value[1] £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
ASSETS									
Cash and balances at central banks						689			689
Items in the course of collection from other banks						2,125			2,125
Trading assets	34,733								34,733
Trading assets which may be repledged or resold by counterparties	3,950								3,950
Financial assets designated at fair value		16							16
Derivatives	17,361	155					–	54	17,570
Loans and advances to banks				19,196					19,196
Loans and advances to customers				134,819					134,819
Financial investments			24		15,359				15,383
Financial investments which may be repledged or resold by counterparties						2			2
Other assets (including deferred tax)						2,476			2,476
Prepayments and accrued income						1,490			1,490
Total financial assets	56,044	171	24	154,015	15,359	6,782	–	54	232,449
Total non-financial assets									16,734
Total assets									249,183
LIABILITIES									
Deposits by banks						27,999			27,999
Customer accounts						141,761			141,761
Items in the course of transmission to other banks						805			805
Trading liabilities	21,303								21,303
Financial liabilities designated at fair value		4,321							4,321
Derivatives	16,662	564					1	24	17,251
Debt securities in issue						8,212			8,212
Other liabilities (including current taxation)						2,941			2,941
Subordinated liabilities						4,479			4,479
Total financial liabilities	37,965	4,885	–	–	–	186,197	1	24	229,072
Total non-financial liabilities									3,990
Total liabilities									233,062

1 *The derivatives included under 'Designated at fair value' are trading derivatives used to economically hedge the corresponding assets and liabilities designated at fair value.*

15 Trading assets

	The group		The bank	
	2005	2004	**2005**	2004
	£m	£m	**£m**	£m
Trading assets:				
– which may be repledged or resold by counterparties	**21,611**	–	**3,950**	–
– not subject to repledge or resale by counterparties	**48,510**	40,754	**34,733**	20,598
	70,121	40,754	**38,683**	20,598
Treasury and other eligible bills	**268**	109	**181**	65
Debt securities	**40,550**	30,982	**17,127**	15,941
Equity securities	**8,881**	9,663	**5,592**	4,592
Loans and advances to banks	**7,993**	–	**4,940**	–
Loans and advances to customers	**12,429**	–	**10,843**	–
	70,121	40,754	**38,683**	20,598

16 Financial assets designated at fair value

	2005	
	The group	**The bank**
	£m	**£m**
Financial assets designated at fair value:		
– not subject to repledge or resale by counterparties	**5,345**	**16**

	2005	
	The group	**The bank**
	£m	**£m**
Treasury and other eligible bills	**10**	**–**
Debt securities	**1,614**	**–**
Equity securities	**3,624**	**–**
Loans and advances to banks	**70**	**–**
Loans and advances to customers	**27**	**16**
	5,345	**16**

17 Derivatives

Fair values of derivatives open positions by product contract type held by the group

	At 31 December 2005					
	Assets			**Liabilities**		
	Trading	**Hedging**	**Total**	**Trading**	**Hedging**	**Total**
	£m	**£m**	**£m**	**£m**	**£m**	**£m**
Exchange rate	**6,807**	**34**	**6,841**	**(7,529)**	**(1)**	**(7,530)**
Interest rate	**18,165**	**828**	**18,993**	**(18,329)**	**(615)**	**(18,944)**
Equities	**2,254**	**–**	**2,254**	**(2,181)**	**–**	**(2,181)**
Credit derivatives	**687**	**–**	**687**	**(677)**	**–**	**(677)**
Commodity and other	**3**	**–**	**3**	**(5)**	**–**	**(5)**
Gross total fair values	**27,916**	**862**	**28,778**	**(28,721)**	**(616)**	**(29,337)**
Netting			**(2,701)**			**2,701**
Total			**26,077**			**(26,636)**

Notes on the Financial Statements (continued)

	At 31 December 2004	
	Total assets	Total liabilities
	£m	£m
Exchange rate	10,106	(10,860)
Interest rate	14,753	(14,043)
Equities	1,239	(1,287)
Credit derivatives	214	(226)
Commodity and other	2	(4)
Gross total fair values	26,314	(26,420)
Netting	(13,029)	13,029
Total	13,285	(13,391)

Fair values of derivatives open positions by product contract type held by the bank

	Year ended 31 December			
	2005		2004	
	Assets	**Liabilities**	Assets	Liabilities
	£m	**£m**	£m	£m
Exchange rate	**6,602**	**(7,246)**	9,653	(10,415)
Interest rate	**9,223**	**(8,419)**	5,030	(4,291)
Equities	**1,062**	**(913)**	824	(1,042)
Credit derivatives	**683**	**(673)**	214	(226)
Gross total fair values	**17,570**	**(17,251)**	15,721	(15,974)
Netting	–	–	(5,025)	5,025
Total	**17,570**	**(17,251)**	10,696	(10,949)

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

Derivatives are carried at fair value and shown in the balance sheet as separate totals of assets and liabilities. Asset values represent the cost to the group of replacing all transactions with a fair value in the group's favour assuming that all the group's relevant counterparties default at the same time, and that transactions can be replaced instantaneously. Liability values represent the cost to the group counterparties of replacing all their transactions with the group with a fair value in their favour if the group were to default. Derivative assets and liabilities on different transactions are only netted if the transactions are with the same counterparty, a legal right of set-off exists and the cash flows are intended to be settled on a net basis.

(a) Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge the group's own risks. For accounting purposes, derivative instruments are classified as held either for trading or hedging. Derivatives that are held as hedging instruments are formally designated as hedges as defined in IAS 39. All other derivative instruments are classified as held-for-trading. The held-for-trading classification includes two types of derivative instruments: those used in sales and trading activities, and those instruments that are used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second type of held-for-trading 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 offsetting deals being utilised to achieve this where necessary. Whilst the group employs the same credit risk management procedures to approve potential credit exposures for derivatives as are used for traditional lending, the calculations and procedures used to assess credit risk for derivatives are more complex.

(b) 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. Ineffective hedging derivatives were previously designated as hedges, but no longer meet the criteria for hedge accounting.

Contract amounts of derivatives held-for-trading purposes by product type

	Year ended 31 December			
	2005		2004	
	The group £m	**The bank £m**	The group £m	The bank £m
Exchange rate	**919,147**	**804,652**	434,789	380,937
Interest rate	**4,196,149**	**2,049,064**	1,142,253	432,114
Equities	**56,698**	**20,289**	23,144	11,255
Credit derivatives	**161,095**	**160,312**	37,141	37,134
Commodity	**351**	**60**	378	9
Total derivatives	**5,333,440**	**3,034,377**	1,637,705	861,449

The notional or contractual amounts of these instruments indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

Derivatives valued using models with unobservable inputs

The amount that has yet to be recognised in the income statement relating to the difference between the fair value at initial recognition (the transaction price) and the amount that would have arisen had valuation techniques used for subsequent measurement been applied at initial recognition, less subsequent releases, is as follows:

	2005 £m
Unamortised balance at 1 January	**16**
Deferral on new transactions	**86**
Recognised in the income statement during the period:	
– amortisation	**(5)**
– subsequent to observability	**(19)**
– maturity or termination	**(10)**
– FX movements and other	**(5)**
Unamortised balance at 31 December	**63**

Notes on the Financial Statements (continued)

(c) 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, or cash flow hedges. These are described under the relevant headings below.

Contract amounts of derivatives held for hedging purposes by product type

	At 31 December 2005			
	The group		The bank	
	Cash flow hedge £m	Fair value hedge £m	Cash flow hedge £m	Fair value hedge £m
Exchange rate contracts	37	232	–	–
Interest rate contracts	168,501	8,338	32	131

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.

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

The fair values of outstanding derivatives designated as fair value hedges at 31 December 2005, were assets of £64 million and liabilities of £96 million.

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

	2005	
	The group £m	The bank £m
Gains/(losses) arising from the change in fair value of fair value hedges:		
– on hedged instruments	(9)	3
– on hedged items attributable to the hedged risk	19	0

The amount reported in the income statement in respect of the ineffectiveness of fair value hedges was insignificant in the year ended 31 December 2005.

Cash flow hedges

The group is exposed 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. These are initially recognised directly in equity as gains or losses not recognised in the income statement and are transferred to current period earnings when the forecast cash flows affect net profit or loss.

At 31 December 2005, the fair values of outstanding derivatives designated as cash flow hedges of forecast transactions were assets of £798 million and liabilities of £520 million.

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2005 is as follows:

	At 31 December 2005			
	3 months or less	**More than 3 months but less than 1 year**	**5 years or less but more than 1 year**	**More than 5 years**
	£m	**£m**	**£m**	**£m**
Cash inflows from assets	**19,326**	**15,049**	**15,845**	**826**
Cash outflows from liabilities	**(7,781)**	**(4,285)**	**(4,285)**	**(152)**
Net cash inflows / (outflows)	**11,545**	**10,764**	**11,560**	**674**

Reconciliation of movements in the cash flow hedge reserve

	At 31 December 2005	
	The group	**The bank**
	£m	**£m**
At 1 January	**177**	**–**
Amounts recognised directly in equity during the year	**93**	**30**
Amounts removed from equity and included in the income statement for the year	**(238)**	**(59)**
Deferred taxation	**46**	**9**
At 31 December	**78**	**(20)**

The amount reported in the income statement in respect of the ineffectiveness of cash flow hedges was £2 million in the year-ended 31 December 2005.

(d) Sensitivity of fair values to changing significant assumptions to reasonably possible alternatives

Fair values of financial instruments recognised in the financial statements may be determined in whole or in part using valuation techniques based on assumptions that are not supported by prices from current market transactions or observable market data. In these instances, the net fair value recorded in the financial statements is the sum of three components:

(i) the value given by application of a valuation model, based upon the group's best estimate of the most appropriate model inputs;

(ii) any fair value adjustments to account for market features not included within the valuation model (for example, bid-mid spreads, counterparty credit spreads and/or market data uncertainty); and

(iii) inception profit, or an unamortised element thereof, not recognised immediately in the income statement in accordance with Note 2, and separately detailed within (b) above.

As the valuation models are based upon assumptions, changing the assumptions will change the resultant estimate of fair value. The group performs various sensitivity analyses on these valuation assumptions. The potential effect of using reasonably possible alternative assumptions in valuation models has been quantified as a reduction in assets of approximately £20 million using less favourable assumptions, and an increase in assets of approximately £20 million using more favourable assumptions. The ranges of reasonably possible alternative assumptions are established by application of professional judgement to an analysis of the data available to support each assumption.

The total amount of the change in fair value estimated using a valuation technique that was recognised in the year ended 31 December 2005 was a loss of £31 million.

Fair value profits on derivatives and complex structured products indicated by a valuation model for which observable market data are not available for key components are not recognised immediately in the income statement. These profits are recognised in the income statement when the model valuation inputs become observable in external markets or when the transaction matures or is closed out. The table below summarises the group's portfolios held at fair value by valuation methodology at 31 December 2005:

Notes on the Financial Statements (continued)

	Assets		Liabilities	
	Trading Securities Purchased %	**Derivatives %**	**Trading securities sold %**	**Derivatives %**
Fair value based on:				
Quoted market prices	92.4	1.5	99.9	1.2
Internal models with significant observable market parameters	7.6	96.7	0.1	98.0
Internal models with significant unobservable market parameters	–	1.8	–	0.8
	100.0	100.0	100.0	100.0

18 Financial investments

	2005		2004	
	The group £m	**The bank £m**	The group £m	The bank £m
Financial investments:				
– which may be pledged or resold by counterparties	**1,965**	**2**	–	–
– not subject to repledge or resale by counterparties	**41,517**	**15,383**	37,594	14,648
	43,482	**15,385**	37,594	14,648

The group

	2005		2004
	Carrying value £m	**Fair value £m**	Carrying value £m
Treasury and other eligible bills	**3,950**	**3,950**	5,774
– available-for-sale	**3,950**	**3,950**	
– held-to-maturity	–	–	
Debt securities	**37,371**	**37,371**	29,970
– available-for-sale	**37,234**	**37,234**	
– held-to-maturity	**137**	**137**	
Equity securities	**2,161**	**2,161**	1,850
– available-for-sale	**2,161**	**2,161**	
Total financial investments	**43,482**	**43,482**	37,594

The bank

	2005		2004
	Carrying value £m	**Fair value £m**	Carrying value £m
Treasury and other eligible bills	**3,554**	**3,554**	5,433
– available-for-sale	**3,554**	**3,554**	
– held-to-maturity	–	–	
Debt securities	**11,505**	**11,505**	9,096
– available-for-sale	**11,505**	**11,505**	
– held-to-maturity	–	–	
Equity securities	**326**	**326**	119
– available-for-sale	**326**	**326**	
Total financial investments	**15,385**	**15,385**	14,648

19 Securitisations and other structured transactions

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 the full or partial derecognition of the financial assets concerned.

(i) Full derecognition occurs when the group transfers its contractual right to receive cash flows from the financial assets and substantially all the risks and rewards of ownership. The risks include credit, interest rate, currency, prepayment and other price risks.

(ii) Partial derecognition occurs when the group sells or otherwise transfers financial assets in such a way that some but not substantially all of the risks and rewards of ownership are transferred but control is retained. These financial assets are recognised on the balance sheet to the extent of the group's continuing involvement.

The majority of transferred financial assets that do not qualify for derecognition are (i) debt securities held by counterparties as collateral under repurchase agreements or (ii) equity securities lent under securities lending agreements. The following table analyses the carrying amount of financial assets as at 31 December 2005 that did not qualify for derecognition during the year and their associated financial liabilities:

	Carrying amount of assets £m	Carrying amount of associated liabilities £m
Nature of transaction		
Repurchase agreements	**21,537**	**13,348**
Securities lending agreements	**2,765**	**2,590**
Total	**24,302**	**15,938**

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

The rights and obligations that the group retains from its continuing involvement in securitisations are initially recorded as an allocation of the fair value of the financial asset between the part that is derecognised and the part that continues to be recognised on the date of transfer. The following is an analysis of the carrying amount of financial assets at 31 December 2005, to the extent of the group's continuing involvement, that qualified for partial derecognition during the year, and their associated liabilities:

	Carrying amount of assets (original) £m	Carrying amount of assets (currently recognised) £m	Carrying amount of associated liabilities £m
Nature of transaction			
Securitisations	**2,565**	**18**	**18**

Notes on the Financial Statements (continued)

20 Interests in associates and joint ventures

Principal associates of the group

	At 31 December 2005		
	Country of incorporation	**The group's interest in equity capital**	**Issued equity capital**
Erisa	France	49.99%	€115m
AEA Investors (Cayman) I LP[1]	–[2]	–[2]	–[2]
HSBC PE European No. 2 LP[1]	–[3]	–[3]	–[3]
Private Equity Portfolio (Investment) LP Inc[1]	–[4]	–[4]	–[4]

1 *Limited partnership where the group owns more than 50% but does not have control due to the limitations within these types of entities.*
2 *Venture Capital Limited partnership. Address of principal place of business is c/o Walkers SPV Limited, Walker House, 87 Mary Street, PO Box 908GT, George Town, Grand Cayman, Cayman Islands.*
3 *Limited partnership. Address of principal place of business is 68 Upper Thames Street, London EC4V 3PE.*
4 *Limited partnership. Address of principal place of business is 68 Upper Thames Street, London EC4V 3PE.*

All the above investments in associates are owned by subsidiaries of HSBC Bank plc.

Summarised aggregate financial information on associates

	2005	2004
	£m	£m
Assets	**4,764**	3,904
Liabilities	**4,515**	3,703
Net Income	**27**	60

Interests in joint ventures

	At 31 December 2005		
	Principal activity	**HSBC's interest in equity capital**	**Issued equity capital**
International Transaction Services	Outsourcing support	51%	€5m

Although the group owns more than 50 per cent of the equity capital of International Transaction Services, the agreement with the other shareholder means that there are severe long-term restrictions which substantially hinder the group's rights over the assets and management of the entity. The group does however continue to exercise significant influence and together with the other shareholder controls the entity.

Summarised aggregate financial information on joint ventures

	2005	2004
	£m	£m
Assets	**67**	68
Liabilities	**67**	68
Net Income	**48**	(2)

21 Goodwill and intangible assets

'Goodwill and intangible assets' includes goodwill arising on business combinations, the present value of in-force long-term assurance business, and other intangible assets.

Goodwill

The group

	2005 £m	2004 £m
Cost		
At 1 January	**8,438**	8,324
Additions[1]	**288**	207
Disposals	**(41)**	(1)
Exchange translation differences	**(61)**	(85)
Other changes[2]	**40**	(7)
At 31 December	**8,664**	8,438
Accumulated impairment losses		
At 1 January	**–**	–
Disposals	**–**	1
Impairment losses recognised in profit or loss	**–**	(1)
At 31 December	**–**	–
Net book value at 31 December	**8,664**	8,438

1 *2005 Additions include goodwill arising on the acquisition of the HFC Cards Business of £248 million.*
2 *2005 Other changes include an increase in goodwill of £44 million arising from the increase in stake of HSBC Trinkaus & Burkhardt KGaA.*

The bank

	2005 £m	2004 £m
Cost		
At 1 January	**56**	33
Additions	**262**	21
Exchange translation differences	**3**	–
Other changes	**–**	2
At 31 December	**321**	56
Accumulated impairment losses		
At 1 January	**–**	–
At 31 December	**–**	–
Net book value at 31 December	**321**	56

1 *2005 Additions include goodwill arising on the acquisition of the HFC Cards Business of £248 million.*

The present value of in-force long-term assurance business ('PVIF')

PVIF-specific assumptions

The key assumptions used in the computation of PVIF for the group's main insurance company are:

	UK Life
Risk free rate	**3.90%**
Risk discount rate	**8.00%**
Expenses inflation	**3.20%**

Movement on the PVIF

	2005 £m
At 1 January	–
IFRS transition adjustment at 1 January 2005	**527**
Addition from current year new business	**45**
Movement from in-force business	**(74)**
Exchange and other adjustments	**(35)**
At 31 December	**463**

Notes on the Financial Statements (continued)

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 reflect local market conditions and management's judgement of local future trends. The calculations are consistent in their objective of achieving a valuation that reflects the shareholder's interest in the in-force business of the life insurance operations. Some of the group's insurance operations incorporate risk margins separately into the projection assumptions for each product, while others incorporate risk margins into the overall discount rate. This is reflected in the wide range of risk discount rates applied. The use of different methodology is, *inter alia*, attributable to the differing nature of the products being valued and the constitution and structure of the local funds, but it represents a consistent application of the policy.

Other intangible assets

The analysis of the movement of intangible assets, excluding the present value of in-force long-term assurance business, for the year ended 31 December 2005 is as follows:

The group

	Trade names £m	Internally generated software £m	Purchased software £m	Customer/ merchant relation-ships £m	Other £m	Total[1] £m
Cost						
At 1 January 2005	**14**	**475**	**7**	**8**	**194**	**698**
Additions[2]	**–**	**110**	**13**	**57**	**4**	**184**
Disposals	**–**	**–**	**(34)**	**–**	**–**	**(34)**
Exchange translation differences	**2**	**(5)**	**–**	**–**	**–**	**(3)**
Other changes	**–**	**(2)**	**70**	**(3)**	**2**	**67**
At 31 December 2005	**16**	**578**	**56**	**62**	**200**	**912**
Accumulated amortisation						
At 1 January 2005	**(3)**	**(296)**	**(6)**	**(8)**	**(2)**	**(315)**
Charge for the year[3]	**(2)**	**(78)**	**(24)**	**(5)**	**(9)**	**(118)**
Disposals	**–**	**–**	**15**	**–**	**–**	**15**
Exchange translation differences	**(1)**	**4**	**–**	**–**	**–**	**3**
Other changes	**1**	**4**	**(15)**	**4**	**–**	**(6)**
At 31 December 2005	**(5)**	**(366)**	**(30)**	**(9)**	**(11)**	**(421)**
Net book value at 31 December 2005	**11**	**212**	**26**	**53**	**189**	**491**
Cost						
At 1 January 2004	11	457	9	12	(6)	483
Additions[2]	–	78	–	(4)	189	263
Disposals	–	–	(2)	–	–	(2)
Exchange translation differences	3	(1)	–	–	–	2
Other changes	–	(59)	–	–	11	(48)
At 31 December 2004	14	475	7	8	194	698
Accumulated amortisation						
At 1 January 2004	–	(290)	(7)	4	–	(293)
Charge for the year[3]	(1)	(64)	(1)	(1)	(1)	(68)
Disposals	–	–	–	–	–	–
Other changes	(2)	58	2	(11)	(1)	46
At 31 December 2004	(3)	(296)	(6)	(8)	(2)	(315)
Net book value at 31 December 2004	11	179	1	–	192	383

1 *Included in the above is intangible assets relating to the purchase of the HFC Cards Business with a net book value of £38 million, on which the amortisation charge for the year to 31 December 2005 was £3 million and intangible assets relating to Marks and Spencer Retail Financial Services Holdings Limited with a net book value of £174 million (2004: £183 million), on which the amortisation charges for the year to 31 December 2005 was £9 million (2004: £1 million).*
2 *The group has £32 million (2004: £46 million) of contractual commitments on the acquisition of intangible assets in the year.*
3 *The amortisation charge for the year is recognised within the income statement under 'Amortisation of intangible assets and impairment of goodwill'.*

The bank

	Internally generated software £m	Customer/ merchant relation-ships £m	Other £m	Total[1] £m
Cost				
At 1 January 2005	**373**	**–**	**–**	**373**
Additions[2]	**105**	**41**	**2**	**148**
Other changes	**1**	**–**	**–**	**1**
At 31 December 2005	**479**	**41**	**2**	**522**
Accumulated amortisation				
At 1 January 2005	**(200)**	**–**	**–**	**(200)**
Charge for the year[3]	**(72)**	**(3)**	**–**	**(75)**
Other changes	**(1)**	**–**	**–**	**(1)**
At 31 December 2005	**(273)**	**(3)**	**–**	**(276)**
Net book value at 31 December 2005	**206**	**38**	**2**	**246**
Cost				
At 1 January 2004	357	–	–	357
Additions[2]	75	–	–	75
Other changes	(59)	–	–	(59)
At 31 December 2004	373	–	–	373
Accumulated amortisation				
At 1 January 2004	(203)	–	–	(203)
Charge for the year[3]	(56)	–	–	(56)
Other changes	59	–	–	59
At 31 December 2004	(200)	–	–	(200)
Net book value at 31 December 2004	173	–	–	173

1 Included in the above is intangible assets relating to the purchase of the HFC Cards Business with a net book value of £38 million, on which the amortisation charge for the year to 31 December 2005 was £3 million.

2 The group has £32 million (2004: £46 million) of contractual commitments on the acquisition of intangible assets in the year.

3 The amortisation charge for the year is recognised within the income statement under 'Amortisation of intangible assets and impairment of goodwill'.

22 Impairment of assets other than financial instruments

During 2005 there was no impairment of goodwill (2004: Nil).

The recoverable amount of cash generating units ('CGUs') has been determined at 1 July 2005 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 GDP and inflation for the countries within which the CGU operates. 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 cash-generating unit 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.

Notes on the Financial Statements (continued)

Management judgement is required in estimating the future cash flows of the cash-generating units. 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 following CGUs include in their carrying value goodwill that is a significant proportion of total goodwill reported by the group. These CGUs do not carry on their balance sheet any intangible assets with indefinite useful lives, other than goodwill.

Cash Generating Unit ('CGU')	Goodwill at 1 July 2005	Discount rate	Nominal growth rate beyond initial cash flow projections
	£m	%	%
Private Banking	3,035	10.0	4.3
France	4,895	8.5	4.3
Total goodwill in the CGUs listed above	7,930	8.5	4.3

During 2005 there was no impairment of the carrying amount of investments in subsidiaries in the bank's financial statements. A review of the net asset value of the subsidiaries against carrying value is performed on an annual basis to determine whether an impairment is required.

23 Property, plant and equipment

The group

	Freehold land and buildings[1]	Long leasehold land and buildings	Short leasehold land and buildings	Equipment, fixtures and fittings[2]	Equipment on operating leases	Total[3]
	£m	£m	£m	£m	£m	£m
Cost or fair value						
At 1 January 2005	1,076	362	261	2,527	3,149	7,375
Additions at cost[4]	23	–	15	303	404	745
Acquisition of subsidiaries	1	–	–	–	–	1
Fair value adjustments	10	–	–	–	–	10
Disposals	(61)	–	(21)	(163)	(195)	(440)
Transfers	–	–	(1)	3	–	2
Exchange translation differences	(14)	–	(2)	14	–	(2)
Other changes	10	8	(17)	(212)	(612)	(823)
At 31 December 2005	1,045	370	235	2,472	2,746	6,868
Accumulated depreciation						
At 1 January 2005	(65)	(12)	(160)	(1,537)	(906)	(2,680)
Depreciation charge for the year	(24)	(9)	(12)	(274)	(164)	(483)
Disposals	1	–	19	112	132	264
Transfers	–	–	1	(2)	–	(1)
Exchange translation differences	1	–	–	(13)	–	(12)
Other changes	(3)	(7)	(1)	158	216	363
At 31 December 2005	(90)	(28)	(153)	(1,556)	(722)	(2,549)
Net book value at 31 December 2005	955	342	82	916	2,024	4,319

1 *Includes assets held on finance leases with a net book value of £nil (2004: £12 million), on which the depreciation charge for the year ended 31 December 2005 was £nil (2004: £nil).*
2 *Includes assets held on finance leases with a net book value of £147 million (2004: £112 million), on which the depreciation charge for the year ended 31 December 2005 was £2 million (2004: £nil).*
3 *Includes assets with a net book value of £147 million (2004: £124 million) pledged as security for liabilities, on which the depreciation charge for the year ended 31 December 2005 was £2 million (2004: £nil).*
4 *HSBC Bank plc incurred £490 million of contractual commitments on the acquisition of tangible assets in 2005.*

	Freehold land and buildings £m	Long leasehold land and buildings £m	Short leasehold land and buildings £m	Equipment, fixtures and fittings £m	Equipment on operating leases £m	Total £m
Cost or fair value						
At 1 January 2004	1,101	372	266	2,321	2,838	6,898
Additions at cost	14	(5)	10	268	546	833
Acquisition of subsidiaries	–	–	–	16	–	16
Fair value adjustments	5	2	–	–	–	7
Disposals	(30)	–	(3)	(96)	(235)	(364)
Transfers	–	(1)	–	(1)	–	(2)
Exchange translation differences	–	–	–	13	–	13
Other changes	(14)	(6)	(12)	6	–	(26)
At 31 December 2004	1,076	362	261	2,527	3,149	7,375
Accumulated depreciation						
At 1 January 2004	(36)	(5)	(162)	(1,304)	(843)	(2,350)
Depreciation charge for the year	(36)	(9)	(12)	(309)	(217)	(583)
Disposals	2	–	3	91	154	250
Transfers	–	–	–	(2)	–	(2)
Exchange translation differences	(3)	–	(1)	(11)	–	(15)
Other changes	8	2	12	(2)	–	20
At 31 December 2004	(65)	(12)	(160)	(1,537)	(906)	(2,680)
Net book value at 31 December 2004	1,011	350	101	990	2,243	4,695

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 2005	**441**	**366**	**216**	**1,763**	**2,786**
Additions at cost[1]	**11**	**–**	**13**	**212**	**236**
Disposals	**–**	**–**	**(21)**	**(55)**	**(76)**
Transfers	**–**	**–**	**–**	**2**	**2**
Other changes	**2**	**10**	**–**	**–**	**12**
At 31 December 2005	**454**	**376**	**208**	**1,922**	**2,960**
Accumulated depreciation					
At 1 January 2005	**(42)**	**(12)**	**(155)**	**(1,095)**	**(1,304)**
Depreciation charge for the year	**(13)**	**(9)**	**(8)**	**(197)**	**(227)**
Disposals	**–**	**–**	**18**	**39**	**57**
Transfers	**–**	**–**	**–**	**(1)**	**(1)**
Other changes	**(7)**	**(7)**	**(2)**	**–**	**(16)**
At 31 December 2005	**(62)**	**(28)**	**(147)**	**(1,254)**	**(1,491)**
Net book value at 31 December 2005	**392**	**348**	**61**	**668**	**1,469**

1 *HSBC Bank plc incurred £176 million of contractual commitments on the acquisition of tangible assets in 2005.*

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 2004	462	358	210	1,667	2,697
Additions at cost	1	14	7	162	184
Disposals	(19)	–	(3)	(70)	(92)
Transfers	–	–	–	1	1
Other changes	(3)	(6)	2	3	(4)
At 31 December 2004	441	366	216	1,763	2,786
Accumulated depreciation					
At 1 January 2004	(37)	(5)	(148)	(964)	(1,154)
Depreciation charge for the year	(14)	(9)	(10)	(192)	(225)
Disposals	2	–	2	64	68
Transfers	–	–	–	(3)	(3)
Other changes	7	2	1	–	10
At 31 December 2004	(42)	(12)	(155)	(1,095)	(1,304)
Net book value at 31 December 2004	399	354	61	668	1,482

Included within 'Short leasehold land and buildings' are the following amounts in respect of assets classed as improvements to buildings, which are carried at depreciated historical cost:

The group

	2005		2004	
	Cost £m	**Accumulated depreciation £m**	Cost £m	Accumulated depreciation £m
At 1 January	**228**	**(162)**	231	(164)
Additions	**15**	**–**	10	–
Disposals	**(21)**	**18**	(3)	2
Transfers	**–**	**–**	–	(11)
Depreciation charge for the year	**–**	**(8)**	–	–
Exchange translation differences	**–**	**–**	1	(1)
Other changes	**9**	**2**	(11)	12
At 31 December	**231**	**(150)**	228	(162)
Net book value at 31 December	**81**		66	

The bank

	2005		2004	
	Cost £m	**Accumulated depreciation £m**	Cost £m	Accumulated depreciation £m
At 1 January	**215**	**(158)**	210	(151)
Additions	**13**	**–**	7	–
Disposals	**(21)**	**18**	(3)	2
Depreciation charge for the year	**–**	**(8)**	–	(9)
Other changes	**–**	**(2)**	1	–
At 31 December	**207**	**(150)**	215	(158)
Net book value at 31 December	**57**		57	

Investment properties

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

	Freehold land and buildings[1] £m
Fair value	
At 1 January 2005	**19**
Additions at cost	**11**
Disposals	**(22)**
Fair value adjustments	**10**
Other changes	**9**
At 31 December 2005	**27**
Fair value	
At 1 January 2004	45
Additions at cost	–
Disposals	–
Fair value adjustments	–
Other changes	(24)
At 31 December 2004	19

1 *Included in Property, plant and equipment on page 74*

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. A surplus of £10 million (2004: surplus of £6 million) was credited to the income statement for the year ended 31 December 2005.

Included within 'Other operating income' was rental income of £2 million (2004: £1 million) earned by the group on its investment properties. Direct operating expenses of £nil (2004: £nil) incurred in respect of the investment properties during the year were recognised in 'General and administrative expenses'.

Group properties leased to customers

The group properties leased to customers, none of which was held by the group, included £25 million at 31 December 2005 (2004: £28 million) let under operating leases, net of accumulated depreciation of £18 million (2004: £20 million).

Notes on the Financial Statements (continued)

24 Investments

Principal subsidiary undertakings of HSBC Bank plc

	Country of incorporation or registration	HSBC Bank plc's interest in equity capital %
HSBC France (formerly CCF S.A.)	France	99.99
HSBC Asset Finance (UK) Limited	England	100
HSBC Bank A.S.	Turkey	100
HSBC Bank International Limited	Jersey	100
HSBC Bank Malta p.l.c.	Malta	68.19
HSBC Guyerzeller Bank AG	Switzerland	99.72
HSBC Invoice Finance (UK) Limited	England	100
HSBC Life (UK) Limited	England	100
HSBC Rail (UK) Limited	England	100
HSBC Private Bank (Guernsey) Limited	Guernsey	99.72
HSBC Private Bank (Suisse) S.A.	Switzerland	94.29
HSBC Private Bank (UK) Limited	England	99.72
HSBC Trinkaus & Burkhardt KGaA	Germany	77.89
HSBC Trust Company (UK) Limited	England	100
Marks and Spencer Retail Financial Services Holdings Limited	England	100

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

Acquisitions

HSBC Bank plc made the following acquisitions of subsidiary undertakings or business operations in 2005, which were accounted for on an acquisition basis:

On 31 December 2005, the group increased its stake in HSBC Trinkaus & Burkhardt KGaA by 4.42 per cent for a cash consideration of £69 million. Goodwill of £44 million arose on the acquisition.

During 2005, as part of the reorganisation of The Bank of Bermuda Limited, the group purchased subsidiary undertakings and business operations for a total cash consideration of £122 million. Goodwill of £34 million was transferred into the group on these acquisitions.

25 Other assets

	The group		The bank	
	2005	2004	**2005**	2004
	£m	£m	**£m**	£m
Bullion	**114**	5	**66**	–
Assets held for sale	**25**	25	**16**	8
Reinsurance assets	**594**	725	**–**	–
Current taxation recoverable	**20**	35	**–**	11
Endorsements and acceptances	**539**	–	**476**	–
Other accounts	**2,604**	3,456	**911**	571
	3,896	4,246	**1,469**	590

Assets held for sale

	The group		The bank	
	2005	2004	**2005**	2005
	£m	£m	**£m**	£m
Disposal groups				
Property, plant and equipment	**25**	25	**16**	8
Non-current assets held for sale	**25**	25	**16**	8
Total assets classified as held for sale	**25**	25	**16**	8

The property, plant and equipment classified as held for sale is a result of repossession of property that had been pledged as collateral by the customers.

26 Financial liabilities designated at fair value

	2005	
	The group	**The bank**
	£m	**£m**
Deposits by banks	**1**	**–**
Liabilities to customers under investment contracts	**3,649**	**–**
Debt securities in issue	**205**	**–**
Subordinated liabilities	**4,006**	**4,321**
Preference shares	**324**	**–**
	8,185	**4,321**

The difference between the carrying amount of financial liabilities designated at fair value and the contractual amount at maturity at 31 December 2005 for the group was a gain of £255 million (the bank: £272 million).

At 31 December 2005, the accumulated amount of the change in fair value attributable to changes in credit risk for the group was £13 million (the bank: £14 million).

27 Other liabilities

	The group		The bank	
	2005	2004	**2005**	2004
	£m	£m	**£m**	£m
Amounts due to investors in funds consolidated by the group	**396**	333	**–**	–
Share-based payments	**89**	–	**56**	–
Obligations under finance leases	**324**	320	**–**	–
Endorsements and acceptances	**539**	–	**476**	–
Other liabilities	**3,440**	4,726	**2,314**	861
	4,788	5,379	**2,846**	861
Obligations under finance leases falling due:				
– between 1 and 5 years	**7**	–	**–**	–
– over 5 years	**317**	320	**–**	–
	324	320	**–**	–

28 Liabilities under insurance contracts issued

	2005		
	Gross	**Reinsurance**	**Net**
	£m	**£m**	**£m**
Non-life insurance provisions			
Unearned premiums	**313**	**(23)**	**290**
Notified claims	**89**	**(39)**	**50**
Claims incurred but not reported	**32**	**(18)**	**14**
	434	**(80)**	**354**
Policyholder liabilities			
Life (non-linked)	**847**	**(474)**	**373**
Life (linked)	**697**	**(40)**	**657**
	1,544	**(514)**	**1,030**
Total liabilities under insurance contracts[1]	**1,978**	**(594)**	**1,384**

1 *Though investment contracts with discretionary participation features are financial instruments, the group continued to treat them as insurance contracts as permitted by IFRS 4.*

Notes on the Financial Statements (continued)

The movement of liabilities under insurance contracts for the year ended 31 December 2005 was as follows:

Non-life insurance

	Year ended 31 December 2005		
	Gross £m	Reinsurance £m	Net £m
Unearned premium provision			
At 1 January	288	–	288
Gross written premiums	(200)	56	(144)
Gross earned premiums	188	(57)	131
Foreign exchange and other movements	37	(22)	15
At 31 December	313	(23)	290
Notified and incurred but not reported			
At 1 January	124	(64)	60
– notified claims	86	(41)	45
– claims incurred but not reported	38	(23)	15
Claims paid in respect of current year	(79)	35	(44)
Current year notifications	76	(29)	47
Foreign exchange and other movements	–	1	1
At 31 December			
– notified claims	89	(39)	50
– claims incurred but not reported	32	(18)	14
At 31 December	121	(57)	64

Life insurance policyholder liabilities

	Year ended 31 December 2005		
	Gross £m	Reinsurance £m	Net £m
Life non-linked			
At 1 January	944	(505)	439
Benefits paid	(92)	56	(36)
Current year notifications	100	(39)	61
Foreign exchange and other movements	(105)	14	(91)
At 31 December	847	(474)	373
Life (linked)			
At 1 January	660	(89)	571
Benefits paid	(124)	6	(118)
Current year notifications	85	–	85
Foreign exchange and other movements	76	43	119
At 31 December	697	(40)	657
Total policyholder liabilities	1,544	(514)	1,030

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

29 Provisions

Deferred taxation

The group

	2005			2004		
	Deferred tax asset £m	**Deferred tax liability £m**	**Total £m**	Deferred tax asset £m	Deferred tax liability £m	Total £m
Temporary differences:						
– retirement benefits	**821**	**58**	**879**	841	–	841
– provision for loan impairment charges	**88**	**41**	**129**	154	–	154
– assets leased to customers	**(696)**	**(24)**	**(720)**	(845)	1	(844)
– revaluation of property	**(36)**	**(67)**	**(103)**	(42)	(54)	(96)
– accelerated capital allowances	**(49)**	**(1)**	**(50)**	(51)	–	(51)
– other short term timing differences	**50**	**(147)**	**(97)**	88	(275)	(187)
Unused tax losses	**17**	**1**	**18**	9	–	9
	195	**(139)**	**56**	154	(328)	(174)

The amount of deferred tax assets for which no deferred tax is recognised in the balance sheet is £113 million (2004: £120 million). This amount is in respect of capital losses that have no expiry date where the recoverability of the potential benefits is not considered likely.

The bank

	2005			2004		
	Deferred tax asset £m	**Deferred tax liability £m**	**Total £m**	Deferred tax asset £m	Deferred tax liability £m	Total £m
Temporary differences:						
– retirement benefits	**821**	**–**	**821**	841	–	841
– provision for loan impairment charges	**85**	**–**	**85**	90	–	90
– revaluation of property	**(36)**	**–**	**(36)**	(42)	–	(42)
– accelerated capital allowances	**(45)**	**–**	**(45)**	(52)	–	(52)
– other short term timing differences	**165**	**(12)**	**153**	88	(4)	84
Unused tax losses	**17**	**–**	**17**	9	–	9
	1,007	**(12)**	**995**	934	(4)	930

The amount of temporary differences for which no deferred tax is recognised in the balance sheet is £104 million (2004: £108 million). This amount is in respect of capital losses that have no expiry date where the recoverability of the potential benefits is not considered likely.

Other provisions

The group

	Provisions £m
At 1 January 2005	**434**
Additional provisions/increase in provisions[1]	**217**
Provisions utilised	**(101)**
Amounts reversed	**(159)**
Exchange and other movements	**(7)**
At 31 December 2005	**384**

1 *Includes unwinding of discounts of £6 million (2004: £7 million) in relation to vacant space provisions.*

Included above is a provision of £73 million (2004: £75 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.

The bank

	Provisions £m
At 1 January 2005	**176**
Additional provisions/increase in provisions[1]	**49**
Provisions utilised	**(16)**
Amounts reversed	**(84)**
Exchange and other movements	**(1)**
At 31 December 2005	**124**

1 *Includes unwinding of discounts of £6 million (2004: £7 million) in relation to vacant space provisions.*

The above includes provisions for onerous property contracts of £87 million (2004: £105 million), of which £19 million (2004: £21 million) relates to discounted future costs associated with leasehold properties that became vacant as a consequence of the bank's move to Canary Wharf in 2002. The provisions cover rent voids while finding new tenants, shortfalls in expected rent receivable compared with rent payable, and the cost of refurbishing the buildings to attract tenants. Uncertainties arise from movements in market rents, delays in finding new tenants and the timing of rental reviews.

30 Subordinated liabilities

The group	Book value **2005 £m**	Book value 2004 £m
Subordinated liabilities:		
– At amortised cost	**4,792**	5,370
Subordinated liabilities	**2,297**	5,370
Preference shares	**2,495**	–
– Designated at fair value	**4,330**	–
Subordinated liabilities	**4,006**	–
Preference shares	**324**	–
	9,122	5,370

The bank	Book value **2005 £m**	Book value 2004 £m
Subordinated liabilities:		
– At amortised cost	**4,479**	7,278
Subordinated liabilities	**3,987**	7,278
Preference shares	**492**	–
– Designated at fair value	**4,321**	–
Subordinated liabilities	**4,321**	–
Preference shares	**–**	–
	8,800	7,278

Subordinated borrowings of the group

		Book value	
		2005	2004
		£m	£m
£200m	9% Subordinated Notes 2005	**–**	199
US$500m	7.625% Subordinated Notes 2006	**296**	259
US$300m	6.95% Subordinated Notes 2011	**193**	155
€1,000m	Floating Rate Subordinated Loan 2012	**686**	–
€250m	HSBC Bank plc Subordinated Loan 2015	**172**	176
€600m	4.25% Callable Subordinated Notes 2016[1]	**440**	423
£350m	Callable Subordinated Variable Coupon Notes 2017[2]	**378**	350
£400m	HSBC Bank plc Subordinated Loan 2020	**400**	400
£500m	4.75% Callable Subordinated Notes 2020	**506**	–
€500m	Callable Floating Rate Notes 2020	**341**	–
£350m	5% Callable Subordinated Notes 2023[3]	**370**	350
£300m	6.5% Subordinated Notes 2023	**295**	298
US$300m	7.65% Subordinated Notes 2025[4]	**214**	155
£350m	5.375% Callable Subordinated Step-up Notes 2030[5]	**378**	350
£500m	5.375% Subordinated Notes 2033	**555**	498
€900m	7.75% Non-cumulative Subordinated Notes 2040	**617**	–
£225m	6.25% Subordinated Notes 2041	**223**	223
£700m	5.844% Non-cumulative Step-up Perpetual Preferred Securities 2048	**700**	–
£300m	5.862% Non-cumulative Step-up Perpetual Preferred Securities 2049	**324**	–
US$750m	Undated Floating Rate Primary Capital Notes	**437**	388
US$500m	Undated Floating Rate Primary Capital Notes	**291**	258
US$300m	Undated Floating Rate Primary Capital Notes (Series 3)	**174**	155
£150m	9.25% Step-up Undated Subordinated Notes[6]	**157**	150
£150m	8.625% Step-up Undated Subordinated Notes[7]	**161**	150
US$875m	Non-cumulative Third US$ Preference Shares	**492**	–
	Other subordinated liabilities less than £50m	**322**	433
		9,122	5,370

1 *The interest rate on the 4.25% Callable subordinated notes changes in March 2011 to three-month EURIBOR plus 1.05 per cent.*
2 *The interest rate on the Callable subordinated variable coupon notes is fixed at 5.75 per cent 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 per cent.*
3 *The interest on the 5% Callable subordinated notes changes in March 2018 to become the rate per annum which is the sum of the gross redemption yield of the prevailing five-year UK gilt plus 1.80 per cent.*
4 *The 7.65 per cent Subordinated notes are repayable at the option of each of the holders in May 2007.*
5 *The interest rate on the 5.375% Callable subordinated step-up notes 2030 changes in November 2025 to three month sterling LIBOR plus 1.50 per cent.*
6 *The interest rate on the 9.25 per cent step-up undated subordinated notes changes in December 2006 to become, for each successive five year period, the rate per annum which is the sum of the yield on the then five year benchmark UK gilt plus 2.15 per cent.*
7 *The interest rate on the 8.625 per cent step-up undated subordinated notes changes in December 2007 to become, for each successive five year period, the rate per annum which is the sum of the yield on the then five year benchmark UK gilt plus 1.87 per cent.*

Footnotes 1 to 7 all relate to notes that are repayable at the option of the borrower on the date of the change of the interest rate, and at subsequent interest rate reset dates and interest payment dates in some cases, subject to the prior consent of the Financial Services Authority.

31 Fair value of financial instruments

The following table provides an analysis of the fair value of financial instruments not measured at fair value in the balance sheet. For all other instruments the fair value is equal to the carrying value:

The group

	2005		2004
	Carrying value	**Fair value**	Carrying value
	£m	**£m**	£m
Assets			
Loans and advances to banks	**31,578**	**31,615**	34,970
Loans and advances to customers	**182,629**	**182,840**	141,527
Financial investments: Debt securities	**137**	**137**	26,509
Liabilities			
Deposits by banks	**34,198**	**34,197**	32,595
Customer accounts	**205,475**	**205,498**	161,069
Debt securities in issue	**26,801**	**28,146**	26,785
Subordinated liabilities	**4,792**	**4,798**	5,370

Notes on the Financial Statements (continued)

The bank

	2005		2004
	Carrying value £m	**Fair value £m**	Carrying value £m
Assets			
Loans and advances to banks	**19,196**	**19,196**	22,983
Loans and advances to customers	**134,819**	**134,835**	101,233
Financial investments: Debt securities	**–**	**–**	8,617
Liabilities			
Deposits by banks	**27,999**	**27,997**	26,982
Customer accounts	**141,761**	**141,753**	104,183
Debt securities in issue	**8,212**	**8,212**	13,646
Subordinated liabilities	**4,479**	**4,474**	7,278

The methods used to determine fair values for financial instruments for the purpose of measurement and disclosure are set out in Note 2. The majority of the group's financial instruments measured at fair value are valued using quoted market prices or valuation techniques based on observable market data. Observable market prices are not, however, available for many of the group's financial assets and liabilities not measured at fair value. The determination of the fair values of the assets and liabilities in the table above are as follows:

(i) Loans and advances to banks and customers

The fair values of personal and commercial loans and advances are estimated by discounting anticipated cash flows (including interest at contractual rates).

Performing loans are grouped, as far as possible, into homogeneous pools segregated by maturity and the coupon rates of the loans within each pool. In general, cash flows are discounted using current market rates for instruments with similar maturity, repricing and credit risk characteristics. For fixed rate loans, assumptions are made on the expected prepayment rates appropriate to the type of loan.

For non-performing uncollateralised commercial loans, fair value is estimated by discounting the future cash flows over the time period they are expected to be recovered. For non-performing commercial loans where collateral exists, fair value is the lower of the carrying values of the loans net of impairment allowances, and the fair value of the collateral, discounted as appropriate.

(ii) Financial investments

In 2004, financial investments include debt securities and equity shares intended to be held on a continuing basis. Such financial investments were included in the balance sheet at cost less provision for any permanent diminution in value.

From 1 January 2005, on implementation of IAS39, the only financial investments not measured at fair value in the balance sheet are held-to-maturity debt securities. Held-to-maturity debt securities are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest rate method, less any impairment losses.

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 future earnings streams and valuations of equivalent quoted securities.

(iii) Deposits by banks and customer accounts

Deposits by banks and customer accounts are grouped by residual maturity. Fair values are estimated using discounted cash flows, applying either market rates, where applicable, or current rates offered for deposits of similar remaining maturities.

(iv) Debt securities in issue and subordinated liabilities

Fair values are determined using quoted market prices at the balance sheet date where applicable, or by reference to quoted market prices for similar instruments.

The fair values presented in the table above are stated at a specific date and may be significantly different from the amounts which will actually be paid or received on the maturity or settlement dates of the instruments. In many cases, it would not be possible to realise immediately the estimated fair values. Accordingly these fair values do not represent the value of these financial instruments to the group as a going concern.

The fair values of intangible assets, such as values placed on portfolios of core deposits, credit card relationships and customer goodwill, are not included above, because they are not financial instruments.

As other financial institutions use different valuation methodologies and assumptions in determining fair values, comparisons of fair values between financial institutions may not be meaningful and users are advised to exercise caution when using this data.

In addition, the following table lists those financial instruments where the carrying amount is a reasonable approximation of fair value, for example, because they are either short term in nature or reprice to current market rates frequently.

Assets	**Liabilities**
Cash and balances at central banks	Items in the course of transmission
Items in the course of collection	Endorsements and acceptances
Endorsements and acceptances	Short-term payables within 'Other Liabilities'
Short term receivables within 'Other Assets'	

32 Maturity analysis of assets and liabilities

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

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
Deposits by banks	7,324	18,557	4,752	3,168	1,636	35,437
Customer accounts	138,061	58,061	6,320	3,809	2,533	208,784
Financial liabilities designated at fair value	3,636	55	478	921	5,141	10,231
Debt securities in issue	831	19,470	2,861	4,984	–	28,146
Subordinated liabilities	–	49	153	868	6,620	7,690
Other financial liabilities	1	2,739	16	12	369	3,137
Total at 31 December 2005	149,853	98,931	14,580	13,762	16,299	293,425

The bank:	On demand £m	Due within 3 months £m	Due between 3 and 12 months £m	Due between 1 and 5 years £m	Due after 5 years £m	Total £m
Deposits by banks	18,945	5,526	3,174	476	329	28,450
Customer accounts	116,815	19,659	2,676	2,775	2,068	143,993
Financial liabilities designated at fair value	–	35	420	750	4,954	6,159
Debt securities in issue	805	4,002	2,086	1,741	–	8,634
Subordinated liabilities	–	43	129	4,159	1,404	5,735
Other financial liabilities	–	1,265	–	–	16	1,281
Total at 31 December 2005	136,565	30,530	8,485	9,901	8,771	194,252

The following is an analysis of assets and liabilities by remaining contractual maturities at the balance sheet date for assets and liability line items that combines amounts expected to be recovered or settled in under one year, and after 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 2005		
	Due within one year	Due after more than one year	Total
	£m	£m	£m
Assets			
Financial assets designated at fair value	**316**	**5,029**	**5,345**
Loans and advances to banks	**30,932**	**646**	**31,578**
Loans and advances to customers	**91,564**	**91,065**	**182,629**
Financial investments	**16,409**	**27,073**	**43,482**
Other financial assets	**1,338**	**63**	**1,401**
	140,559	**123,876**	**264,435**
Liabilities			
Deposits by banks	**30,180**	**4,018**	**34,198**
Customer accounts	**201,076**	**4,399**	**205,475**
Financial liabilities designated at fair value	**3,976**	**4,209**	**8,185**
Debt securities in issue	**22,579**	**4,222**	**26,801**
Other financial liabilities	**1,061**	**381**	**1,442**
Subordinated liabilities	**6**	**4,786**	**4,792**
	258,878	**22,015**	**280,893**

The group	At 31 December 2004		
	Due within one year	Due after more than one year	Total
	£m	£m	£m
Assets			
Loans and advances to banks	34,158	812	34,970
Loans and advances to customers	59,135	82,392	141,527
Financial investments	13,309	24,285	37,594
	106,602	107,489	214,091
Liabilities			
Deposits by banks	30,318	2,277	32,595
Customer accounts	157,704	3,365	161,069
Debt securities in issue	22,653	4,132	26,785
Other financial liabilities	–	320	320
Subordinated liabilities	274	5,096	5,370
	210,949	15,190	226,139

The bank	At 31 December 2005		
	Due within one year	Due after more than one year	Total
	£m	£m	£m
Assets			
Financial assets designated at fair value	**–**	**16**	**16**
Loans and advances to banks	**18,740**	**456**	**19,196**
Loans and advances to customers	**58,106**	**76,713**	**134,819**
Financial investments	**10,203**	**5,180**	**15,383**
Other financial assets	**502**	**28**	**530**
	87,551	**82,393**	**169,944**
Liabilities			
Deposits by banks	**27,371**	**628**	**27,999**
Customer accounts	**138,505**	**3,256**	**141,761**
Financial liabilities designated at fair value	**295**	**4,026**	**4,321**
Debt securities in issue	**6,680**	**1,532**	**8,212**
Other financial liabilities	**485**	**16**	**501**
Subordinated liabilities	**(1)**	**4,480**	**4,479**
	173,335	**13,938**	**187,273**

The bank	At 31 December 2004 Due within one year £m	Due after more than one year £m	Total £m
Assets			
Loans and advances to banks	22,539	444	22,983
Loans and advances to customers	32,181	69,052	101,233
Financial investments	9,108	5,540	14,648
	63,828	75,036	138,864
Liabilities			
Deposits by banks	26,768	214	26,982
Customer accounts	102,240	1,943	104,183
Debt securities in issue	11,785	1,861	13,646
Other financial liabilities	–	–	–
Subordinated liabilities	200	7,078	7,278
	140,993	11,096	152,089

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

33 Foreign currency exposures

Structural currency 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. Gains or losses on structural foreign currency exposures are taken to reserves.

The group's management of structural foreign currency exposures is discussed in Note 38(c).

Net structural currency exposures

	2005 £m	2004 £m
Currency of structural exposure		
Euros	**9,453**	8,327
US dollars	**882**	848
Swiss francs	**1,137**	993
Turkish lira	**534**	364
Maltese lira	**145**	143
Others, less than £100 million	**118**	85
Total	**12,269**	10,760

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

Assets charged as security for liabilities

The group has pledged assets as security for liabilities included under the following headings:

	Group liabilities secured at		Bank liabilities secured at	
	2005 £m	2004 £m	**2005 £m**	2004 £m
Deposits by banks	**367**	746	**329**	727
Customer accounts	**807**	1,038	**780**	1,038
Debt securities in issue	**360**	76	**360**	76
Other liabilities	**85**	365	**85**	108
	1,619	2,225	**1,554**	1,949

Notes on the Financial Statements (continued)

Assets pledged to secure these liabilities are included under the following headings:

	Group assets pledged at		Bank assets pledged at	
	2005	2004	**2005**	2004
	£m	£m	**£m**	£m
Treasury bills and other eligible securities	**323**	–	**323**	–
Loans and advances to banks	**714**	697	**714**	697
Loans and advances to customers	**1,056**	1,163	**1,056**	1,163
Debt securities	**33,655**	10,914	**14,510**	10,274
Equity shares	**2,892**	–	**2,007**	–
	38,640	12,774	**18,610**	12,134

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

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 £33,836 million.

The fair value of financial assets accepted as collateral that have been sold or repledged is £2,056 million. The group is obliged to return these assets.

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

35 Called up share capital

Authorised

The authorised ordinary share capital of HSBC Bank plc at 31 December 2005 and 2004 was £1,000 million divided into 1,000 million ordinary shares of £1 each.

At 31 December 2005 and 2004, the authorised preference share capital of HSBC Bank plc was £150 million non-cumulative preference shares of £1 each, £1 million non-cumulative preference shares of £0.01 each.

Issued

	Number of HSBC Bank plc ordinary shares	**£m**
At 1 January 2005	**796,969,096**	**797**
Shares issued	**3**	–
At 31 December 2005	**796,969,099**	**797**
At 1 January 2004	796,969,095	797
Shares issued	1	–
At 31 December 2004	796,969,096	797

36 Equity

The group

	2005										
				Other reserves							
	Called up share capital £m	Share premium £m	Retained earnings £m	Available-for-sale fair value reserve £m	Cash flow hedging reserve £m	Foreign exchange reserve £m	Share-based payment reserve £m	Associates and Joint Ventures £m	Total share-holders' equity £m	Minority interests £m	Total equity £m
At 1 January	797	12,820	3,194	–	–	(41)	58	–	16,828	2,687	19,515
IFRSs transition adjustment at 1 January 2005	–	(437)	(606)	553	177	–	–	–	(313)	(2,307)	(2,620)
New share capital subscribed, net of costs	–	1,500	–	–	–	–	–	–	1,500	–	1,500
Profit for the year attributable to shareholders	–	–	2,897	–	–	–	–	–	2,897	–	2,897
Dividends to shareholders of the parent company	–	–	(1,400)	–	–	–	–	–	(1,400)	–	(1,400)
Actuarial gains/(losses) on defined benefit plans	–	–	(302)	–	–	–	–	–	(302)	–	(302)
Fair value gains/(losses) taken to equity	–	–	–	49	35	–	–	42	126	–	126
Amounts transferred to the income statement	–	–	–	(194)	(180)	–	–	–	(374)	–	(374)
Charge to the income statement in respect of equity settled share-based payment transactions	–	–	–	–	–	–	53	–	53	–	53
Tax on items taken directly to or transferred from equity	–	–	72	35	54	–	–	–	161	–	161
Transfer to minority interest	–	–	–	(10)	–	–	–	–	(10)	10	–
Profit attributable to minority interests	–	–	–	–	–	–	–	–	–	62	62
Dividends to minority interests	–	–	–	–	–	–	–	–	–	(25)	(25)
Exchange differences	–	–	–	–	–	(75)	–	–	(75)	(8)	(83)
Increase in minority interest stake and other	–	–	–	–	–	–	–	–	–	124	124
At 31 December	797	13,883	3,855	433	86	(116)	111	42	19,091	543	19,634

Notes on the Financial Statements (continued)

	2004								
				Other reserves					
	Called up share capital £m	Share premium £m	Retained earnings £m	Foreign exchange reserve £m	Share-based payment reserve £m	Associates and Joint Ventures £m	Total share-holders' equity £m	Minority interests £m	Total equity £m
At 1 January	797	12,157	2,758	–	18	–	15,730	2,405	18,135
New share capital subscribed, net of costs	–	700	–	–	–	–	700	–	700
Profit for the year attributable to shareholders	–	–	2,057	–	–	–	2,057	–	2,057
Dividends to shareholders of the parent company	–	–	(1,436)	–	–	–	(1,436)	–	(1,436)
Actuarial gains/(losses) on defined benefit plans	–	–	(277)	–	–	–	(277)	–	(277)
Charge to the income statement in respect of equity settled share-based payment instructions	–	–	–	–	40	–	40	–	40
Tax on items taken directly to or transferred from equity	–	–	92	–	–	–	92	–	92
Profit attributable to minority interest	–	–	–	–	–	–	–	173	173
Dividends to minority interests	–	–	–	–	–	–	–	(157)	(157)
Exchange differences	–	(37)	–	(41)	–	–	(78)	(5)	(83)
Increase in minority interest stake and other	–	–	–	–	–	–	–	271	271
At 31 December	797	12,820	3,194	(41)	58	–	16,828	2,687	19,515

The bank

	2005								
				Other reserves					
	Called up share capital £m	Share premium £m	Retained earnings £m	Available-for-sale fair value reserve £m	Cash flow hedging reserve £m	Foreign exchange reserve £m	Share-based payment reserve £m	Associates and Joint Ventures £m	Total equity £m
At 1 January	**797**	**12,820**	**1,494**	–	–	**(8)**	**37**	–	**15,140**
IFRSs transition adjustment at 1 January 2005	–	**(437)**	**(234)**	**34**	–	–	–	–	**(637)**
New share capital subscribed, net of costs	–	**1,500**	–	–	–	–	–	–	**1,500**
Profit for the year attributable to shareholders	–	–	**1,678**	–	–	–	–	–	**1,678**
Dividends to shareholders of the parent company	–	–	**(1,400)**	–	–	–	–	–	**(1,400)**
Actuarial gains/(losses) on defined benefit plans	–	–	**(240)**	–	–	–	–	–	**(240)**
Fair value gains/(losses) taken to equity	–	–	–	–	**(31)**	–	–	–	**(31)**
Amounts transferred to the income statement	–	–	–	**(1)**	–	–	–	–	**(1)**
Exchange differences	–	–	–	–	–	**7**	–	–	**7**
Charge to the income statement in respect of equity settled share-based payment transactions	–	–	–	–	–	–	**32**	–	**32**
Tax on items taken directly to or transferred from equity	–	–	**61**	**3**	**9**	–		–	**73**
At 31 December	**797**	**13,883**	**1,359**	**36**	**(22)**	**(1)**	**69**	–	**16,121**

Notes on the Financial Statements (continued)

	2004						
				Other reserves			
	Called up share capital £m	Share premium £m	Retained earnings £m	Foreign exchange reserve £m	Share-based payment reserve £m	Associates and Joint Ventures £m	Total Equity £m
At 1 January	797	12,157	1,509	–	11	–	14,474
New share capital subscribed, net of costs	–	700	–	–	–	–	700
Profit for the year attributable to shareholders	–	–	1594	–	–	–	1,594
Dividends to shareholders of the parent company	–	–	(1,436)	–	–	–	(1,436)
Actuarial gains/(losses) on defined benefit plans	–	–	(247)	–	–	–	(247)
Charge to the income statement in respect of equity settled share-based payment instructions	–	–	–	–	26	–	26
Tax on items taken directly to or transferred from equity	–	–	74	–	–	–	74
Exchange differences	–	(37)	–	(8)	–	–	(45)
At 31 December	797	12,820	1,494	(8)	37	–	15,140

37 Reconciliation of profit before tax to net cash flow from operating activities

Non-cash items included in income

	The group		The bank	
	2005	2004	**2005**	2004
	£m	£m	**£m**	£m
Depreciation and amortisation	**601**	652	**302**	280
Loan impairment losses	**776**	371	**702**	352
Loans written off net of recoveries	**(1,306)**	(503)	**(1,138)**	(401)
Provisions raised	**90**	163	**(28)**	98
Provisions utilised	**(101)**	(146)	**(16)**	(63)
Impairment of financial investments	**–**	(17)	**–**	–
Accretion of discounts and amortisation of premiums	**(102)**	(74)	**(78)**	(61)
	(42)	446	**(256)**	205

Change in operating assets

	The group		The bank	
	2005	2004	**2005**	2004
	£m	£m	**£m**	£m
Change in prepayments and accrued income	**430**	(647)	**295**	(433)
Change in net trading securities and net derivatives	**421**	3,020	**(5,693)**	3,315
Change in loans and advances to banks	**(119)**	(1,513)	**(3,291)**	(2,515)
Change in loans and advances to customers	**(40,630)**	(19,657)	**(33,215)**	(15,727)
Change in financial assets designated at fair value	**(5,345)**	–	**(16)**	–
Change in other assets	**250**	893	**(729)**	177
	(44,993)	(17,904)	**(42,649)**	(15,183)

Change in operating liabilities

	The group		The bank	
	2005	2004	**2005**	2004
	£m	£m	**£m**	£m
Change in accruals and deferred income	**(368)**	695	**(236)**	491
Change in deposits by banks	**1,603**	2,398	**1,017**	4,745
Change in customer accounts	**44,406**	14,660	**37,578**	9,949
Change in debt securities in issue	**16**	13,502	**(5,434)**	9,663
Change in financial liabilities designated at fair value	**8,185**	–	**4,321**	–
Change in other liabilities	**(4,238)**	638	**1,332**	(202)
	49,604	31,893	**38,578**	24,646

Cash and cash equivalents comprise

	The group		The bank	
	2005	2004	**2005**	2004
	£m	£m	**£m**	£m
Cash and balances at central banks	**1,711**	1,275	**689**	587
Items in the course of collection from other banks	**3,595**	1,495	**2,125**	1,327
Loans and advances to banks of one month or less	**19,535**	23,055	**5,506**	12,589
Treasury bills, other bills and certificates of deposit less than three months	**7,942**	8,759	**6,538**	8,026
Less: items in the course of transmission to other banks	**(2,268)**	(907)	**(805)**	(781)
	30,515	33,677	**14,053**	21,748

38 Risk management

All the group's activities involve analysis, evaluation, acceptance and management of some degree of risk or combination of risks. The most important types of risk arising from financial instruments are credit risk (which includes country and cross-border risk), liquidity risk, market risk, and insurance risk. Market risk includes foreign exchange, interest rate and equity price risk.

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

(a) Credit risk management

Credit risk is the risk that financial loss arises from the failure of a customer or counterparty to meet its obligations under a contract. It arises principally from lending, trade finance, treasury and leasing activities. The group has standards, policies and procedures dedicated to controlling and monitoring risk from all such activities.

HSBC Holdings plc is responsible for the formulation of high-level credit policies. It also reviews the application of the HSBC's universal facility grading system. Historically, the group's risk rating framework has consisted of a minimum of seven grades, taking into account the risk of default and the availability of security or other credit risk mitigation. The first three of which are applied to differing levels of satisfactory risk. Accounts in grade 4 and 5 require different degrees of special attention and grades 6 and 7 indicate non-performing status. A more sophisticated risk rating framework for banks and other customers, based on default probability and loss estimates and comprising up to 22 categories, is being progressively implemented across the group and is already operative in most major business units. This new approach will increasingly allow a more granular analysis of risk and trends. Rating methodology is based upon a wide range of financial analytics together with market data-based tools which are core inputs to the assessment of counterparty risk. Although automated risk rating processes are increasingly in use, for the larger facilities ultimate responsibility for setting risk grades rests with the final approving executive in each case. It is the group's policy to review grades frequently and implement amendments promptly when required.

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

Within the overall framework of the HSBC policy, the group has an established risk management process encompassing credit approvals, the control of exposures (including those to borrowers in financial difficulty), credit policy direction to business units and the monitoring and reporting of exposures both on an individual and a portfolio basis. Local management is responsible for the quality of its credit portfolios and follows a credit process involving delegated approval authorities and credit procedures, the objective of which is to build and maintain risk assets of high quality. Regular reviews are undertaken to assess and evaluate levels of risk concentration, including those to individual industry sectors and products.

Special attention is paid to the management of problem loans. Where deemed appropriate, specialist units are established to provide intensive management and control to maximise recoveries of doubtful debts.

Maximum exposure to credit risk

Maximum exposure to credit risk, collateral held or other credit enhancements:

The group

	Maximum exposure £m
Items in course of collection from other banks	3,595
Trading assets	61,240
– treasury & other similar bills	268
– debt securities	40,550
– loans and advances	20,422
Financial assets designated at fair value	1,721
– treasury and other similar bills	10
– debt securities	1,614
– loans and advances	97
Derivatives	26,077
Loans and advances to banks	31,578
Loans and advances to customers	182,629
Financial investments	41,321
– treasury and other similar bills	3,950
– debt securities	37,371
Other assets	
– endorsements and acceptances	539
– other	2,247
Off-balance sheet	
– financial guarantees and other credit related contingent liabilities	17,557
– loan commitments and other credit related commitments	127,159
At 31 December 2005	495,663

The bank

	Maximum exposure £m
Items in course of collection from other banks	2,125
Trading assets	33,091
– treasury and other similar bills	181
– debt securities	17,127
– loans and advances	15,783
Financial assets designated at fair value	16
– treasury and other similar bills	–
– debt securities	–
– loans and advances	16
Derivatives	17,570
Loans and advances to banks	19,196
Loans and advances to customers	134,819
Financial investments	15,059
– treasury and other similar bills	3,554
– debt securities	11,505
Other assets	
– endorsements and acceptances	476
– other	828
Off-balance sheet	
– financial guarantees and other credit related contingent liabilities	9,840
– loan commitments and other credit related commitments	90,811
At 31 December 2005	323,831

Notes on the Financial Statements (continued)

Collateral and other credit enhancements

Loans and advances

Where appropriate, operating companies are required to implement guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and determine valuation parameters. Such parameters are expected to be conservative, reviewed regularly and be supported by empirical evidence. Security structures and legal covenants are required to be subjected to regular review to ensure that they continue to fulfil their intended purpose and remain in line with local market practice. While collateral is an important mitigant to credit risk, it is the group's policy to establish that loans are within the customer's capacity to repay rather than to over rely on security. In certain cases, depending on the customer's standing and the type of product, facilities may be unsecured. The principal collateral types are as follows:

– in the personal sector, mortgages over residential properties;

– in the commercial and industrial sector, charges over business assets such as premises, stock and debtors;

– in the commercial real estate sector, charges over the properties being financed; and

– in the financial sector, charges over financial instruments such as debt securities and equities in support of trading facilities.

Other securities

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

Concentrations of exposure

The group

	2005	2004
	%	%
United Kingdom	**47**	49
France	**11**	12
Germany	**8**	8
Rest of Continental Europe	**20**	18
Continental Europe	**39**	38
United States	**7**	6
Rest of world	**7**	7
	100	100

The bank

	2005	2004
	%	%
United Kingdom	**68**	70
France	**5**	3
Germany	**3**	3
Rest of Continental Europe	**14**	13
Continental Europe	**22**	19
United States	**5**	4
Rest of world	**5**	7
	100	100

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

- the bank's position as one of the principal UK clearing banks means that the majority of the group's exposure to credit risk is concentrated in the United Kingdom. Within the United Kingdom, the group's credit risk is diversified over a wide range of industrial and economic groupings; and
- the group's position as part of a major international banking group means, that it has a significant concentration of exposure to banking counterparties. The majority of credit risk to the banking industry at 31 December 2005 and 31 December 2004 was concentrated in Europe (including the United Kingdom).

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

Credit quality

Loans and advances

The group

	At 31 December 2005	
	Loans and advances to customers £m	**Loans and advances to banks £m**
Gross loans and advances:		
– neither past due nor impaired	**180,497**	**31,575**
– past due but not impaired	**1,298**	**–**
– impaired	**2,714**	**8**
	184,509	**31,583**

The bank

	At 31 December 2005	
	Loans and advances to customers £m	**Loans and advances to banks £m**
Gross loans and advances:		
– neither past due nor impaired	**133,113**	**19,195**
– past due but not impaired	**1,274**	**–**
– impaired	**1,354**	**5**
	135,741	**19,200**

Distribution of loans and advances neither past due nor impaired

The credit quality of the portfolio of loans and advances that were neither past due nor impaired at 31 December 2005 can be assessed by reference to HSBC's standard credit grading system. The following information is based on that system:

The group

	At 31 December 2005	
	Loans and advances to customers £m	**Loans and advances to banks £m**
Grade 1-3 – satisfactory risk	**173,736**	**31,454**
Grade 4 – watch list	**5,247**	**108**
Grade 5 – sub-standard but not impaired	**1,514**	**13**
	180,497	**31,575**

Notes on the Financial Statements (continued)

The bank

	At 31 December 2005	
	Loans and advances to customers £m	**Loans and advances to banks £m**
Grade 1-3 – satisfactory risk	**128,303**	**19,140**
Grade 4 – watch list	**4,153**	**43**
Grade 5 – sub-standard but not impaired	**657**	**12**
	133,113	**19,195**

Grades 1 and 2 represent corporate facilities demonstrating financial condition, risk factors and capacity to repay that are good to excellent, residential mortgages with low to moderate loan to values ratios, and other retail accounts which are not impaired and are maintained within product guidelines.

Grade 3 represents satisfactory risk and includes corporate facilities that require closer monitoring, mortgages with higher loan to value ratios than grades 1 and 2, all non-impaired credit card exposures, and other retail exposures which operate outside product guidelines without being impaired.

Grade 4 and 5 represent corporate facilities that require various degrees of special attention and all retail exposures that are progressively between 30 and 90 days past due.

Grade 6 and 7 indicate impaired status including all retail accounts that are progressively more than 90 days past due.

Loans and advances which were past due but not impaired

Loans and advances that were past due at 31 December 2005 but not impaired were as follows:

The group

	2005 Loans and advances to customers £m
Past due up to 29 days	**608**
Past due 30 – 59 days	**211**
Past due 60 – 89 days	**135**
	954
Past due 90 – 179 days	**204**
Past due over 180 days but less than 1 year	**110**
Past due more than 1 year	**30**
	1,298

The bank

	2005 Loans and advances to customers £m
Past due up to 29 days	594
Past due 30 – 59 days	207
Past due 60 – 89 days	132
	933
Past due 90 – 179 days	202
Past due over 180 days but less than 1 year	110
Past due more than 1 year	29
	1,274

The past due ageing process of unimpaired loans and advances is intended to indicate the level of potential credit loss in loans and advances not classified as impaired at the balance sheet date. This ageing analysis includes loans and advances less than 90 days past due that have collective impairment allowances set aside to cover credit losses on loans which are in the early stages of arrears.

There are a variety of reasons why certain loans designated as 'past due' are not regarded as impaired. Unless other information is available to indicate to the contrary, all loans less than 90 days past due are not considered impaired. It is also not unusual for short-term trade finance facilities to extend beyond 90 days past due for reasons that do not reflect any concern on the creditworthiness of the counterparty, such as delays in documentation. In addition, past due loans secured in full by cash collateral are not considered impaired and, where appropriate, neither are residential mortgages in arrears by more than 90 days where the value of collateral is sufficient to repay both the debt and all potential interest for at least one year.

Loans and advances to customers and to banks – net total credit risk

Loans and advances against which the group had legally enforceable rights to offset with financial liabilities at 31 December 2005 were as follows:

The group

	At 31 December 2005		
	Book value £m	Amount for which the group has a legally enforceable right to off-set[1] £m	Net total credit risk[2] £m
Loans and advances to customers	182,629	(734)	181,895
Loans and advances to banks	31,578	–	31,578
	214,207	(734)	213,473

The bank

	At 31 December 2005		
	Book value £m	Amount for which the group has a legally enforceable right to off-set[1] £m	Net total credit risk[2] £m
Loans and advances to customers	134,819	–	134,819
Loans and advances to banks	19,196	–	19,196
	154,015	–	154,015

1 *Against financial liabilities with the same counterparty.*
2 *Excluding the value of any collateral or security held.*

Notes on the Financial Statements (continued)

Other securities

Debt securities and other bills by rating agency designation

The following table presents an analysis of debt and similar securities, other than loans, by rating agency designation at 31 December 2005, based on Standard and Poor's ('S&P') ratings or their equivalent:

The group

	At 31 December 2005			
	Treasury bills £m	Other eligible bills £m	Debt securities £m	Total £m
AAA	3,450	221	41,279	44,950
AA – to AA +	18	151	17,160	17,329
A – to A +	146	–	8,881	9,027
Lower than A –	18	–	1,946	1,964
Unrated	224	–	10,269	10,493
Total	3,856	372	79,535	83,763
Of which issued by:				
– governments	2,197	–	31,753	33,950
– local authorities	1,521	–	637	2,158
– corporates	–	–	21,108	21,108
– other	138	372	26,037	26,547
Total	3,856	372	79,535	83,763
Of which classified as:				
– financial instruments designated at fair value	10	–	1,614	1,624
– available-for-sale securities	3,623	327	37,234	41,184
– held-to-maturity investments	–	–	137	137
– held for trading	223	45	40,550	40,818
Total	3,856	372	79,535	83,763

Debt securities with short-term ratings are reported against the long-term rating of the issuer of the short-term debt securities. If major rating agencies have different ratings for the same debt securities, the securities are reported against the lower rating.

The bank

	At 31 December 2005			
	Treasury bills £m	Other eligible bills £m	Debt securities £m	Total £m
AAA	3,414	28	13,216	16,658
AA – to AA +	–	17	6,029	6,046
A – to A +	146	–	5,530	5,676
Lower than A –	–	–	1,396	1,396
Unrated	130	–	2,461	2,591
Total	3,690	45	28,632	32,367
Of which issued by:				
– governments	2,171	–	8,561	10,732
– local authorities	1,382	–	143	1,525
– corporates	–	–	8,191	8,191
– other	137	45	11,737	11,919
Total	3,690	45	28,632	32,367
Of which classified as:				
– financial instruments designated at fair value	–	–	–	–
– available-for-sale securities	3,554	–	11,505	15,059
– held-to-maturity investments	–	–	–	–
– held for trading	136	45	17,127	17,308
Total	3,690	45	28,632	32,367

Debt securities and other bills – net total credit risk

Debt securities and other bills against which the group had legally enforceable rights to offset with financial liabilities at 31 December 2005 were as follows:

The group

	At 31 December 2005		
	Book value £m	Amount for which the group has a legally enforceable right to off set[1] £m	Net total credit risk[2] £m
Trading assets:			
– treasury and other similar bills	**268**	**–**	**268**
– debt securities	**40,550**	**–**	**40,550**
– loans and advances to banks	**7,993**	**–**	**7,993**
– loans and advances to customers	**12,429**	**–**	**12,429**
	61,240	**–**	**61,240**
Financial assets designated at fair value:			
– treasury and other similar bills	**10**	**–**	**10**
– debt securities	**1,614**	**–**	**1,614**
– loans and advances to banks	**70**	**–**	**70**
– loans and advances to customers	**27**	**–**	**27**
	1,721		**1,721**
Derivatives	**26,077**	**(14,011)**	**12,066**
Financial investments:		**–**	
– treasury and other similar bills	**3,950**	**–**	**3,950**
– debt securities	**37,371**	**–**	**37,371**
	41,321	**–**	**41,321**
Other assets			
Acceptances and endorsements	**539**	**–**	**539**
	130,898	**(14,011)**	**116,887**

1 *Against financial liabilities with the same counterparty.*
2 *Excluding the value of any collateral or security held.*

Notes on the Financial Statements (continued)

The bank

	At 31 December 2005		
	Book value £m	Amount for which the group has a legally enforceable right to off-set[1] £m	Net total credit risk[2] £m
Trading assets:			
– treasury and other similar bills	181	–	181
– debt securities	17,127	–	17,127
– loans and advances to banks	4,940	–	4,940
– loans and advances to customers	10,843	–	10,843
	33,091		33,091
Financial assets designated at fair value:			
– loans and advances to customers	16	–	16
	16		16
Derivatives	17,570	(6,215)	11,355
Financial investments:			
– treasury and other similar bills	3,554	–	3,554
– debt securities	11,505	–	11,505
	15,059	–	15,059
Other assets			
Acceptances and endorsements	476	–	476
	66,212	(6,215)	59,997

1 *Against financial liabilities with the same counterparty.*
2 *Excluding the value of any collateral or security held.*

Impairment assessment

It is the group's policy that each operating company makes allowance for impaired loans promptly when required and on a consistent basis in accordance with established group guidelines.

The group's rating process for credit facilities extended by members of the group is designed to highlight exposures requiring greater management attention based on a higher probability of default and potential loss. Management are required to particularly focus on facilities to those borrowers and portfolio segments classified below satisfactory grades. Amendments to risk grades, where necessary, are required to be undertaken promptly. Management are also required to regularly evaluate the adequacy of the established allowances for impaired loans by conducting a detailed review of the loan portfolio, comparing performance and delinquency statistics with historical trends and assessing the impact of current economic conditions.

Two types of impairment allowance are in place; individually assessed and collectively assessed. These are discussed in Note 2.

The group's policy requires a review of the level of impairment allowances on individual facilities that are above materiality thresholds at least half-yearly, and more regularly where individual circumstances require. The policy requires that this will normally include a review of collateral held (including re-confirmation of its enforceability) and an assessment of actual and anticipated receipts. For significant commercial and corporate debts, specialised loan 'work-out' teams with experience in insolvency and specific market sectors are used to determine likely losses. Reversals on individually calculated impairment allowances are recognised whenever the group has reasonable objective evidence that the established estimate of loss has been reduced.

Portfolio allowances are generally reassessed monthly and charges for new allowances, or releases of existing allowances, are calculated for each separately identified portfolio.

In relevant cases, impairment allowances will include an element in respect of cross-border exposures to countries assessed by management to be vulnerable to foreign currency payment restrictions. This assessment includes analysis of both economic and political factors existing at the time. Economic factors include the level of external indebtedness, the debt service burden and access to external sources of funds to meet the debtor country's financing requirements. Political factors taken into account include the stability of the country and its government, threats to security and the quality and independence of the legal system.

Non-performing loans

For individually assessed accounts, loans are required to be designated as non-performing as soon as there is objective evidence that an impairment loss has been incurred. Objective evidence of impairment includes observable data such as when contractual payments of principal or interest are 90 days overdue. Portfolios of homogeneous loans are designated as non-performing if facilities are 90 days or more overdue.

Charge-offs

Loans (and the related impairment allowances) are normally charged-off, either partially or in full, when there is no realistic prospect of recovery of these amounts and when the proceeds from the realisation of security have been received. Unsecured personal facilities are normally charged-off between 150 and 210 days overdue. There are no cases where the charge-off period exceeds 360 days except where certain personal accounts are still deemed collectible beyond this point. In the case of bankruptcy, charge-off occurs at the time of notification.

Impaired loans

Individually impaired loans by industry sector and by geographical region

The group

	Year to 31 December 2005				
	United Kingdom £m	**Continental Europe £m**	**Rest of the world £m**	**Gross loans and advances to customers £m**	**Gross loans by industry sector as a % of total gross loans %**
Personal	**248**	**127**	**–**	**375**	**20**
Commercial and corporate	**847**	**639**	**9**	**1,495**	**80**
Total impaired loans and advances to customers	**1,095**	**766**	**9**	**1,870**	**100**

The bank

	Year to 31 December 2005				
	United Kingdom £m	Continental Europe £m	Rest of the world £m	Gross loans and advances to customers £m	Gross loans by industry sector as a % of total gross loans %
Personal	234	–	–	234	22
Commercial and corporate	796	28	3	827	78
Total impaired loans and advances to customers	1,030	28	3	1,061	100

Impairment allowances

When impairment losses occur, the group reduces the carrying amount of loans and advances and held-to-maturity financial investments through the use of an allowance account. When impairment of available-for-sale financial assets occurs, the carrying amount of the asset is reduced directly.

Movement in allowance accounts for total loans and advances

The group

	Year ended 31 December 2005		
	Individually assessed £m	Collectively assessed £m	Total £m
At 1 January	1,342	1,031	2,373
Amounts written off	(269)	(1,082)	(1,351)
Recoveries of loans and advances written off in previous years	(354)	(182)	(536)
Charge to income statement	564	824	1,388
Transfers	(328)	328	–
Exchange and other movements	(45)	56	11
At 31 December	910	975	1,885

The bank

	Year ended 31 December 2005		
	Individually assessed £m	Collectively assessed £m	Total £m
At 1 January	383	914	1,297
Amounts written off	(169)	(1,011)	(1,180)
Recoveries of loans and advances written off in previous years	(146)	(115)	(261)
Charge to income statement	340	670	1,010
Exchange and other movements	–	60	60
At 31 December	408	518	926

Following a review of the personal unsecured lending portfolio in the UK, £686 million of impaired loans, for which there was no realistic possibility of recovery, were written-off.

Impairment allowances against loans and advances to customers

The group

	2005 %	2004 %
Total impairment allowances to gross lending[1]		
Individually assessed impairment allowances	**0.51**	–
Collectively assessed impairment allowances	**0.55**	–
Total provisions to gross lending[1]		
Specific provisions	**–**	1.48
General provisions	**–**	0.29
Total	**1.06**	1.77

The bank

	2005 %	2004 %
Total impairment allowances to gross lending[1]		
Individually assessed impairment allowances	**0.33**	–
Collectively assessed impairment allowances	**0.42**	–
Total provisions to gross lending[1]		
Specific provisions	**–**	1.16
General provisions	**–**	0.30
Total	**0.75**	1.46

1 *Net of reverse repo transactions and settlement accounts.*

Net impairment charge to income statement by geographical region

The group

	Year ended 31 December 2005			
	United Kingdom £m	**Continental Europe £m**	**Rest of the world £m**	**Total £m**
Individually assessed impairment allowances				
New allowances	**363**	**201**	**–**	**564**
Release of allowances no longer required	**(141)**	**(213)**	**–**	**(354)**
Recoveries of amounts previously written off	**(9)**	**(1)**	**(2)**	**(12)**
	213	**(13)**	**(2)**	**198**
Collectively assessed impairment allowances				
New allowances	**745**	**79**	**–**	**824**
Release of allowances no longer required	**(116)**	**(63)**	**(3)**	**(182)**
Recoveries of amounts previously written off	**(33)**	**–**	**–**	**(33)**
	596	**16**	**(3)**	**609**
Total charge for impairment losses	**809**	**3**	**(5)**	**807**
Bank	**(1)**	**(2)**	**–**	**(3)**
Customer	**810**	**5**	**(5)**	**810**
Other credit risk provisions	**1**	**(32)**	**–**	**(31)**
Loan impairment charges and other credit risk provisions	**810**	**(29)**	**(5)**	**776**
Customer charge for impairment losses as a percentage of closing gross loans and advances	**0.58**	**0.01**	**(0.14)**	**0.44**
	£m	**£m**	**£m**	**£m**
31 December 2005				
Balances outstanding				
Non-performing loans	**1,584**	**1,129**	**9**	**2,722**
Impairment allowances	**1,123**	**759**	**3**	**1,885**
Gross loans and advances	**154,021**	**57,109**	**4,962**	**216,092**
Total allowances cover as a percentage of non-performing loans and advances	**70.90**	**67.23**	**33.33**	**69.25**

Notes on the Financial Statements (continued)

The bank

	Year ended 31 December 2005			
	United Kingdom £m	Continental Europe £m	Rest of the world £m	Total £m
Individually assessed impairment allowances				
New allowances	**335**	**5**	**–**	**340**
Release of allowances no longer required	**(137)**	**(9)**	**–**	**(146)**
Recoveries of amounts previously written off	**(10)**	**–**	**–**	**(10)**
	188	**(4)**	**–**	**184**
Collectively assessed impairment allowances				
New allowances	**669**	**1**	**–**	**670**
Release of allowances no longer required	**(115)**	**–**	**–**	**(115)**
Recoveries of amounts previously written off	**(32)**	**–**	**–**	**(32)**
	522	**1**	**–**	**523**
Total charge for impairment losses	**710**	**(3)**	**–**	**707**
Bank	**(1)**	**–**	**–**	**(1)**
Customer	**711**	**(3)**	**–**	**708**
Other credit risk provisions	**–**	**(5)**	**–**	**(5)**
Loan impairment charges and other credit risk provisions	**710**	**(8)**	**–**	**702**
Customer charge for impairment losses as a percentage of closing gross loans and advances	**0.58**	**(0.02)**	**–**	**0.56**
	£m	**£m**	**£m**	**£m**
31 December 2005				
Balances outstanding				
Non-performing loans	**1,327**	**29**	**3**	**1,359**
Impairment allowances	**909**	**16**	**1**	**926**
Gross loans and advances	**149,783**	**4,461**	**697**	**154,941**
Total allowances cover as a percentage of non-performing loans and advances	**68.50**	**55.17**	**33.33**	**68.14**

Net charge to the profit and loss account for bad and doubtful debts by geographical region

The group

	Year ended 31 December 2004			
	United Kingdom £m	Continental Europe £m	Rest of the world £m	Total £m
Specific provisions				
New provisions	645	263	–	908
Release of provisions no longer required	(193)	(205)	–	(398)
Recoveries of amounts previously written off	(41)	(7)	–	(48)
	411	51	–	462
General provisions	(36)	(46)	(3)	(85)
Total bad and doubtful debt charge	375	5	(3)	377
Bank	–	(4)	–	(4)
Customer	375	9	(3)	381
Other credit risk provisions	1	(7)	–	(6)
Customer bad and doubtful charge and other credit risk provisions	376	(2)	(3)	371
Customer bad and doubtful debt charge as a percentage of closing gross loans and advances	0.36	0.03	(0.10)	0.27
31 December 2004				
Non-performing loans	1,717	1,261	8	2,986
Provisions	1,448	906	7	2,361
Gross loans and advances	124,313	49,948	4,597	178,858
Total provisions cover as a percentage of non-performing loans and advances	84.33	71.85	87.50	79.07

The bank

	Year ended 31 December 2004			
	United Kingdom £m	**Continental Europe £m**	**Rest of the world £m**	**Total £m**
Specific provisions				
New provisions	583	14	–	597
Release of provisions no longer required	(182)	(14)	–	(196)
Recoveries of amounts previously written off	(38)	–	–	(38)
	363	–	–	363
General provisions	(10)	(1)	–	(11)
Total bad and doubtful debt charge	353	(1)	–	352
Bank	–	–	–	–
Customer	353	(1)	–	352
Other credit risk provisions	–	5	–	5
Customer bad and doubtful charge and other credit risk provisions	353	4	–	357
Customer bad and doubtful debt charge as a percentage of closing gross loans and advances	0.39	(0.03)	–	0.38
31 December 2004				
Non-performing loans	1,480	43	6	1,529
Provisions	1,261	32	3	1,296
Gross loans and advances	120,627	3,967	918	125,512
Total provisions cover as a percentage of non-performing loans and advances	85.20	74.42	50.00	84.76

Collateral and other credit enhancements obtained

During 2005, the group obtained assets by taking control of collateral accepted as security, or through other credit enhancements, as follows:

	Carrying value obtained in 2005	
	The group £m	**The bank £m**
Type of asset		
Other assets	14	6
	14	6

Procedures for the disposal of assets not readily convertible into cash are established at operating company level, and depend on the nature of the asset concerned.

Renegotiated loans

Restructuring activity is designed to manage customer relationships, maximise collection opportunities and avoid foreclosure or repossession, if possible. Following restructuring, an overdue personal account will normally be reset from delinquent to current status. Restructuring policies and practices are based on indicators or criteria which, in the judgement of local management, evidence the probability that payment will continue. These policies are reviewed and their application varies depending upon the nature of the market, the product and the availability of empirically based data. Where empirical evidence indicates an increased propensity to default on restructured accounts, the use of roll rate methodologies for the calculation of impairment allowances results in the increased default propensity being reflected in impairment allowances.

Renegotiated loans that would otherwise be past due or impaired

The group

	2005 £m
Loans and advances to customers	977
Loans and advances to banks	–
	977

The bank

	2005 £m
Loans and advances to customers	890
Loans and advances to banks	–
	890

(b) Liquidity and funding management

The objective of the group's liquidity and funding management is to ensure that all foreseeable funding commitments and deposit withdrawals can be met when due, and that wholesale market access is co-ordinated and disciplined. To this end, the group seeks to actively support a diversified and stable funding base comprising core retail and corporate customer deposits and institutional balances, augmented by wholesale funding diversified by currency and maturity portfolios of highly liquid assets, in order to be able to respond quickly and smoothly to unforeseen liquidity requirements.

The management of liquidity and funding is primarily carried out locally in the operating companies of the group in accordance with practice and limits set by the group Risk Management Meeting. These limits vary by local financial unit to take account of the depth and liquidity of the market in which the entity operates. It is the group's general policy that each banking entity should be self-sufficient with regard to funding its own operations. Exceptions are permitted to facilitate the efficient funding of certain short-term treasury requirements and start-up operations or branches which do not have access to local deposit markets, all of which are funded under strict internal and regulatory guidelines and limits from the group's largest banking operations. These internal and regulatory limits and guidelines serve to place formal limitations on the transfer of resources between group entities and are necessary to reflect the broad range of currencies, markets and time zones within which the group operates.

The group's policy is to require operating entities to maintain a strong liquidity position and to manage the liquidity profile of their assets, liabilities and commitments so that cash flows are appropriately balanced and all funding obligations are met when due.

The group's liquidity and funding management policy requires:

- projecting cash flows by major currency and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing the concentration and profile of debt maturities;
- 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 must identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises while minimising adverse long-term implications for the business.

Primary sources of funding

Current accounts and savings deposits payable on demand or at short notice form a significant part of the group's funding. The group places considerable importance on the stability of these deposits.

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

Of total liabilities of £367 billion at 31 December 2005, funding from customers amounted to £205 billion, of which £201 billion was contractually repayable within one year. However, although the contractual repayments of many customer accounts are on demand or at short notice, in practice short-term deposit balances remain stable as inflows and outflows broadly match.

An analysis of cash flows payable by the group and bank under financial liabilities by remaining contractual maturities at the balance sheet date is included in Note 32.

Liabilities in trading portfolios have not been analysed by contractual maturity because trading assets and liabilities are typically held for short periods of time.

Assets available to meet these liabilities, and to cover outstanding commitments to lend (£386 billion), included cash, central bank balances, items in the course of collection and treasury and other bills (£10 billion); loans to banks (£32 billion, including £31 billion repayable within one year); and loans to customers (£183 billion, including £92 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 bank held debt securities marketable at a value of £80 billion. Of these assets, some £34 billion of debt securities and treasury and other bills have been pledged to secure liabilities.

The group would meet unexpected net cash outflows by selling securities and accessing additional funding sources such as interbank or asset-backed markets.

A key measure used by the group for managing liquidity risk is the ratio of net liquid assets to customer liabilities. Generally, liquid assets comprise cash balances, short-term interbank deposits and highly rated debt securities available for immediate sale and for which a deep and liquid market exists. Net liquid assets are liquid assets less all wholesale market funds, and all funds provided by customers deemed to be professional, maturing in the next 30 days. The definition of a professional customer takes account of the size of the customer's total deposits.

Minimum liquidity ratio limits are set for each bank operating entity. Limits reflect the local marketplace, the diversity of funding sources available, and the concentration risk from large depositors.

Although consolidated data is not utilised in the management of the group's liquidity, the consolidated liquidity ratio figures of net liquid assets to customer-liabilities shown in the following table provide a useful insight into the overall liquidity position of the group's banking entities.

Ratio of net liquid assets to customer liabilities

	At 31 December		Average during	Maximum	Minimum
	2005	2004	**2005**	**in 2005**	**in 2005**
The bank:	**11.0%**	5.7%	**9.4%**	**11.6%**	**3.2%**
The group:	**15.6%**	12.8%	**13.9%**	**15.6%**	**10.1%**

(c) Market risk management

The objective of the group's market risk management is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with the group's status as a premier provider of financial products and services.

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

Each operating entity is required to assess the market risks which arise on each product in its business and to transfer these risks to either its local Global Markets unit for management, or to separate books managed under the auspices 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 professionally manage such risks.

Notes on the Financial Statements (continued)

Value at risk ('VAR')

One of the principal tools used by the group to monitor and limit market risk exposure is VAR. VAR is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence (for the group, 99 per cent). The group calculates VAR daily. The VAR model used by the group is predominantly based on historical simulation. The historical simulation model derives plausible future scenarios from historical market rates time series, taking account of inter-relationships between different markets and rates, for example between interest rates and foreign exchange rates. Potential movements in market prices are calculated with reference to market data from the last two years. The group has changed the assumed holding period from a 10-day period to a 1-day period as this reflects the way the risk positions are managed. Comparative VAR numbers have been re-stated to reflect this change.

Although a useful guide to risk, VAR should always be viewed in the context of its limitations. For example:

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a 1-day holding period assumes that all positions can be liquidated or hedged in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a 1-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; and
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

The group recognises these limitations by augmenting its VAR limits with other position and sensitivity limit structures. Additionally, the group applies a wide range of stress testing, both on individual portfolios and on the group's consolidated positions. The group's stress-testing regime provides senior management with an assessment of the financial impact of identified extreme events on the market risk exposures of the group.

The VAR, both trading and non-trading, for Global Markets was as follows:

	£m
Total	
At 31 December 2005	**39.8**
At 31 December 2004	44.8

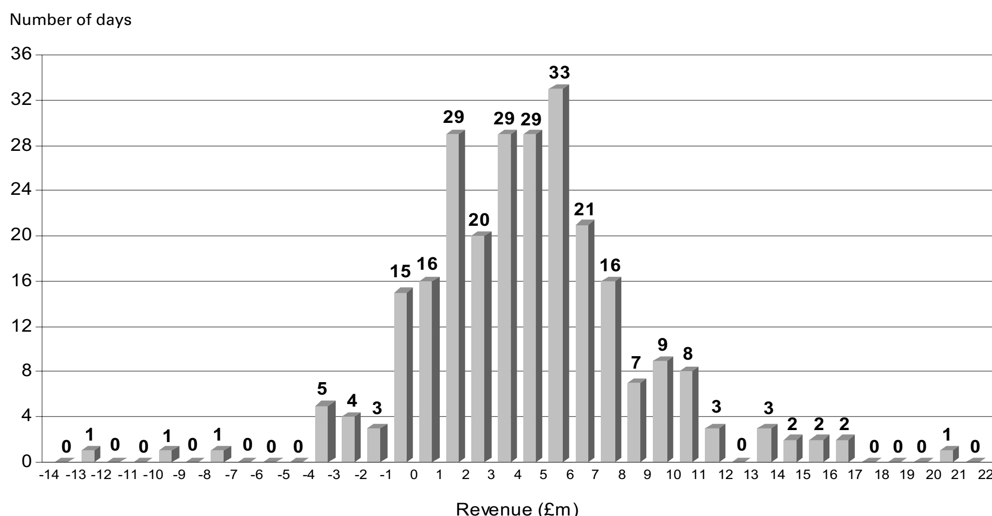
	Average £m	Minimum £m	Maximum £m
2005	36.7	23.3	97.3
2004	35.4	21.9	49.5

The daily revenue earned from market risk-related treasury activities includes net interest income and funding related to dealing positions. The histogram below illustrates the frequency of daily revenue arising from all Global Markets' business and other trading activities. The numbers for 2004 have been restated to include the Futures and Equities revenues which comprise part of the Global Markets' business. As a result of these restatements, the average daily revenue increased from £4.0 million to £4.3 million.

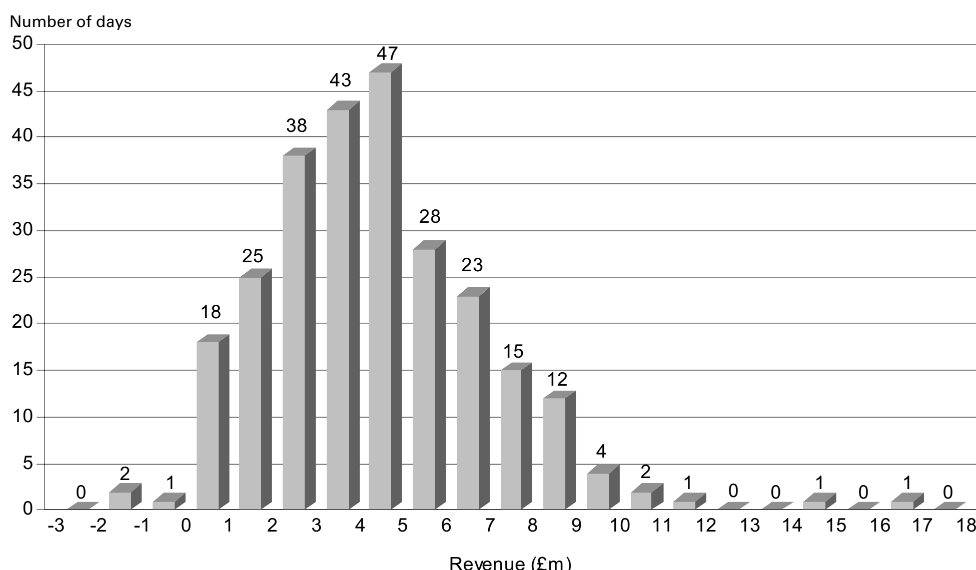
The average daily revenue earned from Global Markets' business and other trading activities in 2005 was £4.4 million, compared with £4.3 million in 2004. The standard deviation of these daily revenues was £4.2 million compared with £2.5 million for 2004. The standard deviation measures the variation of daily revenues about the mean value of those revenues.

An analysis of the frequency distribution of daily revenue shows that there were 30 days with negative revenue during 2005 compared with three days in 2004. Of these 30 days, 15 days were losses of less than £1.0 million. The most frequent result was a daily revenue of between £5 million and £6 million with 33 occurrences.

Daily distribution of Global Markets' and other trading revenues in 2005



Daily distribution of Global Markets' and other trading revenues in 2004



Fair value and price verification control

Where certain financial instruments are carried on the group's balance sheet at fair values, it is the group policy that the valuation and the related price verification processes are subject to independent testing across the group. Financial instruments which are accounted for on a fair value basis include assets held in the trading portfolio, financial instruments designated at fair value, obligations related to securities sold short , all derivative financial instruments and available for sale securities.

The determination of fair values is therefore a significant element in the reporting of the group's Global Markets activities.

All significant valuation policies, and any changes thereto, must be approved by senior finance management. The group's governance of financial reporting requires that Financial Control departments across the group are independent of the risk-taking businesses, with the Finance functions having ultimate responsibility for the determination of fair values included in the financial statements, and for ensuring that the group's policies and relevant accounting standards are adhered to. Senior management are required to assess the resourcing and expertise of Finance functions within the group on a regular basis to ensure that the group's financial control and price verification processes are properly staffed to support the required control infrastructure.

Notes on the Financial Statements (continued)

Trading

Market risk in trading portfolios is monitored and controlled at both portfolio and position levels using a complementary set of techniques, such as VAR and present value of a basis point, together with stress and sensitivity testing and concentration limits. These techniques quantify the impact on capital of defined market movements.

Other controls include restricting individual operations to trading within a list of permissible instruments authorised for each site by Traded Markets Development and Risk, and enforcing rigorous new product approval procedures. In particular, trading in the more complex derivative products is concentrated in offices with appropriate levels of product expertise and robust control systems.

HSBC's policy on hedging is to manage economic risk in the most appropriate way without regard as to whether hedge accounting is available, within limits regarding the potential volatility of reported earnings. Trading VAR is further analysed below by risk type, by positions taken with trading intent and by positions taken without trading intent:

Total trading VAR by risk type

	Foreign exchange £m	Interest rate trading £m	Equity £m	Total £m
At 31 December 2005	**2.4**	**11.7**	**2.9**	**12.9**
At 31 December 2004	2.9	11.2	2.0	12.2
Average				
2005	**3.0**	**15.7**	**2.4**	**15.7**
2004	2.3	9.9	2.4	11.1
Minimum				
2005	**1.4**	**8.6**	**1.1**	**9.1**
2004	0.5	6.3	1.6	7.2
Maximum				
2005	**5.8**	**26.5**	**4.6**	**24.6**
2004	4.8	16.2	3.7	17.9

Positions taken with trading intent – VAR by risk type

	Foreign exchange £m	Interest rate trading £m	Equity £m	Total £m
At 31 December 2005	**2.4**	**11.0**	**2.9**	**12.1**
At 31 December 2004	2.9	11.2	2.0	12.2
Average				
2005	**3.0**	**14.4**	**2.4**	**14.2**
2004	2.3	9.9	2.4	11.1
Minimum				
2005	**1.4**	**7.9**	**1.1**	**8.0**
2004	0.5	6.3	1.6	7.2
Maximum				
2005	**5.8**	**23.9**	**4.6**	**23.2**
2004	4.8	16.2	3.7	17.9

Positions taken without trading intent – VAR by risk type

	Foreign exchange £m	Interest rate trading £m	Equity £m	Total £m
At 31 December 2005	**–**	**1.4**	**–**	**1.4**
At 31 December 2004	–	–	–	–
Average				
2005	**–**	**2.0**	**–**	**2.0**
2004	–	–	–	–
Minimum				
2005	**–**	**–**	**–**	**–**
2004	–	–	–	–
Maximum				
2005	**–**	**8.0**	**–**	**8.0**
2004	–	–	–	–

Non-trading

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

Market 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 optionality in certain product areas, for example, mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand, for example, current accounts. This prospective change in future net interest income from non-trading portfolios will be reflected in the current realisable value of these positions should they be sold or closed prior to maturity. In order to manage this risk optimally, market risk in non-trading portfolios is transferred to Global Markets or to separate books managed under the auspices of the local ALCO.

The transfer of market risk to trading books managed by Global Markets or ALCO is usually achieved by a series of internal deals between the business units and these trading books. When the behavioural characteristics of a product differ from its contractual characteristics, the behavioural characteristics are assessed to determine the true underlying interest rate risk. Local ALCOs regularly monitor all such behavioural assumptions and interest rate risk positions, to ensure they comply with interest rate risk limits established by the HSBC Group Management Board.

As noted above, in certain cases, the non-linear characteristics of products cannot be adequately captured by the risk transfer process. For example, both the flow from customer deposit accounts to more attractive investment products and the precise repayment levels of mortgages will vary at different interest rate levels. In such circumstances simulation modelling is used to identify the impact of varying scenarios on valuations and net interest income.

Once market risk has been consolidated in Global Markets or ALCO-managed books, the net exposure is typically managed through the use of interest rate swaps within agreed limits.

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. This risk principally derives from the pension schemes holding equities against their future pension obligations. The risk is that market movements in equity prices could result in assets which are insufficient over time to cover the level of projected liabilities. Management, together with the trustees who act on behalf of the pension scheme beneficiaries, assess the level of this risk using reports prepared by independent external actuaries.

The present value of the group's defined benefit pension schemes' liabilities was £13 billion at 31 December 2005 compared to £11 billion at 31 December 2004. Assets of the defined benefit schemes at 31 December 2005 comprised: equity investments 46 per cent (57 per cent at 31 December 2004); debt securities 30 per cent (28 per cent at 31 December 2004) and other (including property) 24 per cent (15 per cent at 31 December 2004).

Structural foreign exchange exposures

Structural foreign exchange exposures represent net investments in subsidiaries, branches or associated undertakings, the functional currencies of which are currencies other than the sterling.

Revaluation gains and losses on structural exposures are recorded in the consolidated statement of recognised income and expense. The main operating (or functional) currencies of the group's subsidiaries are sterling, euros, US dollars, Swiss francs, Turkish lira and Maltese lira.

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

Market risk also arises in the group's insurance businesses within their portfolios of investments and policyholder liabilities. The principal market risks are interest rate risk and equity risk, which primarily arise when guaranteed investment return policies have been issued. The insurance businesses have a dedicated HSBC market risk function which oversees management of this risk.

(d) Insurance risk

Within its service proposition, the group offers its personal customers a wide range of insurance products, many of which complement other bank products.

Both life and non-life insurance is underwritten. Life insurance contracts include participating business such as endowments and pensions, credit life business in respect of income and payment protection, annuities, term assurance and critical illness cover. Non-life insurance contracts include motor, fire and other damage, and repayment protection.

The principal insurance risk faced by the group is that the costs of claims combined with acquisition and administration costs may exceed the aggregate amount of premiums received and investment income. The group manages its insurance risks through the application of formal underwriting, reinsurance and claims procedures. These procedures are designed also to ensure compliance with regulations.

The group's overall approach to insurance risk is to seek to maintain a good diversification of insurance business by type and to focus on risks that are straightforward to manage and frequently are directly related to the underlying banking activity. The following tables provide an analysis of the insurance risk exposures by type of business. These tables demonstrate that there is diversification of risk. Separate tables are provided for life and non-life business, reflecting their very distinct risk characteristics. Life business tends to be longer term than non-life and also frequently involves an element of savings and investment in the premium. For this reason the life insurance risk table provides an analysis of the insurance liabilities as the best available overall measure of the insurance exposure. By contrast for non-life business, the table uses written premium as representing the best available measure of risk exposure.

Both life and non-life business insurance risks are controlled through a combination of local and central procedures and policies. These include a centralised approach to the authorisation to write certain classes of business. For life business in particular, use is also made of risk management committees in order to monitor the risk exposures. Market risk limits are also applied centrally as an additional control over the extent of insurance risk that is retained.

As indicated in the specific comments relating to particular classes, use is also made of reinsurance as a means of further mitigating exposure, in particular to aggregations as a result of catastrophe risk.

Analysis of life insurance risk – policyholder liabilities

	£m
Life (non-linked)	
Insurance contracts with DPF[1]	**90**
Credit life	**48**
Annuities	**117**
Term assurance and other long-term contracts	**592**
Total life (non-linked)	**847**
Life (linked)	**697**
Life insurance policyholder liabilities	**1,544**

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

For life insurance business, the insurance risk will vary considerably dependent on the type of business. The principal risks are in relation to mortality, morbidity, lapse and surrender, investment and expense levels. In addition to the local underwriting, claims handling and expense control management functions, the product diversity of the group's life insurance business provides an effective mitigation of exposure to insurance risk.

In general terms, mortality and morbidity risks are mitigated through medical underwriting and the ability in a number of cases to amend the premium in the light of changes in experience. Lapse and surrender risks are mitigated by the setting of appropriate surrender values. Market risk is generally mitigated through a combination of investment policy to match liabilities and the risk being shared with policyholders. In the case of unit linked business, all the market risk is borne by policyholders. In the case of life business with a discretionary participation feature, the risk is shared with policyholders through the management of bonuses.

The principal division of life business is between unit linked and non-linked. There are a number of major sub-categories of non-linked life assurance. Insurance contracts with discretionary participation features include with-profits business. Although *prima facie* this business entails significant market risk, these are managed in conjunction with other risks through the investment policy and adjustment to bonus rates. In practice this means that the majority of the market risk is borne by policyholders. The main risk associated with this product is the value of assigned assets falling below that required to support benefit payments. The group manages this risk by conducting regular actuarial investigations on the supportability of the bonus rates.

Credit life insurance business is written in relation to the banking products. The insurance risk relates to mortality and morbidity risk for the duration of the loans advanced. Claims experience is continuously monitored and premium rates adjusted accordingly. For much of this business, the average term of the credit risk exposure is for two to three years, which limits the insurance risk exposure.

Annuities are contracts providing income from capital investment paid in a stream of regular payments for either a fixed period or during the annuitant's lifetime. Deferred annuities are those where payments to the annuitant begin at a designated future date as opposed to immediate annuities where payments begin at once. The principal risks in respect of annuity business relate to mortality and a market risk in relation to the need to match investments against the anticipated cash flow profile of the policies. Investments are managed to match the anticipated cash flow profile, and the mortality risk is regularly monitored.

The major component of the 'Term assurance and other long-term contracts' category is term assurance and critical illness. The principal risks are in respect of mortality and morbidity, and are mitigated through a combination of sound underwriting, premium adjustment in light of changes in experience and reinsurance.

For linked insurance business, all market risk is generally borne by policyholders. The principal risk retained by the group relate to expenses, although mortality, disability and morbidity risks are also associated with this product and are managed through the application of the techniques set out above for non-linked lines of business.

Notes on the Financial Statements (continued)

Analysis of non-life insurance risk – net written insurance premiums[1]

	£m
Fire and other damage	20
Credit (non life)	124
Total net written insurance premiums	144

1 *Net written insurance premiums represent gross written premiums less gross written premiums ceded to reinsurers.*

The key risks associated with non-life business are underwriting risk and claims experience risk. Underwriting risk is the risk that the group does not charge premiums appropriate for the cover provided and claims experience risk is the risk that portfolio experience is worse than expected. The group manages these risks through prudent pricing (for example, imposing restrictions and deductibles in the policy terms and conditions), product design, risk selection, claims handling, investment strategy and reinsurance policy. All non-life insurance contracts are annually renewable and the underwriters have the right to refuse renewal or to change the terms and conditions of the contract at renewal.

Motor insurance business covers vehicle damage and liability for personal injury. It includes a substantial book from prior years, which is in run-off. Reinsurance protection has been arranged where necessary to avoid excessive exposure to larger losses, particularly those relating to personal injury claims.

In fire and other damage business the predominant focus is insurance for homes and contents. All portfolios at risk from catastrophic losses are protected by reinsurance in accordance with information obtained from professional risk modelling organisations.

The group's life insurance business is accounted for using the embedded value approach, which, *inter alia*, provides a comprehensive framework for the evaluation of insurance and related risks. The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at 31 December 2005 can be stress tested to assess the ability of the book of life business to withstand adverse developments. A key feature of life insurance business is the importance of managing the assets, liabilities and risks in a coordinated fashion rather than individually. This reflects the greater interdependence of these three elements for life insurance than is generally the case for non-life insurance.

The following table shows the effect on the PVIF as at 31 December 2005 of reasonably possible changes in the main economic assumptions within the group's principal insurance underwriting subsidiary:

	PVIF £m
+ 100 basis points shift in risk-free rate	(3)
– 100 basis points shift in risk-free rate	3
+ 100 basis points shift in risk discount rate	(14)
– 100 basis points shift in risk discount rate	14
+ 100 basis points shift in expenses inflation	(2)
– 100 basis points shift in expenses inflation	2
+ 100 basis points shift in lapse rate	(5)
– 100 basis points shift in lapse rate	5

The effects on PVIF shown above are illustrative only and employ simplified scenarios. They do not incorporate actions that could be taken by management to mitigate effects nor do they take account of consequential changes in policyholder behaviour.

General economic and business assumptions

The sensitivity of profit for the year and net assets to reasonably possible changes in conditions at 31 December 2005 across all insurance underwriting subsidiaries is as follows:

	Impact on:	
	Profit after tax for 2005	**Net assets at 31 December 2005**
	£m	**£m**
Economic assumptions		
20 per cent increase in claims costs	**(1)**	**(1)**
20 per cent decrease in claims costs	**1**	**1**
Non-economic assumptions		
10 per cent increase in mortality and/or morbidity rates	**8**	**8**
10 per cent decrease in mortality and/or morbidity rates	**1**	**1**
50 per cent increase in lapse rates	**(29)**	**(29)**
50 per cent decrease in lapse rates	**48**	**48**
10 per cent increase in expense rates	**(5)**	**(5)**
10 per cent decrease in expense rates	**5**	**5**

A key aspect of the risk management for insurance business, and life insurance in particular, is the need to actively manage the assets in relation to the liabilities. Of particular importance for a number of lines of business is the need to match the expected pattern of cash flow, which in some cases (such as annuities) can run for many years.

39 Contingent liabilities and contractual commitments

(a) Contingent liabilities and commitments

	The group		The bank	
	2005	2004	**2005**	2004
	£m	£m	**£m**	£m
Contract amounts				
Contingent liabilities				
Acceptances and endorsements	–	649	–	446
Guarantees and assets pledged as collateral security:				
– guarantees and irrevocable letters of credit	**18,278**	16,776	**10,362**	9,461
	18,278	17,425	**10,362**	9,907
Commitments				
Documentary credits and short-term trade-related transactions	**1,423**	1,260	**695**	765
Forward asset purchases and forward forward deposits placed	**160**	289	**–**	32
Undrawn note issuing and revolving underwriting facilities	**28**	37	**–**	–
Undrawn formal standby facilities, credit lines and other commitments to lend:				
– 1 year and under	**95,714**	72,394	**70,126**	54,217
– over 1 year	**29,834**	27,966	**19,990**	18,138
	127,159	101,946	**90,811**	73,152

The above table discloses the nominal principal amounts of third party off-balance sheet transactions.

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

Notes on the Financial Statements (continued)

(b) 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 2005 were as follows:

The group

	At 31 December 2005		At 31 December 2004	
	Guarantees in favour of third parties £m	Guarantees by the group in favour of other HSBC group entities £m	Guarantees in favour of third parties £m	Guarantees by the group in favour of other HSBC group entities £m
Guarantee type				
Acceptances and endorsements[1]	–	–	625	24
Financial guarantees[2]	**8,310**	**592**	7,320	410
Standby letters of credit which are financial guarantees[3]	**172**	**–**	28	1
Other direct credit substitutes[4]	**747**	**–**	779	–
Performance bonds[5]	**628**	**43**	584	51
Bid bonds[5]	**95**	**3**	22	1
Standby letters of credit related to particular transactions[5]	**626**	**50**	412	64
Other transaction-related guarantees[5]	**6,895**	**34**	7,061	32
Other items	**84**	**(1)**	11	–
Total	**17,557**	**721**	16,842	583

The bank

	At 31 December 2005		At 31 December 2004	
	Guarantees in favour of third parties £m	Guarantees by the group in favour of other HSBC group entities £m	Guarantees in favour of third parties £m	Guarantees by the group in favour of other HSBC group entities £m
Guarantee type				
Acceptances and endorsements[1]	–	–	422	24
Financial guarantees[2]	**6,525**	**464**	6,000	300
Standby letters of credit which are financial guarantees[3]	**–**	**–**	–	1
Other direct credit substitutes[4]	**8**	**–**	5	–
Performance bonds[5]	**604**	**41**	522	49
Bid bonds[5]	**46**	**3**	19	1
Standby letters of credit related to particular transactions[5]	**99**	**–**	35	–
Other transaction-related guarantees[5]	**2,535**	**15**	2,499	22
Other items	**23**	**(1)**	8	–
Total	**9,840**	**522**	9,510	397

1 *Acceptances and endorsements arise when the group agrees to guarantee payment on a negotiable instrument drawn up by a customer. The accepted instrument is then sold into the market on a discounted basis. From 1 January 2005, acceptances and endorsements are recognised on-balance sheet in 'Other assets' and 'Other liabilities' as a result of the adoption of IAS 32.*

2 *Financial guarantees include undertakings to fulfill the obligations of customers or group entities should the obligated party fail to do so. Intra-group financial guarantees include a guarantee of a capital nature issued by the group to a group entity for inclusion as capital support by the latter's regulator.*

3 *Standby letters of credit which are financial guarantees are irrevocable obligations on the part of HSBC Bank plc to pay a third party when a customer fails to meet a commitment.*

4 *Other direct credit substitutes include re-insurance letters of credit and trade-related letters of credit issued without provision for the issuing entity to retain title to the underlying shipment.*

5 *Performance bonds, bid bonds, standby letters of credit and other transaction-related guarantees are undertakings by which the requirement to make payment under the guarantee depends on the outcome of a future event which is unconnected to the creditworthiness of the customer.*

The amounts disclosed in the above table reflect the group's maximum amounts payable 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.

Approximately one half of the above guarantees have a term of less than one year. Guarantees with a term of more than one year are subject to the group's annual credit review process.

When the group gives a guarantee on behalf of a customer, it retains the right to recover from that customer amounts paid under the guarantee.

Provisions in respect of the group's obligations under outstanding guarantees

	2005 **£m**	2004 £m
Acceptances and endorsements	–	44
Guarantees and items pledged as collateral security	**12**	11
Other items	**28**	–

The group had commitments to purchase within one year, land and buildings and other fixed assets from a number of suppliers for a value of £523 million at 31 December 2005 (2004: £481 million).

(c) Joint ventures and associates

The bank and its subsidiaries are contingently liable with respect to lawsuits and other matters that arise in the normal course of business. Management is of the opinion that the eventual outcome of the legal and financial liability is not expected to materially affect the group's financial position and operations.

In relation to joint ventures and associates, the group had no contingent liabilities or commitments, incurred jointly or otherwise.

40 Lease commitments

(a) Finance lease commitments

	2005			2004		
	Total future minimum payments £m	**Interest charges £m**	**Present value £m**	Total future minimum payments £m	Interest charges £m	Present value £m
No later than one year	**14**	**(14)**	**–**	14	(14)	–
Later than one year and no later than five years	**63**	**(56)**	**7**	60	(60)	–
Later than five years	**359**	**(42)**	**317**	377	(57)	320
	436	**(112)**	**324**	451	(131)	320

In 2005 £nil (2004: £nil) was paid as contingent rents and charged to 'General and administrative expenses'.

Future minimum sublease payments of £nil (2004: £nil) were expected to be received under non-cancellable subleases at 31 December 2005.

(b) Operating lease commitments

At 31 December 2005, 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	
	2005 **£m**	2004 £m
Future minimum lease payments under non-cancellable operating leases expiring:		
– no later than one year	**125**	97
– later than one year and no later than five years	**418**	331
– later than five years	**597**	378
	1,140	806

Notes on the Financial Statements (continued)

At 31 December 2005, future minimum sublease payments of £14 million (2004: £14 million) were expected to be received under the non-cancellable subleases at the balance sheet date.

In 2005, £80 million (2004: £87 million) was charged to 'General and administrative expenses' in respect of lease and sublease agreements, all of which related to minimum lease payments.

(c) Finance lease receivables

	2005			2004		
	Total future minimum payments £m	**Unearned finance income £m**	**Present value £m**	Total future minimum payments £m	Unearned interest income £m	Present value £m
Lease receivables:						
– no later than one year	**530**	**(12)**	**518**	581	(94)	487
– later than one year and no later than five years	**1,319**	**(372)**	**947**	1,416	(434)	982
– later than five years	**2,973**	**(1,152)**	**1,821**	3,855	(1,249)	2,606
	4,822	**(1,536)**	**3,286**	5,852	(1,777)	4,075

At 31 December 2005, unguaranteed residual values of £nil (2004: £nil) had been accrued, and the accumulated allowance for uncollectible minimum lease payments receivable amounted to £1 million (2004: £1 million).

In 2005, £nil (2004: £nil) was received as contingent rents and recognised in 'Other operating income'.

Operating lease receivables

	Equipment	
	2005 £m	2004 £m
Future minimum lease payments under non-cancellable operating leases expiring:		
– no later than one year	**203**	274
– later than one year and no later than five years	**587**	592
– later than five years	**236**	216
	1,026	1,082

The group leases a variety of different assets to third parties under operating and finance lease arrangements, including rolling stock, property, aircraft and general plant and machinery.

41 Litigation

The group, through a number of its subsidiary undertakings, is named in and is defending legal actions in various jurisdictions arising from its normal business. No material adverse impact on the financial position of the group is expected to arise from these proceedings.

42 Related party transactions

The ultimate parent company of the group is HSBC Holdings plc, which is incorporated in England.

All transactions were made in the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with persons of a similar standing or, where applicable, with other employees. The transactions did not involve more than the normal risk of repayment or present other unfavourable features.

Transactions, arrangements and agreements involving Directors and others

The group

The table below sets out transactions which fall to be disclosed under IAS24 'Related Party Disclosures' between the group and the Key Management Personnel of both the bank and it's parent company, HSBC Holdings plc, and their connected persons or controlled companies.

	2005			2004		
	Number of persons	**Highest balance during the year[1] £000**	**Balance at 31 December[1] £000**	Number of persons	Highest balance during the year[1] £000	Balance at 31 December[1] £000
Key Management Personnel and connected persons and companies by them						
Loans	**54**	**201,025**	**88,141**	49	484,487	122,120
Credit cards	**42**	**274**	**121**	24	232	103
Guarantees	**1**	**12**	**12**	1	12	12

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 addition to the disclosures of related party transactions with Key Management Personnel under IAS24, the group is required to disclose particulars of transactions, arrangements and agreements entered into by HSBC Bank plc and its subsidiaries with Directors and connected persons and companies controlled by them and with officers of HSBC Bank plc pursuant to section 232 of the Companies Act 1985. Under the Companies Act there is no requirement to disclose transactions with the Key Management Personnel of the bank's parent company, HSBC Holdings plc.

	2005		2004	
	Number of persons	**Balance at 31 December £000**	Number of persons	Balance at 31 December **£000**
Directors and connected persons and companies controlled by them				
Loans	**19**	**11,541**	18	15,581
Credit cards	**19**	**57**	12	52
Guarantees	**1**	**12**	1	12
Officers				
Loans	**32**	**3,037**	33	6,697
Credit cards	**18**	**81**	22	95
Guarantees	**–**	**–**	–	–

Notes on the Financial Statements (continued)

Compensation to the Key Management Personnel of the group under IAS24 is disclosed as follows:

	2005 £000	2004 £000
Short-term employee benefits	**6,529**	5,991
Post-employment benefits	**287**	547
Share-based payment	**3,650**	9,425
	10,466	15,963

Transactions with other related parties

The group

Transactions with other related parties of the group

	2005		2004	
	Highest balance during the year £m	**Balance at 31 December 2005 £m**	Highest balance during the year £m	Balance at 31 December 2005 £m
Amounts due from joint ventures and associates:				
– subordinated	19	–	19	19
– unsubordinated	675	360	445	439
	694	360	464	458
Amounts due to joint ventures and associates	851	851	529	529

Transactions detailed below include amounts due to/from HSBC Holdings plc and fellow subsidiaries of HSBC Holdings plc.

	2005		2004	
	Highest balance during the year £m	**Balance at the year end £m**	Highest balance during the year £m	Balance at the year end £m
Assets				
Trading assets	**731**	**563**	–	–
Derivatives	**9,428**	**3,413**	**3,324**	**3,324**
Loans and advances to banks	**6,742**	**5,200**	**5,720**	**5,720**
Loans and advances to customers	**3,627**	**1,657**	**2,093**	**1,002**
Financial investments	**6,353**	**6,120**	**3,461**	**3,461**
Other assets	**1,323**	**296**	**2,271**	**76**
Liabilities				
Deposits by banks	**6,898**	**6,898**	**4,105**	**4,105**
Customer accounts	**7,888**	**3,594**	**4,928**	**3,849**
Derivatives	**10,967**	**3,979**	**4,439**	**4,439**

	For the year ended 31 December 2005	For the year ended 31 December 2004
	£m	£m
Income Statement		
Interest Income	**437**	204
Interest expense	**343**	112
Dividend income	**4**	–
Fee income	**49**	21
Fee expense	**69**	78
Other operating income	**26**	23
General and administrative expenses	**44**	20

Pension funds

At 31 December 2005, fees of £1.4 million (2004: £0.8 million) were earned by group companies for management services related to the group's pension funds held under management. The group's pension funds had placed deposits of £105 million (2004: £126 million) with its banking subsidiaries.

Transactions detailed below include amounts due to/from subsidiaries of HSBC Bank plc, HSBC Holdings plc and fellow subsidiaries of HSBC Holdings plc.

The bank

	2005		2004	
	Highest balance during the year	**Balance at the year end**	Highest balance during the year	Balance at the year end
	£m	**£m**	£m	£m
Assets				
Trading assets	**197**	**138**	–	–
Derivatives	**6,236**	**5,847**	**4,788**	**4,788**
Loans and advances to banks	**14,228**	**10,120**	**8,588**	**8,448**
Loans and advances to customers	**10,319**	**8,927**	**9,666**	**9,103**
Financial investments	**785**	**–**	**479**	**479**
Other assets	**256**	**84**	**58**	**38**
Liabilities				
Deposits by banks	**14,900**	**12,981**	**10,600**	**9,627**
Customer accounts	**12,211**	**11,075**	**8,192**	**7,242**
Derivatives	**6,810**	**5,638**	**5,259**	**5,259**

	2005		**2004**	
	Highest balance during the year	**Balance at 31 December**	Highest balance during the year	Balance at 31 December
	£m	**£m**	£m	£m
Amounts due from joint ventures and associates	**636**	**360**	408	402
Amounts due to joint ventures and associates	**810**	**810**	521	521

43 Events after the balance sheet date

There have been no material events after the balance sheet date which would require disclosure or adjustment to the 31 December 2005 financial statements.

44 Transition to IFRSs

The group's reported financial position, financial performance and cash flows have been affected by the transition from UK GAAP to IFRSs. The transition has not affected the group's net cash flows or the underlying economics of its businesses, though the periods in which certain income and expenses are recognised have changed.

The group has taken advantage of the section in IFRS 1 which exempts companies from presenting comparative information in accordance with IAS 32, IAS 39 and IFRS 4. The transitional adjustments are therefore set out in two stages: those relating to the restatement of 2004 comparative financial information (Notes (a) to (b) below), and those taking effect from 1 January 2005 (Notes (c) and (e)).

(a) Transitional exemptions adopted by the group in addition to the exemption from restating comparative information in accordance with IAS 32, IAS 39 and IFRS 4.

(b) Key impact analysis of IFRSs on the financial position at 31 December 2004, and financial performance and cash flows for the year ended 31 December 2004. The most significant effects of the transition to IFRSs on the group's and the bank's restated comparative financial information are the result of differences in the accounting treatment applied to goodwill, retirement benefits and dividends.

(c) Key impact analysis of adopting IAS 32, IAS 39 and IFRS 4 on the opening balance sheet at 1 January 2005.

(d) Reconciliation of group and bank balance sheets at 31 December 2004 and 1 January 2005.

(e) Principal accounting policies applicable to the 2004 comparative information which differ from those applied in 2005.

(a) Transitional exemptions

In addition to exempting companies from the requirement to restate comparatives for IAS 32, IAS 39 and IFRS 4, IFRS 1 grants certain exemptions from the full requirements of IFRSs to companies adopting IFRSs for the first time.

The group has taken the following exemptions and elections in making the transition to IFRSs:

(i) Business combinations

The group has elected not to restate business combinations that took place prior to the 1 January 2004 transition date. Had this exemption not been taken the main effects would have been to recognise deferred tax on fair value adjustments made at the date of acquisition and to recognise additional intangible assets with consequential adjustments to the carrying value of goodwill and retained earnings as at 1 January 2004.

The recognition of additional intangibles with a definite life would have given rise to an increased amortisation charge, which would have reduced IFRSs net income prospectively with a consequential reduction in total shareholders' equity. The restatement of goodwill would have had no impact on prospective net income unless it was written off following a subsequent impairment review.

(ii) Fair value or revaluation as deemed cost

The group has elected to measure individual items of property at fair value at the date of transition to IFRSs and use that fair value as deemed cost at that date.

If the group had continued to revalue properties, this would have led to increases in tangible fixed assets at 31 December 2004 and 31 December 2005 with corresponding increases in other reserves (net of deferred tax liabilities). There would have been a slightly increased depreciation charge and reduced net income going forward.

If the group had reverted to original cost as the basis for carrying properties, net income under IFRSs would have been higher for 2004 and 2005 owing to a reduced depreciation charge, and shareholders' equity would have been lower.

(iii) Employee benefits

The group has elected to apply the employee benefits exemption and has, therefore, recognised in equity at 1 January 2004 all cumulative actuarial gains and losses on post-employment benefit plans. Recognising certain actuarial gains and losses under the alternative 'corridor approach' would have reduced liabilities and increased retained earnings at 1 January 2004. The group has not elected to adopt a corridor approach going forward under IAS 19 'Employee benefits'.

(iv) Cumulative translation differences

The group has set the cumulative translation differences for all foreign operations to zero at 1 January 2004. The alternative, a retrospective application of IAS 21 'The effect of changes in foreign exchange rates', would have resulted in a re-allocation between retained earnings and other reserves at 1 January 2004 but would have had no impact on total equity.

(b) Key impact analysis of IFRSs on the financial results and position at 31 December 2004

The group previously prepared its primary financial statements under UK GAAP, which differs in certain significant respects from IFRSs. For a summary of the principal accounting policies followed for preparing the 2004 comparative information, see Note (e) below.

Reconciliation of previously reported profit attributable to shareholders under UK GAAP to profit attributable to shareholders under IFRSs for the year ended 31 December 2004

	The group £m	The bank £m
Profit before tax under UK GAAP	2,592	1,908
Goodwill amortisation	553	3
	3,145	1,911
Other goodwill adjustments	(1)	–
Retirement benefits	(120)	(125)
Leases	(44)	–
Share-based payments	(19)	(6)
Software capitalisation	13	19
Property	(5)	1
Dividends	–	158
Other	(16)	–
Profit before tax under IFRSs	2,953	1,958
Tax – UK GAAP	766	372
Tax – IFRSs adjustments	(43)	(8)
Minority interests – UK GAAP	172	–
Minority interests – IFRSs adjustments	1	–
Profit attributable to shareholders under IFRSs	2,057	1,594

Notes on the Financial Statements (continued)

Reconciliation of previously reported shareholders' funds under UK GAAP to total shareholders' equity under IFRSs at 31 December 2004

The group	At 31 December 2004 £m	At 1 January 2004 £m
Shareholders' funds as previously reported under UK GAAP	17,961	17,064
Goodwill	572	8
	18,533	17,072
Retirement benefits	(3,061)	(2,671)
Dividends	718	712
Leases	(367)	(324)
Share-based payments	131	110
Software capitalisation	179	167
Property	(74)	1
Long leasehold land	7	9
Other	(31)	(25)
Tax	793	679
Total equity attributable to the shareholders of the parent company	16,828	15,730

The bank	At 31 December 2004 £m	At 1 January 2004 £m
Shareholders' funds as previously reported under UK GAAP	17,961	17,064
Goodwill	3	–
	17,964	17,064
Retirement benefits	(3,031)	(2,660)
Dividends	488	328
Share-based payments	95	75
Software capitalisation	173	154
Property	(80)	–
Long leasehold land	7	7
Investments at cost	(1,323)	(1,258)
Tax	847	764
Total equity attributable to the shareholders of the parent company	15,140	14,474

Summary

IFRS 3 'Business Combinations' ('IFRS 3')

The group has applied IFRS 3 with effect from 1 January 2004 but, as permitted by IFRS 1, has not restated business combinations which occurred prior to 1 January 2004.

The carrying value of goodwill existing at 31 December 2003 under UK GAAP is carried forward under IFRS 1 from 1 January 2004, subject to two adjustments. Firstly, previously unrecognised intangible assets that meet the recognition criteria under IAS 38 'Intangible Assets' in the financial statements of the acquired entity are reported separately to the extent that they are included in goodwill at the date of transition. Secondly, only adjustments to provisional fair values (and hence goodwill) made during the first 12 months after an acquisition are reflected in comparative information. Accordingly, goodwill adjustments made after the first 12 months in accordance with UK GAAP have been reversed.

IFRS 3 requires that goodwill should not be amortised but should be tested for impairment on transition and at least annually at the cash-generating unit level by applying a fair-value-based test as described in IAS 36 'Impairment of Assets'. There was no impairment on transition or in any subsequent periods.

Under IFRS 3, the acquirer only recognises adjustments to the provisional fair values of assets and liabilities acquired in a business combination within 12 months of the acquisition date, with a corresponding adjustment to goodwill. These adjustments are made as if they had occurred at the acquisition date, i.e. the comparative

information is adjusted. Adjustments to the fair value of assets, liabilities and contingent liabilities after the 12 month period are recognised only to correct errors or adjust deferred tax assets that could not be recognised separately at the date of acquisition. When such a deferred tax asset is recognised, goodwill is reduced to the amount that would have been recognised if the deferred tax asset had been recognised at the date of the acquisition. Any reduction in goodwill is recognised as an expense, offsetting the benefit taken in the tax charge for the recognition of the deferred tax asset.

The effect of ceasing goodwill amortisation on operating profit for the year ended 31 December 2004 was £553 million.

IAS 19 'Employee Benefits' ('IAS 19')

IAS 19 requires pension fund assets to be assessed at fair value and liabilities on the basis of current actuarial assumptions using the projected unit credit method. As permitted by an amendment to IAS 19 approved by the IASB and endorsed by the EU, the group has elected to recognise all actuarial gains and losses directly in retained earnings.

IAS 10 'Events after the Balance Sheet Date' ('IAS 10')

Under IAS 10, equity dividends declared after the balance sheet date are not included as a liability at the balance sheet date. Accordingly, the group has reversed the liability for proposed dividends at each balance sheet date. This had the effect of increasing shareholders' equity of the group at 31 December 2004 and 1 January 2004 by £718 million and £712 million respectively (bank: £488 million and £328 million respectively).

IAS 17 'Leases' ('IAS 17')

IAS 17 requires that unearned income on finance leases be taken to income at a rate calculated to give a constant rate of return on the net investment in the lease, with no account taken in calculating the net investment of the tax effects of the lease. In general, this leads to a deferral of finance income compared with the pattern of recognition under UK GAAP, where income is recognised at a constant rate of return on the net cash investment in the lease including the effect of tax.

Under UK GAAP, assets leased out under operating leases are depreciated over their useful lives so that, for each asset, rentals less depreciation are recognised at a constant periodic rate of return on the net cash invested in that asset. Under IFRS, operating leased assets are depreciated to ensure that in each period the depreciation charge is at least equal to that which would have arisen on a straight-line basis.

The effect of both finance and operating leases on shareholders' equity at 31 December 2004 was a decrease of £367 million (1 January 2004: decrease of £324 million). The effect of the transition to IAS 17 was to decrease operating profit by £44 million for the year ended 31 December 2004.

IFRS 2 'Share-based Payment' ('IFRS 2')

IFRS 2 requires companies to adopt a fair-value-based method of accounting for share-based compensation plans which takes into account vesting conditions related to market performance, for example total shareholder return. Under this method, compensation cost is measured at the date of grant based on the assessed value of the award and is recognised over the service period, which is usually the vesting period.

In respect of other vesting conditions, an estimate of the number of options that will lapse before they vest is made at grant date and adjustments to this estimate are made over the service period. Accordingly, the expense recognised reflects, over time, the actual number of lapsed options for non-market performance-related conditions.

There is no exemption under IFRS 2 for Save-As-You-Earn schemes, as existed under UK GAAP.

At 31 December 2003, the group had a liability under UK GAAP in relation to certain sign-on and performance bonuses which were to be settled by the purchase of HSBC Holdings plc shares and had been expensed as incurred. Under IFRS 2, these transactions are treated as cash-settled share-based payments and are expensed over the vesting period.

Notes on the Financial Statements (continued)

IAS 27 'Consolidated and Separate Financial Statements' ('IAS 27')

IAS 27 requires that all entities be consolidated on a line-by-line basis. The group's insurance subsidiaries' third party assets, which were historically presented in aggregate on a single line 'Long-term assurance assets attributable to policyholders' within 'Other assets' on the consolidated balance sheet have, therefore, been included in appropriate headings for such assets.

In addition, funds under management have been consolidated where the requirements of IAS 27 and Standard Interpretations Committee 12 'Consolidation – Special Purpose Entities' ('SIC–12') are met.

SIC–12 also requires consolidation of special purpose entities ('SPEs') when the substance of the relationship between the SPE and the reporting entity indicates that the SPE is controlled by that entity. This has resulted in certain of the group's securitisation and conduit vehicles that were off-balance-sheet under UK GAAP being consolidated under IFRS.

The effect of consolidating funds under management and SPEs under IAS 27 and SIC – 12 was to gross up the 31 December 2004 balance sheet of the group by £2,684 million (1 January 2004: £3,045 million) with a minor impact of total sharesholders' equity. The effect on the bank was to gross up the 31 December 2004 balance sheet by £1,053 million (1 January 2004: £570 million).

Under IAS 27, investments in subsidiaries may be carried at cost or accounted for in accordance with IAS 39. In its separate financial statements, the bank took the option of carrying its investments in subsidiaries at cost instead of at net asset value, as under its previous UK GAAP policy. The effect of this change was a decrease in total shareholders' equity by £1,323 million at 31 December 2004 (£1,258 million at 1 January 2004).

IAS 12 'Income Taxes' ('IAS 12')

Under IAS 12, deferred tax liabilities and assets are generally recognised in respect of all temporary differences except where expressly prohibited by the Standard, subject to an assessment of the recoverability of deferred tax assets. Deferred tax assets are recognised to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilised.

In addition, unremitted earnings from subsidiaries, associates and joint ventures operating in lower tax jurisdictions result in a deferred tax liability unless the reporting entity is able to control the timing of the reversal of temporary differences and it is probable that the temporary differences will not reverse in the foreseeable future.

Under IFRS, fair value adjustments made on acquisition are tax-effected in order to present profitability on a tax-equalised basis: under UK GAAP no tax adjustments were required for items which did not affect the amount of tax payable or recoverable.

The IFRSs balance sheet of the group at 31 December 2004 included an increase in total shareholders' equity of £793 million (1 January 2004: £679 million). The IFRSs balance sheet of the bank at 31 December 2004 included an increase in total shareholders' equity of £847million (1 January 2004: £764 million). The net change in deferred tax mainly arose from prospective tax relief on pension deficits, tax-effecting fair value adjustments on acquisitions, previously unrecognised tax-effecting of historical property revaluations, and an adjustment to the grossing up of the value of in-force long-term assurance business.

IAS 38 'Intangible Assets' ('IAS 38')

IAS 38 states that intangible assets should be recognised separately from goodwill in a business combination where they arise from contractual or other legal rights, or if separable, i.e. capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented, or exchanged in combination with a related contract, asset or liability. The effect of this is that certain intangible assets such as trademarks and customer relationships included as part of goodwill under UK GAAP are separately measured and recognised on business combinations.

Where intangible assets have an indefinite useful life, or are not yet ready for use, they are tested for impairment annually. This impairment test may be performed at any time during an annual period, 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 annual period.

Presentationally, intangible assets recognised under UK GAAP, including the value of in-force long-term assurance business were reclassified from 'Other assets' to 'Intangible assets'.

IAS 38 further requires costs incurred in the development phase of a project to produce application software for internal use to be capitalised and amortised over the software's estimated useful life if the software will generate probable future economic benefits, and such costs can be measured reliably. Under UK GAAP these costs were expensed as incurred. This policy change resulted in £179 million of software being capitalised by the group as at 31 December 2004 (1 January 2004: £167 million). The bank capitalised £173 million of software as at 31 December 2004 (1 January: £154 million).

The capitalisation of software previously expensed in full results in a decrease in general and administrative expenses and an increase in depreciation and amortisation charged in respect of capitalised software in the form of regular, ongoing amortisation and any impairment charge. The net effect on the group was that expenses were £13 million lower for the year ended 31 December 2004.

IAS 16 'Property, Plant and Equipment' ('IAS 16')

The group has adopted the 'cost' model by which assets are carried at cost less any accumulated depreciation and impairment losses. The group has also applied the exemption in IFRS 1 which allows fair value at the date of transition to IFRS to be used as deemed cost for the value of property in most circumstances. No adjustments were required to restate property, plant and equipment in the IFRSs opening balance sheet at 1 January 2004 as a result of changing from a policy of revaluation to one of depreciated cost. However, £103 million was transferred out of the group's revaluation reserve to retained earnings on 1 January 2004 (bank: £21 million).

IAS 40 ' Investment Property' ('IAS 40')

Investment properties have been measured at fair value with changes in fair value recognised in the income statement. This resulted in a £5 million decrease in the group's operating profit for the year ended 31 December 2004.

IAS 21 'The Effects of Changes in Foreign Exchange Rates' ('IAS 21')

IAS 21 states that in consolidated financial statements, all exchange differences arising on the retranslation of foreign operations with functional currencies which differ from the entity's reporting currency should be recognised as a separate component of equity, in the foreign exchange reserve.

On disposal of a foreign operation, the exchange differences previously recognised in reserves in relation to that operation are recognised in the income statement for the period.

As permitted by IFRS 1, the group has deemed cumulative translation differences at 1 January 2004 to be zero.

IAS 7 'Cash Flow Statements' ('IAS 7')

The group previously had an exemption under the UK Financial Reporting Standard 1 (Revised 1996) 'Cash Flow Statements' ('FRS 1 (Revised)') from preparing a cash flow statement. However, no such exemption exists under IAS 7 and therefore, the group has been required to produce a cash flow statement in accordance with IAS 7.

(c) Key impact analysis of adopting IAS 32, IAS 39 and IFRS 4 on the opening balance sheet as at 1 January 2005

The group and bank's balance sheet at 1 January 2005 differed from the closing balance sheet dated 31 December 2004 as the former reflected first-time adoption of IAS 32, IAS 39 and IFRS 4.

For a summary of the principal accounting policies followed in preparing the 2004 comparative information, see Note 2 'Principal accounting policies'.

Notes on the Financial Statements (continued)

Reconciliation of previously reported shareholders' funds under UK GAAP to total shareholders' equity under IFRSs at 1 January 2005

The group	At 1 January 2005 £m
Shareholders' funds as previously reported under UK GAAP	17,961
Non IAS 32, IAS 39 and IFRS 4 adjustments	(1,133)
Total shareholders' equity under IFRSs excluding IAS 32, IAS 39 and IFRS 4	16,828
IAS 32, IAS 39 and IFRS 4 adjustments	
Derivatives and hedge accounting	(105)
Investment securities	591
Fair value option	(48)
Fee and commission income	(193)
Insurance	(98)
Other (including taxation)	(460)
Total equity attributable to the shareholders of the parent company	16,515

The bank	At 1 January 2005 £m
Shareholders' funds as previously reported under UK GAAP	17,961
Non IAS 32, IAS 39 and IFRS 4 adjustments	(2,821)
Total shareholders' equity under IFRSs excluding IAS 32, IAS 39 and IFRS 4	15,140
IAS 32, IAS 39 and IFRS 4 adjustments	
Derivatives and hedge accounting	(65)
Investment securities	29
Fair value option	(47)
Fee and commission income	(117)
Other (including taxation)	(437)
Total equity attributable to the shareholders of the parent company	14,503

Explanation of differences

Derivatives and hedge accounting

Under UK GAAP, derivatives were classified as trading or non-trading. Trading derivatives were reported at market value in the balance sheet, with movements in market value recognised immediately in the income statement. Non-trading derivatives, which were transacted for hedging and risk management purposes, were accounted for on an accruals basis, equivalent to the assets, liabilities or net positions being hedged. IAS 39 requires that all derivatives be recognised at fair value in the balance sheet as assets or liabilities. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and its resulting designation, as described in Note 2(k).

The combined impact on shareholders' equity of the group at 1 January 2005 was £(105) million, of which £178 million was taken to the cash flow hedging reserve (bank: £(65) million and £(1) million respectively).

Investment securities

Debt securities and equity shares intended to be held on a continuing basis under UK GAAP were disclosed as investment securities and included in the balance sheet at cost less provision for any permanent diminution in value. Other debt securities and equity shares held for trading purposes were included in the balance sheet at market value.

Under IAS 39, all investment securities (debt securities and equity shares) are classified and disclosed within one of the following three categories: 'held-to-maturity'; 'available-for-sale'; or 'at fair value through profit or loss'. Securities previously classified as held-for-trading purposes remain so classified. The accounting treatment for each of the categories above under IFRSs is described in Note 2, Principal accounting policies. On transition to

IFRSs, under IAS 39 the group classified most of its investment securities as available-for-sale. This resulted in an available-for-sale reserve of £571 million for the group (bank: £35 million), representing the cumulative unrealised gain on these securities being recorded within shareholders' equity.

Fair value option

Under IAS 39, financial assets and financial liabilities may be designated at fair value through profit or loss if they meet the criteria set out in the 'Amendment to IAS 39 Financial Instruments: Recognition and Measurement: The Fair Value Option'. The group has designated at fair value at 1 January 2005 certain loans and advances to customers, financial investments, and some own debt issued which satisfied the criteria in the Amendment. This had the impact of reducing shareholders' equity of the group by £48 million (bank: £47 million) on 1 January 2005.

Fee and commission income

Fee and commission income was previously accounted for in the period when receivable, except when charged to cover the costs of a continuing service to, or risk borne for, the customer, or was interest in nature. In these cases, income was recognised on an appropriate basis over the relevant period. Under IFRSs, the main change in accounting relates to loan fee income and incremental directly attributable loan origination costs, which are amortised to the income statement over the expected life of the loan as part of the effective interest calculation. This resulted in a reduction in shareholders' equity of the group of £193 million (bank: £117 million), as previously recognised fees after deduction of directly attributable costs were reversed and spread forward over the residual term of the financial instrument.

Non-equity minority interest reclassification

Preference shares issued by subsidiaries were previously classified in the balance sheet as non-equity minority interests with preference share dividends recorded as non-equity minority interests in the income statement. Under IAS 32, preference shares are generally classified in the balance sheet as liabilities. This had the impact of increasing the group's liabilities by £2,778 million (bank: £437 million) at 1 January 2005.

Insurance

Under UK GAAP, a value was placed on the group's interest in long-term assurance business, including a valuation of the discounted future earnings expected to emerge from business currently in force. From 1 January 2005, only long-term contracts meeting the definition of an insurance contract under IFRS 4 continue to be accounted for in this way. Long-term contracts not transferring significant insurance risk, referred to as investment contracts, are accounted for as financial instruments. Accordingly, it is no longer possible to include for such contracts an asset representing the value of the discounted future earnings expected to emerge from business currently in force, leading to a reduction in equity of £98 million. Income on such contracts will be recognised in later periods, as investment management fees and incremental directly attributable costs are spread over the period in which the services are provided.

Offsetting of financial assets and financial liabilities

Under UK GAAP, the netting of asset and liability balances in the balance sheet is only allowed when there is the ability to insist on net settlement. Under IAS 32 the offsetting of financial assets and financial liabilities is only allowed when there is a legally enforceable right to offset and the intention to settle net. The move from an ability to insist on net settlement to an intention to settle on a net basis is not in line with market practice in a number of areas and, in consequence, certain financial instruments have been presented gross on the balance sheet. This has increased the group's total assets by £42,839 million (bank: £33,206 million).

Acceptances were accounted for on a net basis under UK GAAP. There was no grossing up of the amount to be paid and the amount receivable from the originator, and thus no balance appeared on the balance sheet for these products. Under IAS 39 it is necessary to recognise a liability for acceptances from the date of acceptance. A corresponding asset due from the originator is also recognised. This resulted in a gross up of the group's balance sheet of £539 million (bank: £476 million), with no impact on shareholders' equity.

(d) Reconciliation of consolidated balance sheets at 31 December 2004 and 1 January 2005

Adjustments to the group's IFRSs balance sheet at 31 December 2004 to incorporate its accounting policies under IFRSs at 1 January 2005 (see Note 2) are set out below:

	IFRSs (except IAS 32/39 & IFRS 4) £m	Derivatives and hedge accounting £m	Investment securities £m	Fair value option £m	Fee and commission income £m	Non-equity reclass-ification £m	Loan impairment £m	Insurance £m	Offsetting £m	Reclass-ifications £m	Other £m	IFRSs £m
ASSETS												
Cash and balances at central banks	**1,275**	–	–	–	–	–	–	–	–	–	–	**1,275**
Items in the course of collection from other banks	**1,495**	–	–	–	–	–	–	–	–	–	–	**1,495**
Trading assets	**40,754**	**58**	–	–	**(21)**	–	–	–	–	**(3,000)**	**(2)**	**37,789**
Financial assets designated at fair value	–	–	–	–	–	–	–	–	–	**5,138**	–	**5,138**
Derivatives	**13,285**	**1,240**	–	**79**	–	–	–	–	**3,975**	**5,021**	–	**23,600**
Loans and advances to banks	**34,970**	–	–	–	–	–	–	–	–	**(201)**	–	**34,769**
Loans and advances to customers	**141,527**	**2**	–	–	**(179)**	–	–	–	**34,460**	**425**	–	**176,235**
Financial investments	**37,594**	**10**	**794**	–	–	–	–	**51**	–	**(2,272)**	**3**	**36,180**
Interests in associates and joint ventures	**224**	–	–	–	–	–	–	**5**	–	–	–	**229**
Goodwill and intangible assets	**8,821**	–	–	–	–	–	–	**527**	–	–	**1**	**9,349**
Property, plant and equipment	**4,695**	–	–	–	–	–	–	–	–	–	–	**4,695**
Other assets (including deferred taxation)	**4,400**	**28**	**(16)**	**20**	**44**	–	–	**(763)**	**4,404**	**(5,111)**	**(165)**	**2,841**
Prepayments and accrued income	**3,441**	**(376)**	**(10)**	–	–	–	–	–	–	–	**1**	**3,056**
Total assets	**292,481**	**962**	**768**	**99**	**(156)**	–	–	**(180)**	**42,839**	–	**(162)**	**336,651**

	IFRSs (except IAS 32/39 & IFRS 4) £m	Derivatives and hedge accounting £m	Investment securities £m	Fair value option £m	Fee and commission income £m	Non-equity reclass-ification £m	Loan impairment £m	Insurance £m	Offsetting £m	Reclass-ifications £m	Other £m	IFRSs £m
LIABILITIES AND EQUITY												
Liabilities												
Deposits by banks	**32,595**	**2**	–	–		–	–			**(1,829)**	**3**	**30,771**
Customer accounts	**161,069**	**6**	–	–	**11**	–	–	**2,525**	**34,460**	**(1,497)**	–	**196,574**
Items in the course of transmission to other banks	**907**	–	–	–	–	–	–	–	–	–	–	**907**
Trading liabilities	**14,982**	–	–	–	–	–	–	–	–	**1,834**	–	**16,816**
Financial liabilities designated at fair value	–	–	–	–	–	–	–	**(2,373)**	–	**5,593**	–	**3,220**
Derivatives	**13,391**	**1,320**	–	–	–	–	–	**12**	**3,976**	**5,136**		**23,835**
Debt securities in issue	**26,785**	**11**	–	**13**	–	–	–	–	**(175)**	**(1,434)**	**6**	**25,206**
Retirement benefit liabilities	**2,935**	–	–	–	–	–	–	–	–	–	–	**2,935**
Other liabilities	**5,841**	–	**18**	–	**42**	–	–	**1,792**	**4,578**	**(7,509)**	**(14)**	**4,748**
Liabilities under insurance contracts issued	–	–	–	–	–	–	–	**2,522**	–	–	–	**2,522**
Liabilities to policyholders under long-term assurance business	**4,513**	–	–	–	–	–	–	**(4,513)**	–	–	–	–
Accruals and deferred income	**3,816**	**(326)**	–	–	**6**	–	–	–	–	–	**9**	**3,505**
Provision for liabilities and charges:												
– deferred taxation	**328**	**37**	**142**	–	**(22)**	–	–	**(47)**	–	–	**(160)**	**278**
– other provisions	**434**	–	–	–	–	–	–	–	–	–	–	**434**
Subordinated liabilities	**5,370**	**17**	–	**134**	–	**2,778**	–	–	–	**(294)**	–	**8,005**
Total liabilities	**272,966**	**1,067**	**160**	**147**	**37**	**2,778**	–	**(82)**	**42,839**	–	**(156)**	**319,756**

Notes on the Financial Statements (continued)

	IFRSs (except IAS 32/39 & IFRS 4) £m	Derivatives and hedge accounting £m	Investment securities £m	Fair value option £m	Fee and commission income £m	Non-equity reclass-ification £m	Loan impairment £m	Insurance £m	Offsetting £m	Reclass-ifications £m	Other £m	IFRSs £m
Total liabilities	**272,966**	**1,067**	**160**	**147**	**37**	**2,778**	**–**	**(82)**	**42,839**	–	**(156)**	**319,756**
Equity												
Called up share capital	**797**	–	–	–	–	–	–	–	–	–	–	**797**
Share premium account	**12,820**	–	–	–	–	**(437)**	–	–	–	–	–	**12,383**
Other reserves	**17**	**178**	**571**	–	–	–	–	–	–	–	**(17)**	**749**
Retained earnings	**3,194**	**(283)**	**20**	**(48)**	**(193)**	–	–	**(98)**	–	–	**(6)**	**2,586**
Total shareholders' equity	**16,828**	**(105)**	**591**	**(48)**	**(193)**	**(437)**	–	**(98)**	–	–	**(23)**	**16,515**
Minority interests	**2,687**	–	**17**	–	–	**(2,341)**	–	–	–	–	**17**	**380**
Total equity	**19,515**	**(105)**	**608**	**(48)**	**(193)**	**(2,778)**	–	**(98)**	–	–	**(6)**	**16,895**
Total equity and liabilities	**292,481**	**962**	**768**	**99**	**(156)**	–	–	**(180)**	**42,839**	–	**(162)**	**336,651**

Reconciliation of the bank's balance sheets at 31 December 2004 and 1 January 2005

Adjustments to the bank's IFRSs balance sheet at 31 December 2004 to incorporate its accounting policies under IFRSs at 1 January 2005 (see Note 2) are set out below:

	IFRSs (except IAS 32/39 & IFRS 4) £m	Derivatives and hedge accounting £m	Investment securities £m	Fair value option £m	Fee and commission income £m	Non-equity reclass-ification £m	Loan impairment £m	Insurance £m	Offsetting £m	Reclass-ifications £m	Other £m	IFRSs £m
ASSETS												
Cash and balances at central banks	**587**	–	–	–	–	–	–	–	–	–	–	**587**
Items in the course of collection from other banks	**1,327**	–	–	–	–	–	–	–	–	–	–	**1,327**
Trading assets	**20,598**	**58**	–	–	–	–	–	–	–	**897**	–	**21,553**
Financial assets designated at fair value	–	–	–	–	–	–	–	–	–	**22**	–	**22**
Derivatives	**10,696**	**5,131**	–	**79**	–	–	–	–	–	–	–	**15,906**
Loans and advances to banks	**22,983**	–	–	–	–	–	–	–	–	**15**	–	**22,998**
Loans and advances to customers	**101,233**	**1**	–	–	**(152)**	–	–	–	**33,206**	**325**	–	**134,613**
Financial investments	**14,648**	**4**	**35**	–	–	–	–	–	–	**(1,259)**	–	**13,428**
Interests in associates and joint ventures	**113**	–	–	–	–	–	–	–	–	–	–	**113**
Investments in subsidiary undertakings	**14,628**	–	–	–	–	–	–	–	–	–	–	**14,628**
Goodwill and intangible assets	**229**	–	–	–	–	–	–	–	–	–	–	**229**
Property, plant and equipment	**1,482**	–	–	–	–	–	–	–	–	–	–	**1,482**
Other assets (including deferred taxation)	**1,524**	**22**	**(6)**	**20**	**47**	–	–	–	–	–	–	**1,607**
Prepayments and accrued income	**1,785**	**(5)**	–	–	–	–	–	–	–	–	–	**1,780**
Total assets	**191,833**	**5,211**	**29**	**99**	**(105)**	–	–	–	**33,206**	–	–	**230,273**

Notes on the Financial Statements (continued)

	IFRSs (except IAS 32/39 & IFRS 4) £m	Derivatives and hedge accounting £m	Investment securities £m	Fair value option £m	Fee and commission income £m	Non-equity reclass-ification £m	Loan impairment £m	Insurance £m	Offsetting £m	Reclass-ifications £m	Other £m	IFRSs £m
LIABILITIES AND EQUITY												
Liabilities												
Deposits by banks	**26,982**	–	–	–	–	–	–	–	–	**(30)**	–	**26,952**
Customer accounts	**104,183**	**(1)**	–	–	**11**	–	–	–	**33,206**	**30**	–	**137,429**
Items in the course of transmission to other banks	**781**	–	–	–	–	–	–	–	–	–	–	**781**
Trading liabilities	**6,852**											**6,852**
Financial liabilities designated at fair value	–	–	–	–	–	–	–	–	–	–	–	–
Derivatives	**10,949**	**5,283**	–	–	–	–	–	–	**175**	–	–	**16,407**
Debt securities in issue	**13,646**	–	–	–	–	–	–	–	**(175)**	–	–	**13,471**
Retirement benefit liabilities	**2,656**	–	–	–	–	–	–	–	–	–	–	**2,656**
Other liabilities	**1,099**	–	–	–	–	**(6)**	–	–	–	–	–	**1,093**
Liabilities to customers under investment contracts	–	–	–	–	–	–	–	–	–	–	–	–
Liabilities under insurance contracts issued	–	–	–	–	–	–	–	–	–	–	–	–
Liabilities to policyholders under long-term assurance business	–	–	–	–	–	–	–	–	–	–	–	–
Accruals and deferred income	**2,087**	**(6)**	–	–	**1**	–	–	–	–	–	–	**2,082**
Provision for liabilities and charges:												
– deferred taxation ...	**4**	–	–	–	–	–	–	–	–	–	–	**4**
– other provisions	**176**	–	–	–	–	–	–	–	–	–	–	**176**
Subordinated liabilities	**7,278**	–	–	**146**	–	**443**	–	–	–	–	–	**7,867**
Total liabilities	**176,693**	**5,276**	–	**146**	**12**	**437**	–	–	**33,206**	–	–	**215,770**

	IFRSs (except IAS 32/39 & IFRS 4) £m	Derivatives and hedge accounting £m	Investment securities £m	Fair value option £m	Fee and commission income £m	Non-equity reclass-ification £m	Loan impairment £m	Insurance £m	Offsetting £m	Reclass-ifications £m	Other £m	IFRSs £m
Total liabilities	**176,693**	**5,276**	**–**	**146**	**12**	**437**	**–**	**–**	**33,206**	**–**	**–**	**215,770**
Equity												
Called up share capital	**797**	–	–	–	–	–	–	–	–	–	–	**797**
Share premium account	**12,820**	–	–	–	–	**(437)**	–	–	–	–	–	**12,383**
Other reserves	**29**	**(1)**	**35**	–	–	–	–	–	–	–	–	**63**
Retained earnings	**1,494**	**(64)**	**(6)**	**(47)**	**(117)**	–	–	–	–	–	–	**1,260**
Total shareholders' equity	**15,140**	**(65)**	**29**	**(47)**	**(117)**	**(437)**	–	–	–	–	–	**14,503**
Minority interests	–	–	–	–	–	–	–	–	–	–	–	–
Total equity	**15,140**	**(65)**	**29**	**(47)**	**(117)**	**(437)**	–	–	–	–	–	**14,503**
Total equity and liabilities	**191,833**	**5,211**	**29**	**99**	**(105)**	–	–	–	**33,206**	–	–	**230,273**

Notes on the Financial Statements (continued)

(e) Principal accounting policies which only apply to the 2004 comparative information

Apart from the exceptions noted below, the same principal accounting policies apply to financial information disclosed in respect of both 2005 (see Note 2) and 2004. The following accounting policies only apply to the 2004 comparatives:

Interest income and expense

Interest income was recognised in the income statement as it accrued, except in the case of impaired loans and advances.

Premiums and discounts on the issue of debt and fair value adjustments to debt arising on acquisitions were amortised to interest payable so as to give a constant rate over the life of the debt. When debt was callable, either by the group or the holder, the premium or discount was amortised over the period to the earliest call date.

Non interest income

Fee income

Fee income was accounted for as follows:

- income earned on the execution of a significant act was recognised as revenue when the act had been completed (for example, commission and fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement for the acquisition of shares or other securities);
- income earned from the provision of services was recognised as revenue as the services were provided (for example, asset management, portfolio and other management advisory and service fees); and
- income which was interest in nature was recognised on an appropriate basis over the relevant period and recorded in 'Interest income'.

Trading income

Trading income comprised gains and losses from the mark to market movements of trading instruments. Interest income, expense and dividends were presented in 'Interest income', 'Interest expense' and 'Dividend income' respectively.

Loans and advances to banks and customers

Loans and advances to banks and customers included loans and advances originated by the group which were not intended to be sold in the short term and had not been classified as held for trading. Loans and advances were recognised when cash was advanced to borrowers. They were measured at amortised cost less provisions for bad and doubtful loans and advances.

Impaired loans and advances

It was the group's policy that each operating company would make provisions for impaired loans and advances when there was objective evidence of impairment. There were two basic types of provision, specific and general, each of which was considered in terms of the charge and the amount outstanding.

Specific provisions

Specific provisions represented the quantification of actual and inherent losses from homogeneous portfolios of assets and individually identified accounts. Specific provisions were deducted from loans and advances in the balance sheet. The majority of specific provisions were determined on a portfolio basis.

Portfolios

When homogeneous groups of assets were reviewed on a portfolio basis, two alternative methods were used to calculate specific provisions:

– When appropriate empirical evidence was available, the group utilised roll rate methodology (a statistical analysis of historical trends of the probability of default and amount of consequential loss, assessed at the end of each time period for which payments were overdue), other historical data and an evaluation of current economic conditions to calculate an appropriate level of specific provision based on inherent loss. Additionally, in certain highly developed markets, sophisticated models taking into account behavioural and account management trends such as bankruptcy and rescheduling statistics were used. Roll rates were regularly benchmarked against actual outcomes to ensure they remained appropriate.

– In other cases, when information was insufficient or not sufficiently reliable to adopt a roll rate methodology, the group adopted a formulaic approach which allocated progressively higher loss rates in line with the period of time for which a customer's loan was overdue.

Individually assessed accounts

Specific provisions on individually assessed accounts were determined by an evaluation of the exposures on a case-by-case basis. This procedure was applied to all accounts that did not qualify for, or were not subject to, a portfolio-based approach. In determining such provisions on individually assessed accounts, the following factors were considered:

– the group's aggregate exposure to the customer (including contingent liabilities);

– 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 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 were evident;

– the amount and timing of expected receipts and recoveries;

– the realisable value of security (or other credit mitigants) and likelihood of successful repossession;

– the 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 in local currency; and

– when available, the secondary market price of the debt.

Releases of individually calculated specific provisions were recognised whenever the group had reasonable evidence that the established estimate of loss had reduced.

Cross-border exposures

Specific provisions were established in respect of cross-border exposures to countries assessed by management to be vulnerable to foreign currency payment restrictions. This assessment included analysis of both economic and political factors.

Provisions were applied to all qualifying exposures within these countries unless these exposures:

– were performing, trade-related and of less than one year's maturity;

– were mitigated by acceptable security cover which was, other than in exceptional cases, held outside the country concerned; or

– were represented by securities held for trading purposes for which a liquid and active market existed, and which were marked to market daily.

General provisions

General provisions augmented specific provisions and provided cover for loans that were impaired at the balance sheet date but which would not be individually identified as such until some time in the future. The group required operating companies to maintain a general provision, which was determined after taking into account:

- historical loss experience in portfolios of similar 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 a specific provision against that loss; and
- management's judgement as to whether the then economic and credit conditions were such that the actual level of inherent loss was likely to be greater or less than that suggested by historical experience.

The estimated period between a loss occurring and its identification (as evidenced by the establishment of a specific provision for that loss) was determined by local management for each identified portfolio.

Loans on which interest was being suspended and non-accrual loans

Loans were designated as non-performing as soon as management had doubts as to the ultimate collectibility of principal or interest or when contractual payments of principal or interest were 90 days overdue. When a loan was designated as non-performing, interest was not normally credited to the income statement and either interest accruals ceased ('non-accrual loans') or interest was credited to an interest suspense account in the balance sheet which was netted against the relevant loan ('suspended interest').

Within portfolios of low value, high volume, homogeneous loans, interest was normally suspended on facilities 90 days or more overdue. In certain operating subsidiaries, interest income on credit cards may have continued to be included in earnings after the account was 90 days overdue, provided that a suitable provision was raised against the portion of accrued interest which was considered to be irrecoverable.

The designation of a loan as non-performing and the suspension of interest could be deferred for up to 12 months in either of the following situations:

- cash collateral was held covering the total of principal and interest due and the right of set-off was legally sound; or
- the value of any net realisable tangible security was considered more than sufficient to cover the full repayment of all principal and interest due, and credit approval had been given to the rolling-up or capitalisation of interest payments.

In certain subsidiaries, principally those in the UK, interest on non-performing loans was charged to the customer's account provided that there was a realistic prospect of interest being paid at some future date. However, the interest was not credited to the income statement but to an interest suspense account in the balance sheet, which was netted against the relevant loan.

In other subsidiaries, when the probability of receiving interest payments was remote, interest was no longer accrued and any suspended interest balance was written off.

On receipt of cash (other than from the realisation of security), the overall risk was re-evaluated and, if appropriate, suspended or non-accrual interest was recovered and taken to the income statement. A specific provision of the same amount as the interest receipt was then raised against the principal balance. Amounts received from the realisation of security were applied to the repayment of outstanding indebtedness, with any surplus used first to recover any specific provisions and then suspended interest.

Loans were not reclassified as accruing until interest and principal payments were up-to-date and future payments were reasonably assured.

Loan write-offs

Loans (and the related provisions) were normally written off, either partially or in full, when there was no realistic prospect of recovery of these amounts and when the proceeds from realising security had been received.

Trading assets and trading liabilities

Treasury bills, debt securities, equity shares and short positions in securities were included in 'Trading assets' or 'Trading liabilities' in the balance sheet at market value. Changes in the market value of these assets and liabilities were recognised in the income statement as 'Net trading income' as they arose. For liquid portfolios, market values were determined by reference to independently sourced mid-market prices. In certain less liquid portfolios, securities were valued by reference to bid or offer prices as appropriate. When independent prices were not available, market values were estimated by discounting the expected future cash flows using a suitable interest rate adjusted for the counterparty's credit risk. Interest income, interest expense and dividends arising from trading assets and liabilities were aggregated in the income statement with similar amounts arising from other activities.

Financial investments

Treasury bills, debt securities and equity shares intended to be held on a continuing basis were classified as financial investments and included in the balance sheet at cost less provision for any permanent diminution in value.

When dated financial investments had been purchased at a premium or discount, those premiums and discounts were amortised through the income statement over the period from the date of purchase to the date of maturity so as to give a constant rate of return. If the maturity was at the borrowers' option within a specified range of years, the earliest maturity was adopted. Those financial investments were included in the balance sheet at cost adjusted for the amortisation of premiums and discounts arising on acquisition. The amortisation of premiums and discounts was included in 'Interest income'. Any gain or loss on realisation of these securities was recognised in 'Gains less losses from financial investments' in the income statement as it arose.

Derivative financial instruments comprised futures, forward, swap and option transactions undertaken by the group in the foreign exchange, interest rate, equity, credit derivative, and commodity markets that were held off-balance sheet. Netting was applied where a legal right of set-off existed.

Accounting for these instruments was dependent upon whether the transactions were undertaken for trading or non-trading purposes.

Trading transactions

Trading transactions included transactions undertaken for market-making, to service customers' needs and for proprietary purposes, as well as any related hedges.

Transactions undertaken for trading purposes were marked to market and the net present value of any gain or loss arising was recognised in the income statement as 'Net trading income', after appropriate deferrals for unearned credit margins and future servicing costs. Derivative trading transactions were valued by reference to an independent liquid price when this was available. For those transactions with no readily available quoted prices, predominantly over the counter transactions, market values were determined by reference to independently sourced rates, using valuation models. If market observable data was not available, the initial increase in fair value indicated by the valuation model, but based on unobservable inputs, was not recognised immediately in the income statement. This amount was held back and recognised over the life of the transaction where appropriate, or released to the income statement when the inputs became observable, or when the transaction matured or was closed out. Adjustments were made for illiquid positions where appropriate.

Assets, including gains, resulting from derivative exchange rate, interest rate, equities, credit derivative and commodity contracts which were marked to market were included in 'Derivatives' on the assets side of the balance sheet. Liabilities, including losses, resulting from such contracts, were included in 'Derivatives' on the liabilities side of the balance sheet.

Non-trading transactions

Non-trading transactions, which were those undertaken for hedging purposes as part of the group's risk management strategy against cash flows, assets, liabilities or positions, were measured on an accrual basis. Non-trading transactions included qualifying hedges and positions that synthetically altered the characteristics of specified financial instruments.

Non-trading transactions were accounted for on an equivalent basis to the underlying assets, liabilities or net positions. Any gain or loss arising was recognised on the same basis as that arising from the related assets, liabilities or positions.

To qualify as a hedge, a derivative was required effectively to reduce the price, foreign exchange or interest rate risk of the asset, liability or anticipated transaction to which it was linked and be capable of designation as a hedge at inception of the derivative contract. Accordingly, changes in the market value of the derivative were required to be highly correlated with changes in the market value of the underlying hedged item at inception of the hedge and over the life of the hedge contract. If these criteria were met, the derivative was accounted for on the same basis as the underlying hedged item. Derivatives used for hedging purposes included swaps, forwards and futures. Interest rate swaps were also used to alter synthetically the interest rate characteristics of financial instruments. In order to qualify for synthetic alteration, a derivative instrument had to be linked to specific individual, or pools of similar, assets or liabilities by the notional principal and interest rate risks of the associated instruments, and had to achieve a result that was consistent with defined risk management objectives. If these criteria were met, accruals-based accounting was applied, i.e. income or expense was recognised and accrued to the next settlement date in accordance with the contractual terms of the agreement.

Any gain or loss arising on the termination of a qualifying derivative was deferred and amortised to earnings over the original life of the terminated contract. When the underlying asset, liability or position was sold or terminated, the qualifying derivative was immediately marked-to-market and any gain or loss arising was taken to the income statement.

Insurance contracts

The value of in-force long-term assurance business was determined by discounting future earnings expected to emerge from business then in force, using appropriate assumptions in assessing factors such as recent experience and general economic conditions. Movements in the value of in-force long-term assurance business were included in ‘Other operating income’ on a gross of tax basis.

Debt securities in issue and subordinated liabilities

Debt securities in issue were initially measured at fair value, which was the consideration received net of transaction costs incurred. Premiums and discounts on the issue of debt and fair value adjustments to debt arising on acquisitions were amortised to interest payable so as to give a constant interest rate over the life of the debt. Where debt was callable, either by the group or the holder, the premium or discount was amortised over the period to the earliest call date.

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