HSBC Bank plc

Annual Report and Accounts 2009

HSBC

The world's local bank

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Annual Report and Accounts 2009

Contents

Presentation of Information

This document comprises the *Annual Report and Accounts 2009* for HSBC Bank plc ('the bank') and its subsidiary undertakings (together 'the group'). It contains the Directors' Report and Financial Statements, together with the Auditor's report, as required by the UK Companies Act 2006. References to 'HSBC' or 'the Group' within this document mean HSBC Holdings plc together with its subsidiaries.

Cautionary Statement Regarding Forward-Looking Statements

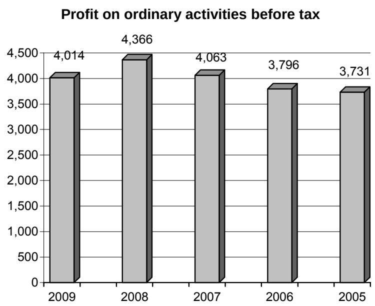
This *Annual Report* contains certain forward-looking statements with respect to the financial condition, results of operations and business of the bank.

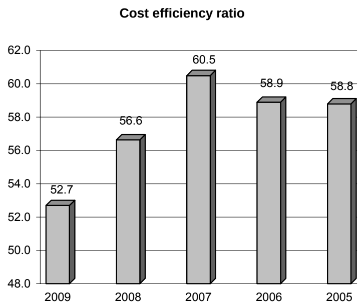
Statements that are not historical facts, including statements about the bank's beliefs and expectations, are forward-looking statements. Words such as 'expects', 'anticipates', 'intends', 'plans', 'believes', 'seeks', 'estimates', 'potential' and 'reasonably possible', variations of these words and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

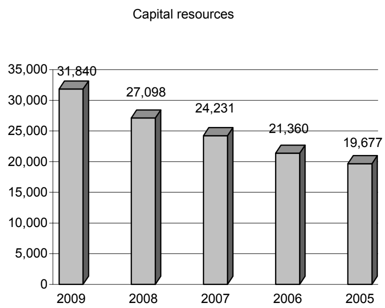
Forward-looking statements involve inherent risks and uncertainties. Readers are cautioned that a number of factors could cause actual results to differ, in some instances materially, from those anticipated or implied in any forward-looking statement.

Financial Highlights

	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
For the year					
Profit on ordinary activities before tax	**4,014**	4,366	4,063	3,796	3,731
Profit attributable to shareholders of the parent company	**3,092**	3,441	3,209	2,722	2,842
At year-end					
Shareholders' funds of the parent company	**27,787**	19,923	24,423	20,399	19,091
Capital resources[1]	**31,840**	27,098	24,231	21,360	19,677
Customer accounts and deposits by banks	**390,625**	431,311	317,055	265,863	239,673
Total assets	**751,928**	924,231	622,280	440,760	386,422
Ratios (%)					
Return on average shareholders' funds (equity) of the parent company	**13.2**	14.5	14.5	13.6	16.4
Loans and advances to customers as a percentage of customer accounts	**82.5**	80.6	84.9	88.2	88.9
Capital ratios					
– total capital[1]	**15.7**	10.5	10.8	11.2	10.8
– tier 1 capital[1]	**11.2**	6.8	7.5	7.5	6.9
Cost efficiency ratio[2]	**52.7**	56.6	60.5	58.9	58.8







1 *2007 capital balances and ratios are stated on a Basel I basis; pro-forma figures as at 31 December 2007 calculated under Basel II are: capital resources: £22,514; total capital ratio: 10.6 per cent; Tier 1 capital ratio: 7.6 per cent.*

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

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

Board of Directors

Directors

S K Green, Chairman

Age 61. Chairman since 2005 and a Director since 1995. Deputy Chairman from 2003 to December 2004. Group Chairman of HSBC Holdings plc. Joined HSBC in 1982.

M F Geoghegan, CBE, Deputy Chairman

Age 56. Deputy Chairman since 2006 and a Director since 2004. Chief Executive from 2004 to 2006. Group Chief Executive of HSBC Holdings plc. Joined HSBC in 1973.

S T Gulliver, Chairman of the Executive Committee

Age 50. A Director since 2006. A Director of HSBC Holdings plc and Chairman, Europe, the Middle East and Global Businesses. Joined HSBC in 1980.

P A Thurston, Chief Executive

Age 56. Chief Executive since April 2009 and a Director since June 2008. A Group Managing Director since April 2008. Managing Director, UK Banking from June 2008 to April 2009. Joined HSBC in 1975.

D C Budd*

Age 56. Chairman of HFC Bank Limited since June 2008. A Director since 2005. A Group General Manager since 2005. Joined HSBC in 1972.

Dame Mary Marsh**

Age 63. Director of the Clore Social Leadership Programme. Governor and Chair of the International Alumni Council, London Business School. A member of the National Council of the Learning and Skills Council. A Trustee of Young Enterprise. A Director since 1 January 2009 and a member of the Corporate Sustainability Committee of HSBC Holdings plc since 31 July 2009. Formerly Chief Executive of the National Society for the Prevention of Cruelty to Children (NSPCC).

R E S Martin**

Age 49. General Counsel & Company Secretary elect, Vodafone Group plc. Member of the Legal Services Board. A Director since 2005.

A R D Monro-Davies**

Age 69. Formerly Chief Executive Officer, Fitch Ratings. A Director since 2004. Chairman of the Audit Committee.

S P O'Sullivan

Age 54. Chief Technology and Services Officer, UK Banking. A Director since 2007. Chairman of HSBC Trust Company (UK) Limited. A Director of HFC Bank Limited and Marks and Spencer Financial Services plc. Joined HSBC in 1980.

P M Shawyer**

Age 59. Formerly a Managing Partner of Deloitte. A Director since 2004. A member of the Audit Committee.

J F Trueman**

Age 67. Formerly Deputy Chairman of S G Warburg & Co. A Director since 2004. A member of the Audit Committee.

* *Non-Executive Director*
** *Independent Non-Executive Director*

Secretary

J H McKenzie

Age 56. Joined HSBC in 1987.

Registered Office: 8 Canada Square, London E14 5HQ

Report of the Directors

Introduction

While 2009 was a difficult year for most European economies, HSBC's financial strength, premium customer base and ability to leverage its brand and global networks ensured that all lines of business remained strong and profitable, supported by a well-funded balance sheet with increased capital strength. Retail customer deposit levels increased despite intense competition and margin compression, and allowed the group to grow in mortgages and continue to lend to commercial customers. The group continued to position its balance sheet conservatively with a focus on delivering long-term sustainable returns.

Results for 2009

The consolidated profit for the year attributable to the shareholders of the group was £3,092 million.

An increase in underlying revenues was driven by a strong performance in the European Global Banking and Markets business, primarily resulting from robust revenues in Rates and Balance Sheet Management. Retail Banking remained profitable despite the deterioration in the economic environment, higher unemployment levels and a subsequent rise in loan impairment charges. The bank continued to provide lending support to customers while maintaining effective credit controls and strengthening collection practices and systems.

Interim dividends of £441 million and £500 million were paid on the ordinary share capital during the year.

The Summary of Financial Performance is given on page 11.

Principal activities

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

As at 31 December 2009, the bank had 1,369 branches in the United Kingdom, and 14 branches in the Isle of Man and the Channel Islands.

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

Significant events

On 12 June 2009, the bank sold its residual 49 per cent holding in HSBC Merchant Services LLP (HMS), the card processing joint venture ('JV') that serves its UK business clients, to its partner in the venture, Global Payments Inc., for a consideration of £192 million. The gain of £180 million is included in 'Other operating income' in the consolidated income statement.

On 13 November 2009, the group agreed the sale and leaseback of 8 Canada Square, Canary Wharf, London to the National Pension Service of Korea ('NPS') for £773 million in cash. As a result of the transaction, a gain of £353 million was recognised in 'Other operating income' in 2009. Further details on this transaction are provided in Note 22 'Property, plant and equipment'.

A change in the basis of delivering death-in-service, ill health and early retirement benefits for some UK employees generated an accounting gain of £322 million in 2009.

Business segments

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

UK Retail Banking

Retail Banking comprises two customer groups, Personal Financial Services ('PFS') and Commercial Banking ('CMB'). UK Personal Financial Services provides current accounts, savings, personal loans, mortgages, cards, financial planning, as well as life and general insurance to UK personal customers through a variety of distribution channels under various HSBC brands, including first direct, Marks & Spencer Money and partnership card™. UK Commercial Banking provides a wide range of products and services to commercial organisations, from sole proprietors to quoted companies. These include current and savings accounts, payments, electronic banking, trade finance, loans, overdrafts, asset finance, foreign exchange and other treasury and capital markets instruments, wealth management services and general insurance.

Continental Europe Retail Banking

Continental Europe Retail Banking provides a comprehensive range of retail financial services to local and expatriate personal and commercial customers in Europe. The principal Retail Banking operations are in

Report of the Directors (continued)

France, Turkey, Germany and Malta, with a growing PFS network in Russia and Poland which supports an existing extensive Commercial Banking network across the region.

Global Banking and Markets

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

Private Banking

Private Banking reflects the operations of HSBC Private Banking Holdings (Suisse) SA and its subsidiaries. Private Banking helps individuals and families meet their complex international financial needs by offering product leadership in areas such as credit, hedge funds advisory, estate planning, and investment advice.

Other

Activities or transactions which do not relate directly to the business segments are reported in Other. The main items reported under Other include movements in the fair value of own debt, the gain in respect of the sale of HSBC's London headquarters, and the gain on sale of the French regional banks in 2008.

Strategic direction

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

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

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

The group seeks to build mutually profitable relationships with all customers, leveraging the Group's global network, intelligence and capabilities to help customers to unlock the world's potential, enabled by globally consistent, highly efficient systems and procedures.

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

UK Retail Banking

In 2009 the UK Commercial Banking business continued to focus on its core strategies of becoming the leading bank for International Business and the Best Bank for Business. Significant growth was seen in trade revenue where the bank responded to the challenge of domestic recession by increasing the availability of Trade Finance to companies trading internationally.

To support the growth and servicing of the international customer base the bank has established Global Relationship Managers for larger Commercial customers and has recruited 80 specialist International Commercial Managers for small and medium sized enterprises ('SME') customers. Extensive training programmes have been launched to ensure the bank can best serve existing international customers and target new international business, leveraging the global network to provide unrivalled local customer service. To maximise the potential this provides, the bank developed a Global Links network to facilitate cross-border business referrals ensuring customers are provided with expert advice and service outside of their domestic market if required.

A key milestone in the aim to become 'Best Bank for Business' was being recognised as the Number 1 Internet Bank for SMEs, and HSBC is now the leading Direct Bank for business in the UK.

Return optimisation on domestic business remains a key focus. The bank successfully repositioned

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exposure to UK Commercial Real Estate early in the economic cycle and the commercial property portfolio decreased by £0.8 billion to £10.3 billion during 2009. These customers are now managed by dedicated specialist relationship managers.

The Personal Financial Services business continued to build its position as a leading provider of financial services to mass affluent customers in the UK. The number of customers utilising the international relationship managed Premier proposition increased by 22 per cent. Critical to the success in this segment was the development and maintenance of competitive life assurance, pensions, mortgages and investments products. HSBC was one of the market leaders in income protection in the UK, outstanding balances in the retail mortgage book increased by 16 per cent, and the bank was able to utilise its global asset management expertise to help grow HSBC World Selection, the uniquely positioned series of investment funds to £959 million in funds under management since launch in February 2009. The bank also invested heavily in improving Life, Pension and Investment distribution through delivery of financial planning systems and advisor training programmes.

2009 was a significant year in the re-alignment of the UK Insurance business. On 18 December 2009 the bank announced that it had reached an agreement to sell HSBC Insurance Brokers Limited to Marsh Inc. for £135 million. Marsh Inc. will become the preferred provider of insurance broking services to corporate and Private Banking clients internationally, and to HSBC Group companies. The bank also disposed of HSBC Actuaries & Consultants Limited and closed the motor insurance underwriter HSBC Insurance (UK) Limited to new business. This has enabled the bank to focus on the core Life and General Insurance propositions delivered directly to HSBC customers and position these channels for future growth. The bank has seen a substantial up-lift in the number of customers that have come to the bank for advice on Life, Pensions and Investments (‘LPI’) coupled with an increase in the proportion of customers that hold LPI products with HSBC Life.

Continental Europe Retail Banking

In Continental Europe, investment is being redirected towards markets with strong group connectivity. The key objective is to provide relationship-driven service to selected internationally minded and emerging market clients. The group’s strategy is Commercial Banking led, meaning that Personal Financial Services only operates in markets where Commercial Banking is established and the group has a market opportunity.

The Commercial Banking offering is focused around Leading International Business, which leverages the group’s expansive international connectivity to meet the needs of customers around the world. A small number of sites have been rationalised. This has allowed greater focus on international business while leveraging the group’s network with selective targeting of domestic business, resulting in higher revenues. Despite the fall in international trade volumes across Continental Europe, the group’s trade business continued to grow with particularly strong growth in Poland and Turkey, and record results in Spain, Armenia, Israel and Ireland. Over the coming year the group will continue to support international businesses in a number of key markets. This will involve launching new products and platforms, increasing the numbers of relationship managers and enhancing the workforce skills through training.

In supporting Business Banking customers the roll out of the Business Direct proposition has continued with new launches in Poland and France during the year. The total number of Business Direct customers as at 31 December 2009 was 47,860 representing a 24 per cent increase over 2008. Moving forward, the focus will be on needs based segmentation of customers and optimising efficiency and standards of servicing through the development of regional target operating models.

In an environment where capital efficiency is paramount, the group has focused on minimising risk weighted assets, for example successfully obtaining the advanced internal ratings based approach Basel II in France. A move towards more capital efficient products is demonstrated by the continued roll out and enhancement of receivables finance services which are now available in 8 European markets.

For Personal Financial Services, the group’s strategy is to provide a relevant, efficient and sustainable business, leveraging Commercial Banking and Global Banking and Markets relationships to build a Premium Segmented and Multi-Channel business.

In 2009 a pilot of a new distribution strategy, Direct Bank with Branches, was launched in Poland. This offers customers a consistent and enhanced experience across all distribution channels. It is expected to be rolled-out to other countries from 2010.

Global Banking and Markets

In 2009, Global Banking and Markets continued to pursue its now well established ‘emerging markets-led and financing-focused’ strategy, encompassing HSBC’s objective to be a leading wholesale bank by:

- utilising HSBC’s extensive distribution network;
- developing Global Banking and Markets’ hub-and-spoke business model; and
- continuing to build capabilities in major hubs to support the delivery of an advanced suite of

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services to corporate, institutional and government clients across the HSBC network.

Ensuring that this combination of product depth and distribution strength meets the needs of both existing and new clients will allow Global Banking and Markets to achieve its strategic goals.

Private Banking

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

The strength of HSBC's brand, capital position, and extensive global network enables Private Banking to help individuals and families meet their complex international financial needs through product leadership in areas such as credit, hedge funds advisory, estate planning, and investment advice.

Through high connectivity with the group's global businesses, continuing investment in its people, integrated IT solutions, and emerging markets-focused domestic operations, Private Banking has been positioned for sustainable long-term growth.

Environment

Economy

The **UK** economy suffered a sharp contraction during the course of 2009, although evidence from the final months of the year suggested that some growth had resumed. Gross Domestic Product ('GDP') fell by 4.9 per cent in 2009 – the sharpest contraction in over sixty years – after a 0.5 per cent increase in 2008. Weakness proved widespread across most areas of the economy and the unemployment rate hit a thirteen year high of 7.9 per cent in July 2009, although some stabilisation of labour market conditions was apparent towards the end of the year. Consumer Price Index ('CPI') inflation reached a five-year low of 1.1 per cent in September 2009 before then moving towards the Bank of England's 2 per cent target by the end of the year. Nominal house prices registered a modest appreciation on most measures during the second half of the year, although indicators of housing market activity remained at relatively weak levels. After reducing interest rates to just 0.5 per cent in March 2009, the Bank of England launched the Asset Purchase Facility in an attempt to improve the circulation of credit across the economy and support expectations of future economic activity.

The **eurozone** economy also performed poorly during 2009, with GDP falling by 4.0 per cent following a 0.5 per cent expansion in 2008. Much of this weakness was concentrated in the early months of 2009 and growth resumed in the third quarter, helped by a variety of fiscal stimulus programmes and a rebuilding of inventory levels across the economy. Consumer spending proved relatively resilient during the early months of 2009, boosted by the operation of a number of purchase incentive schemes for consumer durable goods, and some weakness was observed as these programmes expired. Unemployment rose to an eleven year high of 10 per cent in December 2009, while consumer price inflation temporarily moved into negative territory during the third quarter of the year. The European Central Bank ('ECB') cut interest rates by 150 basis points within a short period at the beginning of 2009 to finish the year at 1.0 per cent.

In **Turkey**, economic activity proved very weak as GDP fell by 8.4 per cent during the first three quarters of 2009 against the comparable period of 2008, although, in common with many other economies, most of this weakness was concentrated within the early months of the year. Labour market conditions deteriorated with the unemployment rate averaging 14.2 per cent during the first ten months of 2009 versus 10.4 per cent during the comparable period of 2008. Headline inflation pressures showed a decelerating trend during much of the year, due in large part to weaker energy and food prices, factors that also led to a sharp narrowing of the current account deficit. Turkey's sovereign credit rating was raised by a single agency in the final months of the year, but concerns remain over substantial foreign currency exposures within the private sector and negotiations over an IMF assistance programme are ongoing.

Competition and Regulation

UK

Changes in the competitive landscape continued throughout 2009 with further consolidation of financial services companies and changes in the level of public ownership in others. The level of government intervention and regulatory scrutiny intensified still further in the UK, across Europe, and globally on a broad range of issues including capital requirements, liquidity, remuneration, business models, deposit guarantee schemes, conduct of business and consumer protection.

The severe contraction in domestic and international money markets which started late in 2008 continued to disrupt the UK market throughout 2009. Competition for retail deposits increased throughout 2009 and is expected to remain intense for the foreseeable future, as banks seek to reduce wholesale funding requirements. HSBC's traditional approach to prudent balance sheet management ensures that the deposit base remains a source of strength, allowing the bank to continue to lend to customers throughout the financial crisis.

Report of the Directors (continued)

On 25 November 2009 the UK Supreme Court decided unanimously that, provided the terms of unauthorised overdraft charges were expressed in plain and intelligible language, the amount of those charges could not be assessed for fairness under the Unfair Terms in Consumer Contracts Regulations 1999. This brings to a conclusion the court action between the Office of Fair Trading ('OFT') and a number of UK financial institutions including the bank which commenced in July 2007. Subsequently, on 22 December 2009, the OFT announced its decision that it would not be continuing its investigation, under the Regulations, into the fairness of the charges. The OFT also confirmed that it would address its ongoing concerns, about the operation of the market for personal current accounts, by discussing the issues with banks, consumer groups and other organisations, with the aim of reporting on progress by the end of March 2010.

HSBC has intervened in support of MasterCard in its appeal to the European Court of the First Instance against the decision of the European Commission on the level of interchange fees. Although no trial date has yet been set, the case is not expected to be heard until mid 2010 at the earliest.

On 29 September 2009 the FSA issued a Consultation Paper (09/23) on the assessment and redress of payment protection insurance (PPI) complaints. The proposals in the Paper stem from the FSA's concerns about the fairness with which firms have assessed consumer complaints about past PPI sales, which have, according to the FSA, significantly increased in recent times. The FSA's proposals have generated a significant number of responses both at an Industry and individual firm level and the FSA has confirmed it is currently reviewing these. No date has yet been set by the FSA for publication of its formal policy statement on the issues. Separately, the Competition Commission continues to consult on whether a ban on firms selling PPI at point of sale of the credit product is an appropriate and justified remedy for the deficiencies in the PPI market it identified in its report published on 29 January 2009. In December 2007, the group decided to cease selling PPI (but not short-term protection products) under its HSBC, first direct and M&S Money brands. A phased withdrawal was completed across these brands and channels in 2008.

HSBC continues to adopt the highest ethical standards in its dealings with customers, which includes adherence to FSA Principle 6 – Treating Customers Fairly.

Increased capital requirements and Pillar 3 disclosures for market risk and securitisations have already been announced by the Basel Committee and are due for implementation in the EU in 2011. The Basel Committee issued a consultative document *Strengthening the resilience of the banking sector* on 17 December 2009. These proposals aim to raise the quality, consistency and transparency of the tier 1 capital base, introduce a leverage ratio, a minimum global standard for funding liquidity, a framework for countercyclical capital buffers and increase RWAs for both counterparty credit risk and financial institution exposures. These proposals are subject to consultation and quantitative impact study during 2010, with the aim of implementation by the end of 2012.

France

In order to limit the impact of the financial crisis, the French government continued to take various measures aimed at stabilising the French economy.

A €35 billion initiative, 'Plan de relance', was launched to focus mainly on investments in the building and SME sectors. The main aim was to improve SME liquidity, where the government will guarantee commercial debts in the absence of insurers.

In addition, actions were taken to support the banking sector by injecting funds through Société de Prises de Participations de l'Etat by subscribing to subordinated debt, and the creation of a special vehicle, Société de Financement de l'Economie Française, 34 per cent owned by the state.

During the second half of 2009 the three main French banks repaid €13 billion of subordinated debt issued to the French State. This repayment together with a planned €22 billion public bond issue at the beginning of 2010 will be used to finance projects for the future and to encourage potential growth in the French economy.

In the French retail banking sector, the merger of two mutual groups took place during the last quarter of 2009 to create one of the largest retail banks in France. On-line banks also continued to expand with at least ten banks offering this service. Whilst most of these on-line banks are subsidiaries of existing banks there are three that are subsidiaries of insurance companies.

During 2009 BNP Paribas became a more diversified retail bank and a stronger European competitor with its acquisition of Fortis. Societe Generale decided to merge its asset management activities with those of Credit Agricole to create the 4th largest asset manager in Europe.

In the French parliament debates took place on the change in legal status of 'La Poste'. As well as operating postal services La Poste also provides a full range of banking services to personal customers through its subsidiary, Banque Postal.

In line with the recommendations of the Committee of European Banking Supervisors, 'CESB' the French Regulator 'Commission Bancaire' issued changes to the regulatory liquidity framework which will apply from June 2010. This updates the previous framework issued in 1988 and takes into account the experience learned during the liquidity crisis. Banks will have the choice of reporting on either a standard mainly quantitative approach or on an advanced approach based on internal methodologies. The strengthening of the framework will undoubtedly result in some banks incurring additional funding costs.

Turkey

Although the global crisis led to a severe recession in the Turkish economy in 2009, the crisis had a limited impact on the banking sector, which is well regulated, well capitalised and highly liquid. Turkey's markets were largely immune from subprime loans and derivatives, as derivatives markets are still developing.

The Central Bank of Turkey responded to the global crisis with a significant cycle of interest rate cuts in 2009. The overnight borrowing rate was reduced from 15 per cent at year-end 2008 to 6.5 per cent in December 2009. The Central Bank also decreased the reserve requirements for local currency deposits and non-deposit liabilities from 6 per cent to 5 per cent, in order to support credit growth.

The Turkish government also introduced a number of measures to combat the impact of the global crisis on the Turkish economy. In particular, a state sponsored loan scheme was introduced to support credit extension to small and medium sized enterprises, in collaboration with Turkish banks. Discussions between the government and the IMF continue regarding a potential IMF standby agreement.

The Turkish banking industry is a highly competitive mix of large domestic, state-owned and global banks. Three state-owned banks have a 32.1 per cent share, while foreign-owned banks, including partial shareholdings, have 24 per cent. The remainder is controlled by privately-owned domestic banks. The four largest domestic banks dominate a market of 32 commercial banks and comprise some 47.2 per cent of the industry's assets.

The growth of the Turkish banking industry is mainly driven by lending and highly dependent on the availability of foreign financing. The effects of the global crisis heavily inhibited the sector's growth in 2009 to 8.2 per cent. Loan markets growth, both commercial and personal, was almost flat. Banks invested heavily in high-yield and risk-free government securities, up by 24.4 per cent against 2008. Despite unprecedented conditions, competition was intense in the domestic funding market and the industry managed to build its deposit base by 6.5 per cent in 2009. The global crisis has also halted infrastructure investments: network expansion has been limited to 246 branches only (up by 3 per cent) with total industry staffing levels increasing by 0.5 per cent.

Key Performance Indicators ('KPIs')

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

Financial KPIs

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

The table below and related commentary presents, on an underlying basis, the measures for the period 2008 and 2009. At a business level, KPIs are complemented by various benchmarks, which are relevant to the planning process and to reviewing business performance.

	2009	2008
Revenue growth[1] (%)	23.1	7.2
Revenue mix[2] (%)		
Net interest income	51.1	41.9
Net fee income	25.8	29.7
Trading income	16.6	22.3
Other income	6.5	6.1
Cost efficiency[3] (%)	51.8	60.6
Return on average invested capital[4] (%)	9.2	7.8
Advances to deposits ratio[5] (%)	89.3	88.9

1 *The percentage increase in net operating income before loan impairment charges and other credit risk provisions compared with the previous reporting period.*
2 *As a percentage of net operating income before loan impairment charges and other credit risk provisions.*
3 *Total operating expenses divided by net operating income before loan impairment charges and other credit risk provisions.*
4 *Profit attributable to ordinary shareholders divided by average invested capital.*
5 *Loans and advances to customers as a percentage of the total of core current and savings accounts and term funding with a remaining term to maturity in excess of one year.*

Revenue growth provides an important guide to the group's success in generating business. While the economic recession depressed demand for lending and lower interest rates increased competition for deposits, revenue still grew by 23.1 per cent in 2009. Global Banking and Markets reported significant growth as robust revenues across core trading activities were driven by higher margins and an increase in market share.

Revenue mix represents the relative distribution of revenue streams between net interest income, net fee income, trading income and other income. It is used to understand how changing economic factors affect the group, to highlight dependence on balance sheet

Report of the Directors (continued)

utilisation for income generation and to indicate success in cross-selling fee-based services to customers with loan facilities. This understanding assists management in making business investment decisions. The change in revenue mix in 2009 is attributable to increased net interest income driven by robust performance in Balance Sheet Management.

Cost efficiency is a relative measure that indicates the consumption of cost resources in generating revenue. Management uses this to assess the success of technology utilisation and, more generally, the productivity of the group's distribution platforms and sales forces. Cost efficiency improved from 60.6 per cent in 2008 to 51.8 per cent in 2009, primarily due to stronger revenues and tight control over operating expenses.

Return on average invested capital measures the return on the capital investment made in the business, enabling management to benchmark HSBC against competitors. In 2009, the ratio of 9.2 per cent was higher than that reported in 2008, reflecting higher profit attributable to shareholders on an underlying basis.

Advances to deposits ratio describes loans and advances to customers as a percentage of the total of core current and savings accounts and term funding with a remaining term to maturity in excess of one year. Management uses this to ensure that loans are being funded with stable funding sources and not short term wholesale market sources. The values of the Advances to Deposits ratios at year end 2009 and 2008 were respectively 89.3 per cent and 88.9 per cent.

Non-financial KPIs

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

Employee engagement

Employee engagement is a measure of employees' emotional and rational attachment to HSBC that motivates them to remain with the Group and align themselves wholeheartedly with its success. HSBC measures employee engagement through its annual Global People Survey, which took place in June / July 2009. Over 68,000 employees from HSBC's UK and European businesses shared their views last year, with extremely favourable results. Despite the challenging external environment, results showed an 8 percentage point increase in employee engagement, from 58 per cent to 66 per cent.

Each year HSBC benchmarks its employee engagement scores against a peer group of institutions both from financial services and from other sectors. The 2009 score of 66 per cent indicates that HSBC is performing significantly better than both the European average of 59 per cent and the global financial services industry as a whole of 64 per cent. Managers and leaders are now working together with their people to determine the areas of focus for 2010, with the objective of meeting 'best in class' engagement levels by 2012.

Brand perception

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

HSBC monitors the strength of it brands through surveys conducted by accredited, independent, third-party organisations. A weighted score card is used to produce an overall score on a 100-point scale which is then benchmarked against HSBC's main competitors.

Brand strength 2009

Across Europe, HSBC's brand became more recognised and respected. It was frequently cited as the strongest financial services brand in the UK.

The benchmark brand scores set in 2008 for Personal Financial Services ('PFS') and Commercial Banking ('CMB') were ahead of the competitor average by 8 and 10 points respectively. The 2009 results show very good progress with PFS recording a score of +10 (target +8) and CMB +15 (target +10).

Customer satisfaction

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

The bank does this by aggregating data from accredited, independent, third-party organisations and the resulting recommendation scores, measured out of 100, are benchmarked against competitors.

Results 2009

The benchmark recommendations seen in 2009 for PFS and CMB were ahead of the competitor average by 2 points and 5 points respectively on a 100 point scale.

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

Awards

HSBC was recognised in several industry awards throughout 2009. A small selection of those follows:

Report of the Directors (continued)

- 'UK's best and most innovative mortgage lender' – *Mortgage Finance Gazette;*
- HSBC Invoice Finance (HIF) was awarded 'Best Factoring Institution' in the Trade Finance Awards for Excellence 2009 for the 7th consecutive year and the UK's Best Trade Finance provider by *Global Finance* Magazine;
- 'Best Corporate / Institutional Internet Banking Service in the UK' – *Global Finance;*
- 'Best Debt House in Turkey' – *Euromoney;*
- 'Outstanding Global Private Bank' – *Private Banker International;*
- The *Euromoney* 2010 Private Banking Survey placed HSBC second in the Global Private banking category for the second consecutive year; and
- 'UK Private Bank of the Year' – by the Spear's Wealth Management Awards.

In the annual *Financial News* Awards, Global Banking and Markets was recognised as:

- European DCM House of the Year and European Corporate Bond House of the Year.

IT performance and systems reliability

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

Number of customer transactions processed

The overall number of customer transactions processed is a reflection of the usage of IT in the delivery channels used to service customers. Its aim is to manage the rate of increase in customer transactions cost effectively and enable growth in customer numbers. While the overall level of customer transactions is impacted by economic conditions, the transition of customer transactions from labour intensive (branch and call centre) to automated (credit card, internet and self service) channels is continuing.

Percentage of IT services meeting or exceeding targets

HSBC's IT function establishes with its end users agreed service levels for systems performance, such as systems running at 99.9 per cent of the time and processing credit card authorisations within two seconds. It monitors the achievement of each of these against their agreed service levels. Performance in 2009 at 98.7 per cent exceeded all previous years in all measures. At the same time, the number of services in production grew by 5 per cent, providing robust and high performing services to the group's customers across Europe.

Outlook

A moderate improvement in global economic conditions and a low level of resource utilisation are expected to contain inflationary pressures, encouraging only a gradual increase in interest rates from exceptionally low levels within both the UK and Eurozone.

The bank expects UK GDP to increase by 2.2 per cent in 2010 following a decline of 4.9 per cent in 2009, with the pace of recovery likely to improve as the year progresses. The recovery in many commodity prices is expected to contribute to a temporary period of high levels of consumer price inflation during the early months of 2010. Consumer and investment expenditure are expected to remain largely subdued, with an increased level of exports seen as supporting economic recovery. A modest further increase in unemployment is anticipated during the course of 2010.

Eurozone GDP is expected to rise by 1.2 per cent in 2010 following a contraction of 4.0 per cent in 2009. Some recovery is expected to be recorded across the region's major economies, although the relatively high exposure of the German economy to stronger growth in other areas of the global economy presents the scope for a limited out-performance by that economy. Consumer spending is expected to remain subdued given the possibility for a further deterioration in labour markets across the Eurozone.

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Reconciliation of reported and underlying profit before tax

The group measures its performance internally on a like-for-like basis by eliminating acquisitions and disposals of subsidiaries and businesses, and fair value movement on own debt attributable to credit spread where the net result of such movements will be zero upon maturity of the debt.

Reported results include the effects of the above items. They are excluded when monitoring progress against past profit because management believes that the underlying basis more accurately reflects operating performance.

'Underlying basis' is adjusted for the following:

- £180 million gain on the disposal of the residual 49 per cent stake in the UK card acquiring joint venture with Global Payments Inc. in June 2009. The 2008 results included a £215 million gain realised on the sale of the first tranche;
- £644 million gain on the disposal of seven regional banks in France in July 2008;
- £80 million operating profit from the seven regional banks in France during 2008; and
- the change in own credit spread on long-term debt which resulted in a £439 million loss in 2009 compared with a gain of £477 million for 2008.

Summary of Financial Performance

	2009 £m Reported	2008 £m Reported	2009 £m Underlying	2008 £m Underlying
Net interest income	**8,091**	5,697	**8,091**	5,660
Net fee income	**4,077**	3,957	**4,077**	3,924
Trading income	**2,626**	2,967	**2,626**	2,967
Net income/ (expense) from financial instruments designated at fair value	**543**	(1,097)	**982**	(1,574)
Gains less losses from financial investments	**(73)**	82	**(73)**	49
Net earned insurance premiums	**2,716**	2,891	**2,716**	2,891
Other operating income	**1,122**	1,678	**942**	800
Net insurance claims incurred and movement in liabilities to policyholders	**(3,540)**	(1,835)	**(3,540)**	(1,835)
Net operating income before loan impairment charges and credit risk provisions	**15,562**	14,340	**15,821**	12,882
Loan impairment charges and other credit risk provisions	**(3,364)**	(1,861)	**(3,364)**	(1,858)
Net operating income	**12,198**	12,479	**12,457**	11,024
Total operating expenses	**(8,198)**	(8,122)	**(8,198)**	(8,083)
Operating profit	**4,000**	4,357	**4,259**	2,941
Share of profit in associates and joint ventures	**14**	9	**14**	9
Profit on ordinary activities before tax	**4,014**	4,366	**4,273**	2,950
Tax on profit on ordinary activities	**(856)**	(843)		
Profit on ordinary activities after tax	**3,158**	3,523		
Attributable to shareholders of the parent company	**3,092**	3,441		

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

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

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

Report of the Directors (continued)

The commentary that follows is on an underlying basis.

Net interest income increased by £2,431 million, or 43 per cent. Balance Sheet Management revenues in Global Banking and Markets rose significantly due to the early positioning of balance sheet in anticipation of decisions by central banks to preserve a low base rate environment. Net interest income also benefited from a reduction in the cost of funding trading activities as interest rates fell. Conversely, the retail business and payments and cash management were adversely affected by margin compression following interest rate reductions in late 2008 and early 2009. Mortgage balances increased as the bank gained market share in the UK, through the success of a new Rate Matcher mortgage promotion and other campaigns launched in line with its secured lending growth strategy. In 2009 the bank more than met its commitment to make available £15 billion of new mortgage lending. In Commercial Banking, net lending fell compared with 2008 as a result of muted customer demand. Customer utilisation of committed overdraft facilities provided by the bank in the UK to commercial customers was only 40 per cent at the end of 2009 illustrating the availability of credit when demand resumes. Across most businesses asset balances declined reflecting reduced customer demand for credit, increased debt issuance as the bond markets reopened in 2009 and the group's diminished appetite for unsecured lending in the UK and Continental Europe. Asset spreads widened, most notably in the UK and Turkey, as funding costs reduced in the low interest rate environment and the market pricing of corporate lending increased.

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

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

Trading income decreased by £341 million, or 11 per cent. This reflects £956 million of foreign exchange losses on trading assets, held as economic hedges of foreign currency debt designated at fair value, which offset the £615 million increase in other trading income arising from a strong performance in Global Banking and Markets.

A net gain of £982 million was recognised as *Net income from financial instruments designated at fair value*, compared with a loss in 2008. This was primarily due to gains on the fair value of assets held to meet liabilities under insurance and investment contracts as equity markets recovered from declines experienced in 2008. To the extent that these gains were attributed to policyholders holding either insurance contracts or investment contracts with discretionary participation feature ('DPF'), there was a corresponding increase in net insurance claims incurred and movement in liabilities to policyholders. Foreign exchange gains on debt designated at fair value were largely offset by losses on the tightening of credit spreads on own debt.

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

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

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

Net insurance claims incurred and movement in liabilities to policyholders increased by £1,705 million. The majority of the movement was due to the change in liabilities to policyholders reported above in 'Financial instruments designated at fair value', and the large one-

Report of the Directors (continued)

off reinsurance transaction in France in 2008. In addition, an increase of £200 million in claims reserving was required to reflect a higher incidence and severity of insurance claims in the UK motor underwriting business and a higher incidence of credit protection claims through the reinsurance business in Ireland. Risk mitigation measures implemented in 2009 included the decision to cease originations of UK motor insurance premiums. This was partly offset by the decrease in liabilities following reduced sales of the personal insurance bond product offering noted above.

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

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

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

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

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

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

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

Report of the Directors (continued)

Performance and Business Review

Profit on ordinary activities before tax

	2009 £m Reported	2008 £m Reported	2009 £m Underlying	2008 £m Underlying
UK Retail Banking	**988**	2,139	**808**	1,924
Continental Europe Retail Banking	**197**	236	**197**	156
Global Banking and Markets	**2,511**	122	**2,511**	122
Private Banking	**728**	726	**728**	726
Other	**(410)**	1,143	**29**	22
	4,014	4,366	**4,273**	2,950

Review of Business Performance

HSBC Bank plc and its subsidiary undertakings reported a pre-tax profit of £4,014 million, compared with £4,366 million in 2008, a decrease of 8 per cent.

On an underlying basis pre-tax profits increased by 45 per cent. Global Banking and Markets delivered an exceptional performance with robust revenues across core countries, driven by higher margins and an increase in market share. Revenues grew faster than operating expenses, with continued emphasis on active cost management limiting the latter to a relatively modest rise. Offsetting this, the Retail businesses encountered significant liability margin compression, and higher impairments and provisions.

The commentary that follows is on an underlying basis for each of the principal business segments.

UK Retail Banking

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

The above table is on a reported basis. UK Retail Banking reported a profit of £988 million for 2009, against £2,139 million in 2008.

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

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

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

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

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

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

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

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

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

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

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

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

Continental Europe Retail Banking

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

The above table is on a reported basis. Continental Europe Retail Banking reported a profit of £197 million for 2009, against £236 million in 2008.

Underlying basis is adjusted for £80 million operating profit from the seven regional banks in France that were disposed of in July 2008.

On an underlying basis and excluding foreign exchange movements profit before tax increased by £22 million. Commercial Banking profits increased by 31 per cent as a result of improved lending margins, partially offset by higher loan impairment charges reflecting the general economic downturn with a small number of larger cases having a material impact. The bank continued to support small business through the economic cycle, lending £150 million to the SME sector in France and Malta. Despite sharp falls in international trade volumes across the region, the group's trade business continued to grow with revenues up 4 per cent on 2008 with particularly strong growth in key markets such as Poland and Turkey, and record results in Spain, Armenia, Israel and Ireland. Despite steady net interest income

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growth, Personal Banking losses increased in 2009 due to a large re-insurance loss of £47 million in Ireland and an increase in impairment charges.

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

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

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

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

Global Banking and Markets

	2009 £m	2008 £m
Net interest income[1]	**2,849**	1,963
Net fee income	**1,060**	845
Trading income[1]	**1,972**	318
Other income	**708**	(110)
Net operating income before impairments and provisions	**6,589**	3,016
Loan impairment charges and credit risk provisions	**(1,405)**	(453)
Net operating income	**5,184**	2,563
Total operating expenses	**(2,674)**	(2,442)
Operating profit	**2,510**	121
Share of profit in associates and joint ventures	**1**	1
Profit on ordinary activities before tax	**2,511**	122

1 The group's balance sheet management business, reported within Global Banking and Markets, provides funding to the trading businesses. To report Global Banking and Markets *Net trading income* on a fully funded basis, *Net interest income* and *Net interest income/ (expense) on trading activities* are grossed up to reflect internal funding transactions prior to their elimination in the intersegment column. (Refer to Note 12).

The above table is on a reported basis and there is no difference between reported and underlying basis.

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

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

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

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

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

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

Private Banking

	2009 £m	2008 £m
Net interest income	**815**	746
Net fee income	**626**	627
Trading income	**210**	212
Other income	**28**	49
Net operating income before impairments and provisions	**1,679**	1,634
Loan impairment charges and credit risk provisions	**(19)**	(31)
Net operating income	**1,660**	1,603
Total operating expenses	**(932)**	(877)
Operating profit	**728**	726
Share of profit in associates and joint ventures	**–**	–
Profit on ordinary activities before tax	**728**	726

The above table is on a reported basis and there is no difference between reported and underlying basis.

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

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

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

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

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

Other

	2009 £m	2008 £m
Net interest income	**(192)**	(108)
Net fee income	**55**	36
Trading income	**(35)**	264
Other income	**(152)**	1,082
Net operating income before impairments and provisions	**(324)**	1,274
Loan impairment charges and credit risk provisions	**(2)**	(3)
Net operating income	**(326)**	1,271
Total operating expenses	**(84)**	(128)
Operating profit	**(410)**	1,143
Share of profit in associates and joint ventures	**–**	–
Profit on ordinary activities before tax	**(410)**	1,143

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

Other includes:

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

Share capital

In January 2009, HSBC Holdings plc subscribed £526.6 million for one ordinary share of £1 credited as fully paid in the ordinary share capital of the bank. In March and May 2009, HSBC Holdings plc subscribed £500 million and £1,750 million, respectively, for two further ordinary shares of £1 credited as fully paid in the ordinary share capital of the bank.

Save for this, there have been no other changes to the issued ordinary share capital of the bank in the year ended 31 December 2009.

The concept of authorised share capital was abolished under the UK Companies Act 2006 with effect from 1 October 2009 and amendments to the Company's Articles of Association were approved by shareholders in General Meeting on 1 October 2009.

Capital management and allocation

Capital management

(Audited)

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

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

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

Capital

The group's capital is divided into two tiers:

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

To ensure the overall quality of the capital base, the FSA's rules set limits on the amount of hybrid capital instruments that can be included in tier 1 capital relative to core tier 1 capital, and also limits overall tier 2 capital to no more than tier 1 capital.

The basis of consolidation for financial accounting purposes is described on page 41 of the Annual Report and Accounts 2009 and differs from that used for regulatory purposes. Investments in banking associates, which are equity accounted in the financial accounting consolidation, are proportionally consolidated for regulatory purposes. Subsidiaries and associates engaged in insurance and non-financial activities are excluded from the regulatory consolidation and are deducted from regulatory capital. The regulatory consolidation does not include Special Purpose Entities ('SPEs') where significant risk has been transferred to third parties. Exposures to these SPEs are risk-weighted as securitisation positions for regulatory purposes.

Pillar 1

Pillar 1 covers the capital resources requirements for credit risk, market risk and operational risk. Credit risk also covers both counterparty credit risk and securitisation requirements. All these requirements are expressed in terms of Risk Weighted Assets (RWAs).

Credit risk

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

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

For credit risk, with the FSA's approval, the group has adopted the IRB advanced approach for the majority of its business, with the remainder on either

Report of the Directors (continued)

IRB foundation or standardised approaches. A rollout plan is in place, over the next few years, to extend coverage of the advanced approaches, for both local and consolidated group reporting, leaving a small residue of exposures on the standardised approach. As at December 2009, the corporate portfolio in France completed the transition from the foundation to the advanced IRB approach.

Counterparty credit risk

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

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

Securitisation

Basel II specifies two methods for calculating credit risk requirements for securitisation positions in the non-trading book, being the standardised and IRB approaches. Both approaches rely on the mapping of rating agency credit ratings to risk weights, which range between 7 per cent and 1,250 per cent. Positions that would be weighted at 1,250 per cent are instead deducted from capital. Within the IRB approach, the group uses the Ratings Based Method ('RBM') for the majority of its non-trading book securitisation positions, and the Internal Assessment Approach ('IAA') for unrated liquidity facilities and programme wide enhancements for asset-backed securitisations.

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

Market risk

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

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

Operational risk

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

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

Pillar 2

The second pillar of Basel II (Supervisory Review and Evaluation Process) involves both firms and regulators taking a view on whether a firm should hold additional capital against risks not covered in pillar 1. Part of the pillar 2 process is the Internal Capital Adequacy Assessment Process (ICAAP) which is the firm's self assessment of the levels of capital that it needs to hold. The pillar 2 process culminates in the FSA providing firms with Individual Capital Guidance ('ICG'). The ICG is set as a capital resources requirement higher than that required under pillar 1.

Pillar 3

Pillar 3 of Basel II is related to market discipline and aims to make firms more transparent by requiring them to publish specific, prescribed details of their risks, capital and risk management under the Basel II framework. The group published the first full set of pillar 3 disclosures for 31 December 2008, including quantitative tables, as a separate document on the investor relations section of its website. The group's disclosures for 31 December 2009 will also be published as a separate document in the same location.

Future developments

The regulation and supervision of financial institutions is currently undergoing a period of significant change in response to the global financial crisis. Increased capital requirements for market risk and securitisations have already been announced by the Basel Committee and are due for implementation in 2011. The Basel Committee issued further proposals in a Consultative Document 'Strengthening the resilience of the banking sector' on 17 December 2009. The Committee's proposals are part of global initiatives to strengthen the financial regulatory system, and have been endorsed by the Financial Stability Board and the G20 Leaders. A comprehensive impact assessment will be carried out on the proposals in the first half of 2010, with the aim of developing a fully calibrated set of standards by the end of 2010. The proposals will be phased in as financial conditions improve and the economic recovery is assured, with the aim of implementation by the end of 2012. Within this context, the Committee will also consider the appropriate transition and grandfathering arrangements. The consultation period for these proposals closes on 16 April 2010.

Report of the Directors (continued)

Capital structure at 31 December

Composition of regulatory capital (audited)	31 Dec 2009 £m	31 Dec 2008 £m restated [1]
Shareholders' equity [2]	**32,248**	28,985
Shareholders' equity per balance sheet	**27,787**	19,923
Preference share & related premium	**(431)**	(431)
Other equity instruments	**(1,750)**	(1,750)
Deconsolidation of special purpose entities [3]	**6,642**	11,243
Minority Interests	**641**	738
Regulatory Adjustments to the accounting basis	**(562)**	(2,144)
Unrealised (gains)/losses on available for sale debt securities [4]	**(109)**	825
Own credit spread	**(168)**	(365)
Defined benefit pension fund adjustment [5]	**695**	(469)
Cash flow hedging reserve	**(350)**	(327)
Reserves arising from revaluation of property & unrealised gains on available-for-sale equities	**(480)**	(341)
Other regulatory adjustments	**(150)**	(1,467)
Deductions	**(11,518)**	(12,011)
Goodwill capitalised & intangible assets	**(10,560)**	(11,239)
50% of securitisation positions	**(514)**	(318)
50% of excess expected losses over impairment allowances	**(616)**	(640)
50% of tax credit adjustment for excess expected losses	**172**	186
Core tier 1 capital	**20,809**	15,568
Other tier 1 capital before deductions	**2,241**	2,220
Preference shares & related premium	**431**	431
Innovative tier 1 securities	**1,810**	1,789
Deductions	**(343)**	(265)
Unconsolidated investments [6]	**(515)**	(451)
50% of tax credit adjustment for excess expected losses	**172**	186
Tier 1 capital	**22,707**	17,523
Total qualifying tier 2 capital before deductions	**11,272**	11,442
Reserves arising from unrealised gains on revaluation of property & available-for-sale equities	**480**	342
Collective impairment allowances [7]	**368**	-
Perpetual subordinated debt	**3,320**	3,451
Term subordinated debt	**7,104**	7,649
Total deductions other than from tier 1 capital	**(2,139)**	(1,867)
Unconsolidated investments [6]	**(1,004)**	(899)
50% of securitisation positions	**(514)**	(318)
50% of excess expected losses over impairment allowances	**(616)**	(640)
Other deductions	**(5)**	(10)
Total regulatory capital	**31,840**	27,098
Risk-weighted assets (unaudited)		
Credit and counterparty risk	**167,259**	211,206
Market risk	**12,655**	25,311
Operational risk	**23,367**	21,366
Total	**203,281**	257,883
Capital ratios (unaudited)	**%**	**%**
Core tier 1 ratio	**10.2**	6.0
Tier 1 ratio	**11.2**	6.8
Total capital ratio	**15.7**	10.5

1 *In May 2009 the FSA confirmed changes to the definition of core equity tier 1 capital for disclosure purposes. HSBC Bank's core equity tier 1 capital for December 2008 has been restated accordingly for comparison.*
2 *Includes externally verified profits for the year to 31 December 2009.*
3 *Mainly comprises unrealised losses on available-for-debt securities owned by deconsolidated special purpose entities.*
4 *Under FSA rules unrealised gains/losses on available-for-sale debt securities must be excluded from capital resources.*
5 *FSA rules permit banks to replace a liability in a defined benefit pension scheme by the additional funding that will be paid into the scheme over a 5 year period.*
6 *Mainly comprise investment in insurance entities.*
7 *Under Basel II rules collective impairment allowances on loan portfolios under the standardised approach may be included in tier 2 capital.*

Report of the Directors (continued)

Board of Directors

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

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

The names of Directors serving at the date of this report and brief biographical particulars for each of them are set out on page 2.

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

J D Fishburn and D D J John CBE retired as Directors on 1 May 2009 and 29 June 2009, respectively.

Dame Mary Marsh was appointed as a Director on 1 January 2009.

Board committees

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

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

Audit Committee

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

The members of the Audit Committee are A R D Monro-Davies (Chairman), P M Shawyer and J F Trueman. All of the members of the Audit Committee who served during 2009 are independent non-executive Directors.

Executive Committee

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

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 misstatement, errors, losses or fraud. The procedures also enable the bank to discharge its obligations under the Handbook of Rules and Guidance issued by the Financial Services Authority, the bank's lead regulator.

The key procedures that the Directors have established are designed to provide effective internal control within the group and accord with the Internal Control: Revised Guidance for Directors on the Combined Code issued by the Financial Reporting Council. Such procedures for the ongoing identification, evaluation and management of the significant risks faced by the group have been in place throughout the year and up to 1 March 2010, the date of approval of the Annual Report and Accounts 2009. 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 Chairman who has responsibility for overseeing the establishment and maintenance of appropriate systems and controls, and has authority to delegate such duties and responsibilities as he deems fit among the Directors and senior management. The appointment of executives to the most senior positions within the group requires the approval of the Board of Directors.
- Functional, operating, financial reporting and certain management reporting standards are established by HSBC Holdings' management for

application across the whole HSBC Group. These are supplemented by operating standards set by the bank's management, as required.

- Systems and procedures are in place in the group to identify, control and report on the major risks including credit, changes in the market prices of financial instruments, liquidity, operational error, breaches of law or regulations, unauthorised activities and fraud. Exposure to these risks is monitored by the bank's or major subsidiaries' executive committees, risk management committees and the asset and liability management committees.

- Processes are in place to identify new risks from changes in market practices or customer behaviours which could expose the group to heightened risk of loss or reputational damage. During 2009, attention was focused on evolving best practice in liquidity management and stress testing; aggregating more efficiently counterparty risk data and improving the counterparty crisis management framework; rolling out successfully piloted anti fraud systems; revised guidance on the approval/review of new products and business initiatives, with greater oversight by the Risk function; the identification of market pricing anomalies; changes in consumer protection standards with personal financial services markets and, more generally, changes in regulation and public policy towards the financial services industry, including the impact of government interventions to address the under capitalisation and funding difficulties of certain systemically important financial institutions.

- Comprehensive annual financial plans setting out the key business initiatives and the likely financial effects of those initiatives are prepared, reviewed and approved by the Board of Directors. Results are monitored regularly and reports on progress as compared with the related plan are prepared monthly.

- Governance and oversight arrangements are in place to ensure that risk analytical models are fit for purpose, used accordingly and complemented by a variety of model-specific and enterprise-wide stress tests that evaluate the impact of severe yet plausible events and other unusual circumstances not fully captured by quantitative models.

- Centralised functional control is exercised over all IT developments and operations. Common systems are employed where possible for similar business processes. Credit and market risks are measured and reported on in the bank and major subsidiaries, and aggregated for review of risk concentrations on an HSBC Group-wide basis.

- Responsibilities for financial performance against plans and for capital expenditure, credit exposures and market risk exposures are delegated with limits to line management. In addition, functional management in HSBC Holdings is responsible for setting policies, procedures and standards in the following areas of risk: credit risk; market risk; liquidity risk; operational risk; IT risk; insurance risk; accounting risk; tax risk; legal and regulatory compliance risk; human resources risk; reputational risk and purchasing risk; and for certain global product lines.

- Policies and procedures have been established to guide the bank, subsidiary companies and management at all levels in the conduct of business to avoid reputational risk which can arise from social, ethical or environmental issues, or as a consequence of operational risk events. As a banking group, HSBC's good reputation depends upon the way in which it conducts its business but it can also be affected by the way in which clients, to which it provides financial products and services, conduct their business.

- The establishment and maintenance of appropriate systems of internal control is primarily the responsibility of business management. The internal audit function, which is centrally controlled, monitors compliance with policies and standards and the effectiveness of internal control structures across the group. The work of the internal audit function is focused on areas of greatest risk to the group as determined by a risk management approach.

- Executive management is responsible for ensuring that recommendations made by the internal audit function are implemented within an appropriate and agreed timetable. Confirmation to this effect must be provided to internal audit. Management must also confirm annually to internal audit that offices under their control have taken, or are in the process of taking, the appropriate actions to deal with all significant recommendations made by external auditors in management letters or by regulators following regulatory inspections.

The Audit Committee has kept under review the effectiveness of this system of internal control and has reported regularly to the Board of Directors. The key processes used by the Committee in carrying out its reviews include regular reports from the heads of key risk functions; the production and regular updating of summaries of key controls measured against group benchmarks which cover all internal controls, both financial and non-financial; annual confirmations from senior executives that there have been no material losses, contingencies or uncertainties caused by weaknesses in internal controls; internal audit reports; external audit reports; prudential reviews; and regulatory reports. The Audit Committee has reviewed a ‘Risk Map’ of the status of key areas which impact the group and has considered the mitigating actions put in place. In addition, where unexpected losses have arisen or where incidents have occurred which indicate gaps in the control framework or in adherence to Group policies, the Audit Committee has reviewed special reports, prepared at the instigation of management, which analyse the cause of the issue, the lessons learned and the actions proposed by management to address the issue.

The Directors, through the Audit Committee, have conducted an annual review of the effectiveness of the group’s system of internal control covering all material controls, including financial, operational and compliance controls and risk management systems. The Audit Committee has received confirmation that management has taken or is taking the necessary action to remedy any failings or weaknesses identified through the operation of the group’s framework of controls.

Risk management

The financial risk management objectives and policies of the bank and its subsidiaries, including those in respect of financial instruments, together with an analysis of the exposure to such risks, as required under the Companies Act and International Financial Reporting Standards are set out in Note 37 ‘Risk management’ of the Notes on the Financial statements.

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

Health and safety

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

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

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

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

Directors' emoluments

Details on the emoluments of the Directors of the bank for 2009, disclosed in accordance with the Companies Act, are shown in Note 7 'Employee compensation and benefits' in the Notes on the Financial statements.

Diversity policy: employees with disabilities

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

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

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

Corporate sustainability

Sustainability is central to HSBC's strategy and culture. HSBC as a whole reports on its progress in developing and implementing its sustainability strategy annually in the HSBC Sustainability Report, which is externally verified and prepared using the Global Reporting Initiative. The HSBC Sustainability Report 2009 will be issued on 28 May 2010 and will be available at www.hsbc.com/sustainability.

The bank manages its business in accordance with overarching Group policies and adopts the same long-term approach to managing economic, social and environmental issues that are within its ability to influence. Primarily, this concerns achieving sustainable profit growth so that the bank can continue to reward shareholders and employees, build long-lasting relationships with customers and suppliers, pay taxes and duties in those countries where it operates, and invest in communities for future growth. The ability to identify and address certain non-financial considerations which are material to the business, and to mitigate the risks and maximise the opportunities arising from them is key to the bank's continuing financial success. These generally fall into one or more of the following six broad areas:

- Business Sustainability
- Environmental Issues
- Community Investment
- Employee Engagement
- Sustainability Risk
- Sustainability Governance

Business Sustainability

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

HSBC aims to take advantage of the opportunities and manage the risks presented by emerging global trends by leading the development of sustainable business models to address them. As an HSBC Group member, the bank considers factors such as increased longevity, the relative growth rates of emerging and mature economies and the need to move to a lower-carbon economy when setting its strategy and considering its product offerings. For example, in France legislation has been introduced which makes it mandatory to offer SRI (Socially Responsible Investment) funds in company retirement saving arrangements. As a result HSBC France has seen significant asset growth in its in-house SRI fund range.

Environmental Issues

HSBC focuses its environmental initiatives primarily on addressing and responding to issues associated with climate change, including energy, water management and biodiversity. Climate change has the potential to materially affect HSBC's customers and, by extension, HSBC's long-term success, introducing new risks to business activity. However, it also has the potential to stimulate a new era of low carbon growth, innovation and development.

Community Investment

HSBC has a long record of support for the communities in which it operates and aims to encourage social and economic opportunity through its community investment activity.

During 2009, the bank gave £6.5m in charitable donations to support community activities in the UK. The donations were used to fund a wide variety of initiatives, as described below, with the main focus on education, particularly for under-privileged primary and secondary school students, and the environment.

While some community activities are managed centrally, in 2009 the bank continued its policy of allowing employees to propose local projects for support. As a result, over 200 employee-led projects were initiated with financial support exceeding £650,000 and actively involving over 5,000 employees. In addition, over £3 million was donated to charities to match funds raised, or time given, by employees through our staff charity scheme.

Education

In 2007 HSBC in the UK launched a £3.4m partnership with the financial education charity *pfeg* (Personal Finance Education Group). Called *What Money Means*, this partnership is increasing the quality and quantity of financial capability education in UK primary schools. *What Money Means* brings *pfeg*, local authorities and educationalists together to develop resources and approaches that are helping primary school teachers feel more confident in teaching money skills to younger children. In addition to HSBC's financial commitment, during 2009, around 2,500 HSBC employees were engaged with *What Money Means* and by the end of the year around 29,000 students had participated in the programme.

HSBC France has conducted an impact evaluation of its *Fondation HSBC pour l'Education* programme, a youth education scheme. This evaluation highlighted that 96 per cent of employees surveyed have a positive opinion of the programme, that the NGOs selected are appropriate and that employee participation is viewed positively by all partners.

Environment

Employees are involved in a variety of projects related to environmental sustainability and climate change. In 2007, HSBC launched a groundbreaking five-year partnership (the *HSBC Climate Partnership)* between HSBC and four world-class environmental charities - The Climate Group, Earthwatch, Smithsonian Tropical Research Institute and WWF - to tackle climate change. Working with these partners, the Partnership aims to create cleaner, greener cities across the world; create individual HSBC climate champions worldwide; help protect some of the world's major rivers; and conduct the world's largest ever field experiment on the long-term effects of climate change on the world's forests. During 2009, over 1,000 employees took part in projects across the UK designed to increase their personal awareness and understanding of climate change. 120 employees took part in a two week long residential learning experience at a bespoke field centre near Oxford and became HSBC Climate Champions. As such, their roles are to inspire their colleagues and local communities to take action to combat climate change. In 2009, HSBC France sponsored a mobile exhibition that visited 23 cities in France explaining the connection between banking and sustainable development. The exhibition provided general education on such issues to customers and the general public, including school children, and was visited by 41,000 people.

Employee Engagement

'Employee engagement' describes employees' emotional and intellectual commitment to their organisation and its success and is critical to the long-term ability of the bank to deliver the highest quality of financial services. HSBC's annual surveys of employees show that they value HSBC's commitment to sustainable business practices and view the bank as being a leader in this regard. HSBC has also made sustainability a key element of the employee induction and senior management training programmes.

As an HSBC Group member, the bank has a well established framework for employees to provide feedback and develop action plans at local and national level to improve the working experience and engagement. In the HSBC Group annual employee engagement survey launched in June and July 2009, the UK achieved a response rate of 91 per cent and the UK employee engagement score rose from 58 per cent in 2008 to 72 per cent in 2009. The strongest improvement areas included corporate sustainability, reward and behaviour change which measures the extent to which changes have been introduced as a result of the previous year's survey.

The improvement in engagement results reflects the continued commitment of all levels of leadership within the bank to deliver local action plans.

The key objective for 2010 is sustaining this high level of engagement, and priorities for action include managing and developing people, customer orientation and collaboration.

In response to employee feedback, HSBC introduced a flexible benefit package in July 2009. This comprises a 'menu' of benefits from which employees can choose, including health, finance and protection, and leisure and lifestyle benefits. In the employee engagement survey, the per cent favourable response to the statement 'I am satisfied with the benefits I receive at HSBC' rose from 48 per cent in 2008 to 64 per cent in 2009.

Report of the Directors (continued)

In the UK, the bank was recognised as one of the Top 50 Employers for Women to Work For in 2009 by The Times newspaper index for the second year running.

In the UK, the bank has continued to use numerous complementary programmes to involve employees – 'Best Place to Discuss'; 'Best Place to Workout'; 'Best Place to Blog'; 'Best Place to Meet'; 'Best Place to Bank for Employees' and in October, the Chief Executive and his leadership team hosted the 'To Be The Best' event.

Sustainability risk

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

Sustainability Governance

The Corporate Sustainability Committee of the HSBC Holdings Board is responsible for advising on corporate sustainability policies, including environmental, social and ethical issues.

Implementation of these policies is managed primarily by Human Resources, Risk, Compliance and Corporate Sustainability. At Group level, Corporate Sustainability exists as a business function, with senior executives charged with implementing sustainable business practice in all major regions, through inclusion in the HSBC Group Standards Manuals, and through induction and developmental training. Local teams are in charge of embedding corporate sustainability strategies within banking activities. In France for example the team reports directly to the deputy CEO and coordinate the local quarterly Corporate Sustainability committees.

Valuation of freehold and leasehold land and buildings

The group's freehold and long leasehold properties were valued in 2009. The value of these properties was £153 million in excess of their carrying amount in the consolidated balance sheet. The group no longer revalues freehold and long leasehold properties under IFRSs.

Supplier payment policy

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

The amount due to the bank's trade creditors at 31 December 2009 represented 24 days' average daily purchases of goods and services received from those creditors, calculated in accordance with the Companies Act 2006, as amended by Statutory Instrument 2008/410.

Auditor

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

Conflicts of interest and indemnification of Directors

The bank's Articles of Association approved by shareholders in General Meeting give the Board authority to approve Directors' conflicts and potential conflicts of interest. The board has adopted a policy and procedures for the approval of Director's conflicts or potential conflicts of interest. The Board's powers to authorize conflicts are operating effectively and the procedures are being followed. A review of situational conflicts which have been authorized, including the terms of authorisation, will be undertaken annually.

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

Report of the Directors (continued)

Going concern basis

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

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

A summary of financial performance and review of business performance.

The group's approach to capital management and allocation.

In addition, the objectives, policies and processes for managing credit, liquidity and market risk are set out in Note 37 'Risk management' of the Notes on the Financial Statements.

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

Disclosure of information to the Auditor

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

On behalf of the Board
J H McKenzie, *Secretary* 1 March 2010

Statement of Directors' Responsibilities in Respect of the *Annual Report and Accounts 2009* and the Financial Statements

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

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

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

The group and bank financial statements are required by law and IFRSs as adopted by the EU to present fairly the financial position of the group and the bank and the performance for that period; the Companies Act 2006 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 judgments and estimates that are reasonable and prudent; and
- state whether they have been prepared in accordance with IFRSs as adopted by the EU.

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

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

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

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

On behalf of the Board
J H McKenzie, *Secretary* 1 March 2010

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

We have audited the group and parent company financial statements of HSBC Bank plc ('the bank') for the year ended 31 December 2009 set out on pages 30 to 182. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU and, as regards the parent company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

This report is made solely to the bank's member, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the bank's member those matters we are required to state to them in an 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 auditor

As explained more fully in the Directors' Responsibilities Statement set out on page 28, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

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

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the group's and of the parent company's affairs as at 31 December 2009 and of the group's profit for the year then ended;
- the group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU;
- the parent company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the group financial statements, Article 4 of the IAS Regulation.

Opinion on other matter prescribed by the Companies Act 2006

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

Matters on which we are required to report by exception

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

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

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

1 March 2010

Financial Statements

Consolidated income statement for the year ended 31 December 2009

	Notes	2009 £m	2008 £m
Interest income		**12,643**	18,998
Interest expense		**(4,552)**	(13,301)
Net interest income		**8,091**	5,697
Fee income		**5,560**	5,453
Fee expense		**(1,483)**	(1,496)
Net fee income		**4,077**	3,957
Trading income excluding net interest income		**970**	1,165
Net interest income on trading activities		**1,656**	1,802
Net trading income		**2,626**	2,967
Net income/(expense) from financial instruments designated at fair value		**543**	(1,097)
Gains less losses from financial investments		**(73)**	82
Dividend income		**29**	85
Net earned insurance premiums	*4*	**2,716**	2,891
Other operating income		**1,093**	1,593
Total operating income		**19,102**	16,175
Net insurance claims incurred and movement in liabilities to policyholders	*5*	**(3,540)**	(1,835)
Net operating income before loan impairment charges and other credit risk provisions		**15,562**	14,340
Loan impairment charges and other credit risk provisions		**(3,364)**	(1,861)
Net operating income	*6*	**12,198**	12,479
Employee compensation and benefits	*7*	**(4,452)**	(4,498)
General and administrative expenses		**(3,114)**	(3,049)
Depreciation and impairment of property, plant and equipment	*22*	**(482)**	(466)
Amortisation and impairment of intangible assets	*21*	**(150)**	(109)
Total operating expenses		**(8,198)**	(8,122)
Operating profit		**4,000**	4,357
Share of profit in associates and joint ventures		**14**	9
Profit before tax		**4,014**	4,366
Tax expense	*10*	**(856)**	(843)
Profit for the year		**3,158**	3,523
Profit attributable to shareholders of the parent company		**3,092**	3,441
Profit attributable to minority interests		**66**	82

Financial Statements (continued)

Consolidated statement of comprehensive income for the year ended 31 December 2009

	2009 £m	2008 £m
Profit for the year	**3,158**	3,523
Other comprehensive income		
Available-for-sale investments:		
– fair value gains/ (losses)	**4,666**	(11,551)
– fair value losses/ (gains) transferred to income statement on disposal	**49**	(330)
– amounts transferred to the income statement in respect of impairment losses	**1,317**	429
– income taxes	**(248)**	558
Cash flow hedges		
– fair value gains	**133**	545
– fair value gains transferred to income statement	**(91)**	(8)
– income taxes	**(19)**	(151)
Actuarial losses on defined benefit plans		
– before income taxes	**(2,396)**	(129)
– income taxes	**676**	26
Exchange differences and other	**(848)**	3,226
Other comprehensive income/ (expense) for the year, net of tax	**3,239**	(7,385)
Total comprehensive income/ (expense) for the year	**6,397**	(3,862)
Total comprehensive income/ (expense) for the year attributable to:		
– shareholders of the parent company	**6,352**	(4,062)
– minority interests	**45**	200
	6,397	(3,862)

Financial Statements (continued)

Consolidated statement of financial position at 31 December 2009

	Notes	2009 £m	2008 £m
ASSETS			
Cash and balances at central banks		**14,274**	9,470
Items in the course of collection from other banks		**2,082**	1,917
Trading assets	*15*	**165,008**	172,026
Financial assets designated at fair value	*16*	**16,435**	13,895
Derivatives	*17*	**118,516**	243,084
Loans and advances to banks	*31*	**46,994**	50,719
Loans and advances to customers	*31*	**274,659**	298,304
Financial investments	*18*	**86,695**	103,511
Other assets	*24*	**8,013**	8,802
Current tax assets		**172**	215
Prepayments and accrued income		**3,357**	5,625
Interests in associates and joint ventures	*20*	**79**	73
Goodwill and intangible assets	*21*	**11,199**	11,780
Property, plant and equipment	*22*	**4,090**	4,697
Deferred tax assets	*10*	**355**	113
Total assets		**751,928**	924,231
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	*31*	**57,729**	61,431
Customer accounts	*31*	**332,896**	369,880
Items in the course of transmission to other banks		**1,477**	1,802
Trading liabilities	*25*	**118,881**	124,450
Financial liabilities designated at fair value	*26*	**18,164**	15,184
Derivatives	*17*	**118,689**	241,031
Debt securities in issue	*31*	**39,340**	52,308
Other liabilities	*27*	**5,867**	6,897
Current tax liability		**197**	197
Liabilities under insurance contracts issued	*28*	**16,505**	16,132
Accruals and deferred income		**3,752**	5,464
Provisions	*29*	**368**	428
Deferred tax liability	*10*	**158**	443
Retirement benefit liabilities	*7*	**2,678**	664
Subordinated liabilities	*30*	**6,799**	7,259
Total liabilities		**723,500**	903,570
Equity			
Called up share capital	*35*	**797**	797
Share premium account		**20,025**	17,249
Other equity instruments	*35*	**1,750**	1,750
Other reserves		**(2,920)**	(7,842)
Retained earnings		**8,135**	7,969
Total equity attributable to shareholders of the parent company		**27,787**	19,923
Minority interests		**641**	738
Total equity		**28,428**	20,661
Total equity and liabilities		**751,928**	924,231

S K Green, Chairman

1 March 2010

Financial Statements (continued)

Consolidated cash flow statement for the year ended 31 December 2009

	Notes	**2009 £m**	2008 £m
Cash flows from operating activities			
Profit before tax		**4,014**	4,366
Adjustments for:			
– non-cash items included in profit before tax	*36*	**4,224**	2,733
– change in operating assets	*36*	**25,222**	(72,242)
– change in operating liabilities	*36*	**(53,082)**	118,194
– elimination of exchange differences[1]		**9,707**	(24,765)
– net gain from investing activities		**(657)**	(1,284)
– share of profits in associates and joint ventures		**(14)**	(9)
– distributions from associates		**8**	2
– contributions paid for defined benefit plans		**(258)**	(273)
– tax paid		**(923)**	(795)
Net cash (used in)/generated from operating activities		**(11,759)**	25,927
Cash flows from investing activities			
Purchase of financial investments		**(73,475)**	(102,333)
Proceeds from the sale of financial investments		**87,764**	71,626
Purchase of property, plant and equipment		**(613)**	(782)
Proceeds from the sale of property, plant and equipment		**897**	281
Purchase of intangible assets		**(162)**	(182)
Proceeds from the sale of intangible assets		**–**	18
Net cash outflow from acquisition of and increase in stake of subsidiaries		**(247)**	(28)
Net cash outflow from acquisition of and increase in stake of associates		**(16)**	(1)
Proceeds from disposal of subsidiaries		**–**	1,554
Proceeds from disposal of associates		**215**	62
Purchases of HSBC Holdings plc shares to satisfy share based payment transactions		**(15)**	(197)
Net cash generated from/(used in) investing activities		**14,348**	(29,982)
Cash flows from financing activities			
Issue of share capital		**2,776**	1,750
Issue of capital securities		**–**	750
Subordinated loan capital issued		**–**	1,014
Subordinated loan capital repaid		**(101)**	(51)
Dividends paid to shareholders		**(1,067)**	(2,974)
Dividends paid to minority interests		**(7)**	(25)
Net cash generated from financing activities		**1,601**	464
Net increase/(decrease) in cash and cash equivalents		**4,190**	(3,591)
Cash and cash equivalents at 1 January		**60,855**	51,235
Effect of exchange rate changes on cash and cash equivalents		**(4,239)**	13,211
Cash and cash equivalents at 31 December	*36*	**60,806**	60,855

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

Financial Statements (continued)

Consolidated statement of changes in equity for the year ended 31 December 2009

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

1 *All new capital subscribed in the year was issued to HSBC Holdings plc. See note 35 for further details.*
2 *Relates to the purchase of minority interest in HSBC Private Bank (Suisse) SA. See Note 41 for further details.*
3 *Movements in the cash flow hedging reserve include amounts transferred to the income statement of £91 million comprising a £120 million loss taken to 'Net interest income' and a £29 million gain taken to 'Net trading income'.*

Financial Statements (continued)

	2008									
					Other reserves					
	Called up share capital £m	Share premium £m	Other equity Instruments £m	Retained earnings £m	Available-for-sale fair value reserve £m	Cash flow hedging reserve[2] £m	Foreign exchange reserve £m	Total share-holders' equity £m	Minority interests £m	Total equity £m
At 1 January	797	15,499	1,000	7,587	(757)	(60)	357	24,423	576	24,999
Profit for the year	–	–	–	3,441	–	–	–	3,441	82	3,523
Other comprehensive income (net of tax)	–	–	–	(96)	(10,894)	386	3,101	(7,503)	118	(7,385)
Available-for-sale investments	–	–	–	–	(10,894)	–	–	(10,894)	–	(10,894)
Cash flow hedges	–	–	–	–	–	386	–	386	–	386
Actuarial losses on defined benefit plans	–	–	–	(101)	–	–	–	(101)	(2)	(103)
Exchange differences and other	–	–	–	5	–	–	3,101	3,106	120	3,226
Total comprehensive income for the year	–	–	–	3,345	(10,894)	386	3,101	(4,062)	200	(3,862)
Share capital issued, net of costs[1]	–	1,750	–	–	–	–	–	1,750	–	1,750
Capital securities issued	–	–	750	–	–	–	–	750	–	750
Dividends	–	–	–	(2,999)	–	–	–	(2,999)	(38)	(3,037)
Net impact of equity-settled share-based payments	–	–	–	49	–	–	–	49	–	49
Purchase of minority interest	–	–	–	–	27	1	–	28	–	28
Transfers from associates	–	–	–	–	(3)	–	–	(3)	–	(3)
Other movements	–	–	–	(13)	–	–	–	(13)	–	(13)
At 31 December	797	17,249	1,750	7,969	(11,627)	327	3,458	19,923	738	20,661

1 *All new capital subscribed in the year was issued to HSBC Holdings plc. See note 35 for further details.*

2 *Movements in the cash flow hedging reserve include amounts transferred to the income statement of £8 million comprising a £13 million gain taken to 'Net interest income' and a £21 million loss taken to 'Net trading income'.*

Financial Statements (continued)

HSBC Bank plc statement of financial position at 31 December 2009

	Notes	2009 £m	2008 £m
ASSETS			
Cash and balances at central banks		**13,130**	6,779
Items in the course of collection from other banks		**1,071**	692
Trading assets	*15*	**123,957**	130,205
Financial assets designated at fair value	*16*	**6,592**	4,592
Derivatives	*17*	**100,800**	197,128
Loans and advances to banks	*31*	**20,729**	18,295
Loans and advances to customers	*31*	**208,669**	217,309
Financial investments	*18*	**27,389**	46,608
Other assets	*24*	**4,230**	3,637
Current tax assets		**160**	291
Prepayments and accrued income		**1,263**	2,705
Interests in associates and joint ventures	*20*	**63**	53
Investments in subsidiary undertakings	*23*	**15,226**	15,236
Goodwill and intangible assets	*21*	**632**	598
Property, plant and equipment	*22*	**1,280**	1,515
Deferred tax assets	*10*	**779**	138
Total assets		**525,970**	645,781
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	*31*	**39,346**	54,986
Customer accounts	*31*	**223,652**	240,397
Items in the course of transmission to other banks		**595**	772
Trading liabilities	*25*	**96,821**	98,389
Financial liabilities designated at fair value	*26*	**10,675**	9,429
Derivatives	*17*	**101,161**	197,247
Debt securities in issue	*31*	**14,636**	8,670
Other liabilities	*27*	**2,636**	3,163
Current taxation		**8**	4
Accruals and deferred income		**1,852**	2,585
Provisions	*29*	**176**	158
Deferred tax liability	*10*	**2**	2
Retirement benefit liabilities	*7*	**2,524**	414
Subordinated liabilities	*30*	**6,955**	7,310
Total liabilities		**501,039**	623,526
Equity			
Called up share capital	*35*	**797**	797
Share premium account		**20,025**	17,249
Other equity instruments	*35*	**1,750**	1,750
Other reserves		**(356)**	(622)
Retained earnings		**2,715**	3,081
Total equity		**24,931**	22,255
Total equity and liabilities		**525,970**	645,781

S K Green, Chairman

1 March 2010

Financial Statements (continued)

HSBC Bank plc cash flow statement for the year ended 31 December 2009

	Notes	2009 £m	2008 £m
Cash flows from operating activities			
Profit before tax		**2,967**	3,235
Adjustments for:			
– non-cash items included in profit before tax	*36*	**3,126**	1,448
– change in operating assets	*36*	**14,404**	(39,012)
– change in operating liabilities	*36*	**(26,542)**	70,364
– elimination of exchange differences[1]		**377**	(7,301)
– net gain from investing activities		**(535)**	(733)
– contributions paid for defined benefit plans		**(236)**	(252)
– tax paid		**(461)**	(365)
Net cash (used in)/generated from operating activities		**(6,900)**	27,384
Cash flows from investing activities			
Purchase of financial investments		**(31,309)**	(77,011)
Proceeds from the sale of financial investments		**50,482**	48,606
Purchase of property, plant and equipment		**(312)**	(393)
Proceeds from the sale of property, plant and equipment		**791**	67
Purchase of goodwill and intangible assets		**(133)**	(132)
Proceeds from the sale of intangible assets		**–**	16
Net cash outflow from acquisition of and increase in stake of subsidiaries		**–**	(28)
Net cash outflow from acquisition of and increase in stake of associates		**(16)**	(7)
Net cash inflow due to repayment of capital in subsidiary		**–**	1,116
Proceeds from disposal of subsidiaries		**–**	224
Proceeds from disposal of associates		**188**	–
Purchases of HSBC Holdings plc shares to satisfy share based payment transactions		**–**	(99)
Net cash generated from/(used in) investing activities		**19,691**	(27,641)
Cash flows from financing activities			
Issue of ordinary share capital		**2,776**	1,750
Issue of capital securities		**–**	750
Subordinated loan capital issued		**–**	1,612
Subordinated loan capital repaid		**–**	–
Dividends paid		**(1,067)**	(2,974)
Net cash generated from financing activities		**1,709**	1,138
Net increase in cash and cash equivalents		**14,500**	881
Cash and cash equivalents at 1 January		**27,791**	22,592
Effect of exchange rate changes on cash and cash equivalents		**(1,589)**	4,318
Cash and cash equivalents at 31 December	*36*	**40,702**	27,791

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

Financial Statements (continued)

HSBC Bank plc statement of changes in equity for the year ended 31 December 2009

	2009							
					Other reserves			
	Called up share capital £m	Share premium £m	Other equity instruments £m	Retained earnings £m	Available-for-sale fair value reserve £m	Cash flow hedging reserve[2] £m	Foreign exchange reserve £m	Total equity £m
At 1 January	797	17,249	1,750	3,081	(977)	407	(52)	22,255
Profit for the year	–	–	–	2,531	–	–	–	2,531
Other comprehensive income (net of tax)	–	–	–	(1,764)	313	(75)	28	(1,498)
Available-for-sale investments	–	–	–	–	313	–	–	313
Cash flow hedges	–	–	–	–	–	(75)	–	(75)
Actuarial losses on defined benefit plans	–	–	–	(1,769)	–	–	–	(1,769)
Exchange differences and other	–	–	–	5	–	–	28	33
Total comprehensive income for the year	–	–	–	767	313	(75)	28	1033
Share capital issued, net of costs[1]	–	2,776	–	–	–	–	–	2,776
Dividends to shareholders	–	–	–	(1,067)	–	–	–	(1,067)
Net impact of equity-settled share-based payments	–	–	–	(66)	–	–	–	(66)
At 31 December	797	20,025	1,750	2,715	(664)	332	(24)	24,931

1 *All new capital subscribed in the year was issued to HSBC Holdings plc. See note 35 for further details.*
2 *Movements in the cash flow hedging reserve include an amount transferred to the income statement of a £148 million loss taken to 'Net interest income'.*

Financial Statements (continued)

	2008				Other reserves			
	Called up share capital £m	Share premium £m	Other equity Instruments £m	Retained earnings £m	Available- for-sale fair value reserve £m	Cash flow hedging reserve[2] £m	Foreign exchange reserve £m	Total equity £m
At 1 January	797	15,499	1,000	3,301	179	13	(12)	20,777
Profit for the year	–	–	–	2,681	–	–	–	2,681
Other comprehensive income (net of tax)	–	–	–	29	(1,156)	394	(40)	(773)
Available-for-sale investments	–	–	–	–	(1,156)	–	–	(1,156)
Cash flow hedges	–	–	–	–	–	394	–	394
Actuarial losses on defined benefit plans	–	–	–	24	–	–	–	24
Exchange differences and other	–	–	–	5	–	–	(40)	(35)
Total comprehensive income for the year	–	–	–	2,710	(1,156)	394	(40)	1,908
Share capital issued, net of costs	–	1,750	–	–	–	–	–	1,750
Capital securities issued[1]	–	–	750	–	–	–	–	750
Dividends to shareholders	–	–	–	(2,974)	–	–	–	(2,974)
Net impact of equity-settled share-based payments	–	–	–	28	–	–	–	28
Other movements	–	–	–	16	–	–	–	16
At 31 December	797	17,249	1,750	3,081	(977)	407	(52)	22,255

1 *All new capital subscribed in the year was issued to HSBC Holdings plc. See note 35 for further details.*
2 *Movements in the cash flow hedging reserve include an amount transferred to the income statement of a £16 million loss taken to 'Net interest income'.*

Notes on the Financial Statements (continued)

1 Basis of preparation

(a) Compliance with International Financial Reporting Standards

The consolidated financial statements of the group and the separate financial statements of HSBC Bank plc have been prepared in accordance with International Financial Reporting Standards ('IFRSs') as issued by the International Accounting Standards Board ('IASB') and as endorsed by the EU. EU-endorsed IFRSs may differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2009, there were no unendorsed standards effective for the year ended 31 December 2009 affecting these consolidated and separate financial statements, and there was no difference between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to the group. Accordingly, the group's financial statements for the year ended 31 December 2009 are prepared in accordance with IFRSs as issued by the IASB.

IFRSs comprise accounting standards issued by the IASB and its predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee ('IFRIC') and its predecessor body.

During 2009, the group adopted the following standards and amendments to standards:

- IFRS 8 'Operating Segments' ('IFRS 8'), which replaced IAS 14 'Segment Reporting' requires an entity to disclose information about its segments which enables users to evaluate the nature and financial effects of its business activities and the economic environments in which it operates. The group is organized into five segments, UK Retail, Continental Europe Retail, Global Banking and Markets, Private Banking and Other. Due to the nature of the group, the chief operating decision-maker regularly reviews operating activity on a number of bases, including by geography, by customer group, and by retail businesses and global businesses. The group's operating segments were determined using the same measures reported to the chief operating decision-maker, for the purpose of making decisions about allocating resources to the operating segments and assessing their performance. Information provided to the chief operating decision-maker of the group to make decisions about allocating resources and assessing performance of operating segments is measured in accordance with IFRSs.
- IAS 1 'Presentation of Financial Statements' ('IAS 1') (Revised 2007) aims to improve users' ability to analyse and compare information given in financial statements. The adoption of the revised standard has no effect on the results reported in the group's consolidated financial statements or the separate financial statements of HSBC Bank plc. It does, however, result in certain presentational changes in the group's consolidated financial statements and the separate financial statements of HSBC Bank plc, including:
  - the presentation of all items of income and expenditure in two financial statements, the 'Consolidated income statement' and the 'Consolidated statement of comprehensive income'; and
  - the presentation of the 'Consolidated statement of changes in equity' as a financial statement replaces the previous 'Equity' note on the financial statements.

  During the year the group, adopted a number of amendments to standards and interpretations which had an insignificant effect on the consolidated financial statements of the group and the separate financial statements of HSBC Bank plc. These amendments include:
- An amendments to IFRS 7 'Financial Instruments: Disclosures – Improving Disclosures about Financial Instruments.' The most significant additional disclosures required by this amendment in the consolidated financial statements of the group and the separate financial statement of HSBC Bank Plc include tables of fair value measurement disclosing the source of inputs using a three level fair value hierarchy, and reconciliation of the movement between opening and closing balances of Level 3 financial instruments which are being those measured at fair value using a valuation technique with significant unobservable inputs.

(b) Presentation of information

In publishing the parent company financial statements together with the group financial statements, the group has taken advantage of the exemption in s408 of the Companies Act 2006 not to present its individual income statement and related notes that form part of these approved financial statements.

Notes on the Financial Statements (continued)

Certain partnerships have taken advantage of the exemption under Regulation 7 of the Partnership (Accounts) Regulations 2008 from preparing their own financial statements by virtue of being consolidated with these group financial statements.

Capital disclosures under IAS 1 'Presentation of Financial Statements' have been included in the audited sections of the Report of the Directors on pages 18-20.

The functional currency of the bank is Sterling, which is also the presentation currency of the consolidated financial statements of the group.

(c) Consolidation

The consolidated financial statements of the group comprise the financial statements of HSBC Bank plc and its subsidiaries made up to 31 December. Subsidiaries are consolidated from the date that the group gains control. The purchase method of accounting is used to account for the acquisition of subsidiaries by the group. The cost of an acquisition is measured at the fair value of the consideration given at the date of exchange, together with costs directly attributable to that acquisition. The acquired identifiable assets, liabilities and contingent liabilities are measured at their fair values at the date of acquisition. Any excess of the cost of acquisition over the fair value of the group's share of the identifiable assets, liabilities and contingent liabilities acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the group's share of the identifiable assets, liabilities and contingent liabilities of the business acquired, the difference is recognised immediately in the income statement.

Entities that are controlled by the group are consolidated until the date that control ceases.

In the context of Special Purpose Entities ('SPEs'), the following circumstances may indicate a relationship in which, in substance, the group controls and, consequently, consolidates an SPE:

- the activities of the SPE are being conducted on behalf of the group according to its specific business needs so that the group obtains benefits from the SPE's operation;
- the group has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an 'autopilot' mechanism, the group has delegated these decision-making powers;
- the group has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
- the group retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

The group performs a re-assessment of consolidation whenever there is a change in the substance of the relationship between the group and an SPE. All intra-group transactions are eliminated on consolidation.

The consolidated financial statements of the group also include the attributable share of the results and reserves of joint ventures and associates. These are based on financial statements made up to dates not earlier than three months prior to 31 December, adjusted for the effect of any significant transactions or events that occur between that date and the group's reporting date.

(d) Future accounting developments

At 31 December 2009, a number of standards and interpretations, and amendments thereto, had been issued by the IASB, which are not effective for the group's consolidated financial statements or the separate financial statements of HSBC Bank Plc as at 31 December 2009. Those which are expected to have a significant effect on the group's consolidated financial statements and the separate financial statements of HSBC Bank Plc are discussed below.

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

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

Notes on the Financial Statements (continued)

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

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

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

IFRS 9 'Financial Instruments' introduces new requirements for the classification and measurement of financial assets. The standard is effective for annual periods beginning on or after1 January 2013 with early adoption permitted. IFRS 9 is required to be applied retrospectively. If the standard is adopted prior to 1 January 2012, an entity will be exempt from the requirement to restate prior period comparative information. IFRS 9 is subject to EU endorsement, the timing of which is uncertain. Accordingly, the group is unable to provide a date by which it plans to apply IFRS 9. The main changes to the requirements of IAS 39 are summarised below.

- All financial assets that are currently in scope of IAS 39 will be classified and measured at either amortised cost or fair value through profit or loss. The available-for-sale and held-to-maturity categories will no longer exist.
- Classification is based on an entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets. Reclassifications between the two categories are prohibited unless there is a change in the entity's business model.
- A financial asset is measured at amortised cost if two criteria are met: i) the objective of the business model is to hold the financial asset for the collection of the contractual cash flows; and ii) the contractual cash flows of the instrument are solely payments of principal and interest on the principal outstanding. All other financial assets are measured at fair value. Movements in the fair value of financial assets classified at fair value are recognised in profit or loss, except for equity investment where an entity takes the option to designate an equity instrument that is not held for trading at fair value through other comprehensive income. If this option is taken, all subsequent changes in fair value are recognised in other comprehensive income with no recycling of gains or losses to the income statement. Dividend income would continue to be recognised in the income statement.
- An entity is only permitted to designate a financial asset otherwise meeting the amortised cost criteria at fair value through profit or loss if doing so significantly reduces or eliminates an accounting mismatch. This designation is made on initial recognition and is irrevocable.
- Financial instruments which contain embedded derivatives are to be classified in their entirety either at fair value or amortised cost depending on whether the contracts as a whole meet the relevant criteria under IFRS 9.

IFRS 9 is the first instalment in the IASB's planned phased replacement of IAS 39 with a less complex and improved standard for financial instruments. The next steps in the IASB's project will address the classification and measurement requirements for financial liabilities, the impairment for financial assets measured at amortised cost and hedge accounting. The IASB has indicated that it aims to finalise the replacement of IAS 39 by the end of 2010. In addition, the IASB is working with the US Financial Accounting Standards Board to reduce inconsistencies between US GAAP and IFRS in accounting for financial instruments. The impact of IFRS 9 may change as a consequence of further developments resulting from the IASB's financial instruments project. As a result, it is impracticable to quantify the impact of IFRS 9 as at the date of publication of these financial statements.

2 Summary of significant accounting policies

(a) Interest income and expense

Interest income and expense for all financial instruments except for those classified as held-for-trading or designated at fair value (other than debt securities issued by the group and derivatives managed in conjunction with such debt securities issued) are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest method. The effective interest method is a way of calculating the amortised cost of a financial asset or a financial liability (or groups of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

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

Interest on impaired financial assets is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

(b) Non interest income

Fee income is earned from a diverse range of services provided by the group to its customers. Fee income is accounted for as follows:

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

Net trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with related interest income, expense and dividends.

Net income from financial instruments designated at fair value includes all gains and losses from changes in the fair value of financial assets and financial liabilities designated at fair value through profit or loss. Interest income and expense and dividend income arising on those financial instruments are also included in 'Net income from financial instruments designated at fair value', except for interest arising from debt securities issued, and derivatives managed in conjunction with debt securities, which is recognised in 'Interest expense'.

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

(c) Segment reporting

The group is organised into five segments, UK Retail, Continental Europe Retail, Global Banking and Markets, Private Banking and Other. Due to the nature of the group, the chief operating decision-maker regularly reviews operating activity on a number of bases, including by geography, by customer group, and by retail businesses and global businesses. The group's operating segments were determined using the same measure reported to the chief operating decision-maker for the purpose of making decisions about allocating resources and assessing performance.

Measurement of segment assets, liabilities, income and expenses is based on the group's accounting policies. Segment income and expenses include transfers between segments and these transfers are conducted on arm's length terms and conditions. Shared costs are included in segments on the basis of the actual recharges made.

Notes on the Financial Statements (continued)

(d) Determination of fair value

All financial instruments are recognised initially at fair value. In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (that is, the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, the group recognises a trading gain or loss on inception of the financial instrument. When unobservable market data have a significant impact on the valuation of financial instruments, the entire initial difference in fair value indicated by the valuation model from the transaction price is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis, or when the inputs become observable, or the transaction matures or is closed out, or when the group enters into an offsetting transaction.

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

Valuation techniques incorporates assumptions about factors that other market participants would use in their valuation, including interest rate yield curves, exchange rates, volatilities, and prepayment and default rates. If there are additional factors that are not incorporated within the valuation model but would be considered by market participants, further fair value adjustments are applied to model calculated fair values. These fair value adjustments include adjustments for bid-offer spread, model uncertainty, credit risk and model limitation. Where a financial instrument has a quoted price in an active market and it is part of a portfolio, the fair value of the portfolio is calculated as the product of the number of units and quoted price and no block discounts are made.

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

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

(e) Reclassification of financial assets

Non-derivative financial assets (other than those designated at fair value through profit or loss upon initial recognition) may be reclassified out of the fair value through profit or loss category in the following circumstances:

- Financial assets that would have met the definition of loans and receivables at initial recognition (if the financial asset had not been required to be classified as held for trading) may be reclassified out of the fair value through profit or loss category if there is the intention and ability to hold the financial asset for the foreseeable future or until maturity; and
- Financial assets (except financial assets that would have met the definition of loans and receivables at initial recognition) may be reclassified out of the fair value through profit or loss category and into another category in rare circumstances.

When a financial asset is reclassified as described in the above circumstances, the financial asset is reclassified at its fair value on the date of reclassification. Any gain or loss already recognised in the income statement is not reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortised cost, as applicable.

Notes on the Financial Statements (continued)

A reclassification from the available for sale category to the held to maturity category is permitted once any tainting period has lapsed, or if there is a change in intention or ability or in the rare circumstance that a reliable measure of fair value is no longer available. The fair value carrying amount of the financial asset or the financial liability on that date becomes its new cost or amortised cost, as applicable. Any previous gain or loss on that asset that has been recognised in equity shall be accounted for as follows:

- In the case of a financial asset with a fixed maturity, the gain or loss shall be amortised to profit or loss over the remaining life of the held-to-maturity investment using the effective interest method. Any difference between the new amortised cost and maturity amount shall also be amortised over the remaining life of the financial asset using the effective interest method, similar to the amortisation of a premium or a discount. If the financial asset is subsequently impaired, any gain or loss that has been recognised in other comprehensive income is reclassified from equity to profit or loss.
- In the case of a financial asset that does not have a fixed maturity (unlikely to be applicable), the gain or loss shall be recognised in profit or loss when the financial asset is sold or otherwise disposed of. If the financial asset is subsequently impaired, any previous gain or loss that has been recognised in other comprehensive income is reclassified from equity to profit or loss.

(f) Loans and advances to banks and customers

Loans and advances to banks and customers include loans and advances originated by the group which are not classified either as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to borrowers. They are derecognised when either borrower repays their obligations, or the loans are sold or written off, or substantially all the risks and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method, less impairment losses. Where exposures are hedged by derivatives designated and qualifying as fair value hedges, the carrying value of the loans and advances so hedged includes a fair value adjustment for the hedged risk only.

The group may commit to underwrite loans on fixed contractual terms for specified periods of time, where the drawdown of the loan is contingent upon certain future events outside the control of the group. Where the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a trading derivative and measured at fair value through profit and loss. On drawdown, the loan is classified as held for trading and measured at fair value through profit and loss. Where it is not the group’s intention to trade the loan, a provision on the loan commitment is only recorded where it is probable that the group will incur a loss. This may occur, for example, where a loss of principal is probable or the interest rate charged on the loan is lower than the cost of funding. On inception of the loan, the hold portion is recorded at its fair value and subsequently measured at amortised cost using the effective interest method. However, where the initial fair value is lower than the cash amount advanced (for example, due to the rate of interest charged on the loan being below the market rate of interest), the write down is charged to the income statement. The write down will be recovered over the life of the loan, through the recognition of interest income using the effective interest method, unless the loan becomes impaired. The write down is recorded as a reduction to other operating income.

Financial assets which have been reclassified out of the fair value through profit and loss category into the loans and receivables category are initially recorded at the fair value at the date of reclassification. The reclassified assets are subsequently measured at amortised cost, using the effective interest rate determined at the date of reclassification.

(g) Impairment of loans and advances

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

Notes on the Financial Statements (continued)

Individually assessed loans and advances

For all loans that are considered individually significant, the group assesses on a case-by-case basis at each balance sheet date whether there is any objective evidence that a loan is impaired. For those loans where objective evidence of impairment exists, impairment losses are determined by considering the following factors:

- the group's aggregate exposure to the customer;
- the viability of the customer's business model and its capability to trade successfully out of financial difficulties and generate sufficient cash flow to service its debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or pari passu with, the group and the likelihood of other creditors continuing to support the company;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency; and
- when available, the secondary market price of the debt.

Impairment losses are calculated by discounting the expected future cash flows of a loan at its original effective interest rate, and comparing the resultant present value with the loan's current carrying amount.

Collectively assessed loans and advances

Impairment is assessed on a collective basis in two circumstances:

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

Incurred but not yet identified impairment

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

The collective impairment allowance is determined after taking into account:

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

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

Homogeneous groups of loans and advances

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

- When appropriate empirical information is available, the group uses roll-rate methodology. This methodology employs statistical analyses of historical data and experience of delinquency and default to estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date which the group is not able to identify on an individual loan basis, and that can be reliably estimated. Under this methodology, loans are grouped into ranges according to the number of days past due, and statistical analysis is used to estimate the likelihood that loans in each range will progress through the various stages of delinquency and ultimately prove irrecoverable. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. In certain highly developed markets, sophisticated models also take into account behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.
- In other cases, when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, the group adopts a formulaic approach which allocates progressively higher percentage loss rates the longer a customer's loan is overdue. Loss rates are based on historical experience.

In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio. In certain circumstances, historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, where there have been changes in economic, regulatory or behavioural conditions, such that the most recent trends in the portfolio risk factors are not fully reflected in the statistical models.

These additional portfolio risk factors may include recent loan portfolio growth and product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features (such as the ability of borrowers to repay adjustable-rate loans where reset interest rates give rise to increases in interest charges), economic conditions such as national and local trends in housing markets and interest rates, portfolio seasoning, account management policies and practices, current levels of write-offs, changes in laws and regulations and other items which can affect customer payment patterns on outstanding loans, such as natural disasters. These risk factors, where relevant, are taken into account when calculating the appropriate level of impairment allowances by adjusting the impairment allowances derived solely from historical loss experience.

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

Write-off of loans and advances

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

Reversals of impairment

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

Reclassified loans and advances

Where financial assets have been reclassified out of the fair value through profit or loss category to the loans and receivables category, the effective interest rate determined at the date of reclassification is used to calculate any impairment losses.

Notes on the Financial Statements (continued)

Following reclassification, where there is a subsequent increase in the estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase is recognised as an adjustment to the effective interest rate from the date of change in the estimate rather than as an adjustment to the carrying amount of the asset at the date of change in the estimate.

Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans as part of an orderly realisation are recorded as assets held for sale and reported in 'Other assets'. The asset acquired is recorded at the lower of its fair value (less costs to sell) and the carrying amount of the loan (net of impairment allowance) at the date of exchange. No depreciation is charged in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recognised in the income statement, in 'Other operating income'. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative write down, is also recognised in 'Other operating income', together with any realised gains or losses on disposal.

Renegotiated loans

Loans subject to collective impairment assessment whose terms have been renegotiated are no longer considered past due, but are treated as new loans for measurement purposes once the minimum numbers of payments required under the new arrangements have been received. These renegotiated loans are segregated from other parts of the loan portfolio for the purpose of collective impairment assessment, to reflect their risk profile. Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or should be considered past due. The carrying amount of loans that have been classified as renegotiated retain this classification until maturity or derecognition.

(h) Trading assets and trading liabilities

Treasury bills, debt securities, equity shares, loans, deposits, debt securities in issue, and short positions in securities are classified as held for trading if they have been acquired principally for the purpose of selling or repurchasing in the near term, or they form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking. These financial assets or financial liabilities are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase or sell financial instruments, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently their fair values are remeasured, and gains and losses from changes therein are recognised in the income statement in 'Net trading income'.

(i) Financial instruments designated at fair value

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

- eliminates or significantly reduces measurement or recognition inconsistencies that would otherwise arise from measuring financial assets or financial liabilities, or recognising gains and losses on them, on different bases. Under this criterion, the main classes of financial instruments designated by the group are:

  Long-term debt issues – The interest payable on certain fixed rate long-term debt securities issued has been matched with the interest on 'receive fixed/pay variable' interest rate swaps as part of a documented interest rate risk management strategy. An accounting mismatch would arise if the debt securities issued were accounted for at amortised cost, because the related derivatives are measured at fair value with changes in the fair value recognised in the income statement. By designating the long-term debt at fair value, the movement in the fair value of the long-term debt will also be recognised in the income statement.

  Financial assets and financial liabilities under investment contracts – Liabilities to customers under linked contracts are determined based on the fair value of the assets held in the linked funds, with changes recognised in the income statement. If no designation was made for the assets relating to the customer liabilities they would be classified as available-for-sale and the changes in fair value would be recorded directly in other comprehensive income. These financial instruments are managed on a fair value basis and information is provided to management on that basis. Designation at fair value of the financial assets and liabilities under investment contracts allows the changes in fair values to be recorded in the income statement and presented in the same line.

- applies to groups of financial assets, financial liabilities or combinations thereof that are managed, and their performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, and where information about the groups of financial instruments is reported to management on that basis. Under this criterion, certain financial assets held to meet liabilities under insurance contracts are the main class of financial instrument so designated. The group has documented risk management and investment strategies designed to manage such assets at fair value, taking into consideration the relationship of assets to liabilities in a way that mitigates market risks. Reports are provided to management on the fair value of the assets. Fair value measurement is also consistent with the regulatory reporting requirements under the appropriate regulations for these insurance operations.
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, including certain debt issues and debt securities held.

The fair value designation, once made, is irrevocable. Designated financial assets and financial liabilities are recognised when the group enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and are normally derecognised when sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken directly to the income statement. Subsequently, the fair values are remeasured, and gains and losses from changes therein are recognised in 'Net income from financial instruments designated at fair value'.

(j) Financial investments

Treasury bills, debt securities and equity shares intended to be held on a continuing basis, other than those designated at fair value, are classified as available-for-sale or held-to-maturity. Financial investments are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase securities, and are normally derecognised when either the securities are sold or the borrowers repay their obligations.

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

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

At each balance sheet date an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset. Impairment losses are recognised if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the financial asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset that can be reliably estimated.

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

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

Once an impairment loss has been recognised on an available-for-sale financial asset, the subsequent accounting treatment for changes in the fair value of that asset differs depending on the nature of the available-for-sale financial asset concerned:

Notes on the Financial Statements (continued)

- For an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement when there is further objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in fair value of the financial asset is recognised in other comprehensive income. If the fair value of the debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement to the extent of the increase in fair value.
- For an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised directly in other comprehensive income. Impairment losses recognised on the equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement, to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost of the equity security.

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

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

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

Securities lending and borrowing transactions are generally secured, with collateral taking the form of securities or cash advanced or received. The transfer of securities to counterparties under these agreements is not normally reflected on the balance sheet. Cash collateral advanced or received is recorded as an asset or a liability respectively.

Securities borrowed are not recognised on the balance sheet. If they are sold on to third parties, an obligation to return the securities is recorded as a trading liability and measured at fair value, and any gains or losses are included in ‘Net trading income’.

(l) Derivatives and hedge accounting

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

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative would meet the definition of a stand-alone derivative if they were contained in a separate contract, and the combined contract is not held for trading nor designated at fair value. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

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

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

Hedge accounting

At the inception of a hedging relationship, the group documents the relationship between the hedging instruments and hedged items, its risk management objective and its strategy for undertaking the hedge. The group also requires a documented assessment, both at hedge inception and on an ongoing basis, of whether or not the hedging instruments, primarily derivatives, that are used in hedging transactions are highly effective in offsetting the changes attributable to the hedged risks in the fair values or cash flows of the hedged items. Interest on designated qualifying hedges is included in ‘Net interest income’.

Fair value hedge

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement, along with changes in the fair value of the hedged assets, liabilities or group thereof that are attributable to the hedged risk.

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

Cash flow hedge

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income within the “Cash flow hedging reserve”. Any gain or loss in fair value relating to an ineffective portion is recognised immediately in the income statement.

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

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

Hedge effectiveness testing

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

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

For prospective effectiveness the hedging instrument must be expected to be highly effective in offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. For actual effectiveness to be achieved, the changes in fair value or cash flows must offset each other in the range of 80 per cent to 125 per cent.

Hedge ineffectiveness is recognised in the income statement in ‘Net trading income’.

Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in 'Net trading income', except where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives managed in conjunction with debt securities issued by the group), in which case gains and losses are reported in 'Net income from financial instruments designated at fair value'. The interest on derivatives managed in conjunction with debt securities issued by the group which are designated at fair value is recognised in 'Interest expense'. All other gains and losses on these derivatives are reported in 'Net income from financial instruments designated at fair value'.

(m) Derecognition of financial assets and liabilities

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

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

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

(n) Offsetting financial assets and financial liabilities

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

(o) Subsidiaries, associates and joint ventures

The group classifies investments in entities which it controls as subsidiaries. Where the group is a party to a contractual arrangement whereby, together with one or more parties, it undertakes an economic activity that is subject to joint control, the group classifies its interest in the venture as a joint venture. The group classifies investments in entities over which it has significant influence, and that are neither subsidiaries nor joint ventures, as associates. For the purpose of determining this classification, control is considered to be the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The bank's investments in subsidiaries are stated at cost less any impairment losses. An impairment loss recognised in the prior period shall be reversed through profit and loss if, and only if, there has been a change in the estimates used to determine the investment in subsidiary's recoverable amount since the last impairment loss was recognised.

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

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

(p) Goodwill and intangible assets

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

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

Goodwill is allocated to cash-generating units for the purpose of impairment testing, which is undertaken at the lowest level at which goodwill is monitored for internal management purposes. Impairment testing is performed at least annually, and whenever there is an indication that the cash-generating unit may be impaired, by comparing the recoverable amount from a cash-generating unit with the carrying amount of its net assets, including attributable goodwill. The recoverable amount of an asset is the higher of its fair value less cost to sell and its value in use. Value in use is the present value of the expected future cash flows from a cash-generating unit. If the recoverable amount is less than the carrying value, an impairment loss is charged to the income statement. Goodwill is stated at cost less accumulated impairment losses.

Goodwill on acquisitions of interests in joint ventures and associates is included in ‘Interests in associates and joint ventures’.

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

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

- Intangible assets that have an indefinite useful life, or are not yet ready for use, are tested for impairment annually. This impairment test may be performed at any time during the year, provided it is performed at the same time every year. An intangible asset recognised during the current period is tested before the end of the current year.
- Intangible assets that have a finite useful life, except for the present value of in-force long-term insurance business, are stated at cost less amortisation and accumulated impairment losses and are amortised over their estimated useful lives. Estimated useful life is the lower of legal duration and expected useful life. The amortisation of mortgage servicing rights is included within ‘Net fee income’.

For the accounting policy governing the present value of in-force long-term insurance businesses, see note 2(y).

(iii) Intangible assets with finite useful lives are amortised, generally on a straight-line basis, over their useful lives as follows:

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

(q) Property, plant and equipment

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

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

Equipment, fixtures and fittings (including equipment on operating leases where the group is the lessor) are stated at cost less any impairment losses and depreciation calculated on a straight-line basis to write off the assets over their useful lives, which run to a maximum of 35 years but are generally between 5 years and 20 years.

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

Notes on the Financial Statements (continued)

The group holds certain properties as investments to earn rentals or for capital appreciation, or both. Investment properties are included in the balance sheet at fair value with changes therein recognised in the income statement in the period of change. Fair values are determined by independent professional valuers who apply recognised valuation techniques.

(r) Finance and operating leases

Agreements which transfer to counterparties substantially all the risks and rewards incidental to the ownership of assets, but not necessarily legal title, are classified as finance leases. When the group is a lessor under finance leases the amounts due under the leases, after deduction of unearned charges, are included in 'Loans and advances to banks' or 'Loans and advances to customers', as appropriate. The finance income receivable is recognised in 'Net interest income' over the periods of the leases so as to give a constant rate of return on the net investment in the leases.

When the group is a lessee under finance leases, the leased assets are capitalised and included in 'Property, plant and equipment' and the corresponding liability to the lessor is included in 'Other liabilities'. A finance lease and its corresponding liability are recognised initially at the fair value of the asset or, if lower, the present value of the minimum lease payments. Finance charges payable are recognised in 'Net interest income' over the period of the lease based on the interest rate implicit in the lease so as to give a constant rate of interest on the remaining balance of the liability.

All other leases are classified as operating leases. When acting as lessor, the group includes the assets subject to operating leases in 'Property, plant and equipment' and accounts for them accordingly. Impairment losses are recognised to the extent that residual values are not fully recoverable and the carrying value of the assets is thereby impaired. When the group is the lessee, leased assets are not recognised on the balance sheet. Rentals payable and receivable under operating leases are accounted for on a straight-line basis over the periods of the leases and are included in 'General and administrative expenses' and 'Other operating income' respectively.

A sale and leaseback transaction involves the sale of an asset followed by the leasing back of the same asset. The resulting lease is classified either as a finance lease or an operating lease and it is accounted for accordingly. If a sale and leaseback transaction results in the recognition of a finance lease, any excess of sales proceeds over the carrying amount is deferred and amortised over the lease term. If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss is recognised immediately. If the sale price is below fair value, any profit or loss is recognised immediately except that, if the loss is compensated for by future lease payments below market price, it is deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value is deferred and amortised over the period for which the asset is expected to be used.

(s) Income tax

Income tax comprises current tax and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised in other comprehensive income or directly in equity, in which case it is recognised in the same statement in which the related item appears.

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantively enacted by the balance sheet date, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are offset when the group intends to settle on a net basis and the legal right to offset exists.

Deferred tax is recognised on temporary differences between the carrying amounts of assets and liabilities in the balance sheet and the amounts attributed to such assets and liabilities for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that future taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled based on tax rates and laws enacted, or substantively enacted, by the balance sheet date. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when the group has a legal right to offset.

Deferred tax relating to actuarial gains and losses on post-employment benefits is recognised directly in other comprehensive income. Deferred tax relating to share-based payment transaction is recognised directly in other comprehensive income to the extent that the amount of the estimated future tax deduction exceeds the amount of the related cumulative remuneration expense. Deferred tax relating to fair value remeasurement of available-for-sale investments and cash flow hedging instruments which are charged or credited directly to other comprehensive income, is also credited or charged directly to other comprehensive income and is subsequently recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

(t) Pension and other post-employment benefits

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

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

The defined benefit pension costs and the present value of defined benefit obligations are calculated at the reporting date by the scheme's actuaries using the Projected Unit Credit Method. The net charge to the income statement mainly comprises the current service cost, plus the unwinding of the discount rate on plan liabilities, less the expected return on plan assets, and is presented in operating expenses. Past service costs are charged immediately to the income statement to the extent that the benefits have vested, and are otherwise recognised on a straight-line basis over the average period until the benefits vest. Actuarial gains and losses comprise experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), as well as the effects of changes in actuarial assumptions. Actuarial gains and losses are recognised in other comprehensive income and presented in the Statement of Other Comprehensive Income in the period in which they arise.

The defined benefit liability recognised in the balance sheet represents the present value of defined benefit obligations adjusted for unrecognised past service costs and reduced by the fair value of plan assets. Any net defined benefit surplus is limited to unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan.

The costs of obligations arising from other defined post-employment benefits plans, such as defined benefit health-care plans, are accounted for on the same basis as defined benefit pension plans.

(u) Share-based payments

The cost of share-based payment arrangements with employees is measured by reference to the fair value of equity instruments on the date they are granted, and recognised as an expense on a straight-line basis over the vesting period, with corresponding credit to Retained Earnings. The vesting period is the period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied. The fair value of equity instruments that are made available immediately, with no vesting period attached to the award, are expensed immediately.

Fair value is determined by using appropriate valuation models, taking into account the terms and conditions upon which the equity instruments were granted. Vesting conditions include service conditions and performance conditions. Market performance conditions are taken into account when estimating the fair value of equity instruments at the date of grant, so that an award is treated as vesting irrespective of whether the market performance condition or non-vesting condition is satisfied, provided all other conditions are satisfied.

Vesting conditions, other than market performance conditions, are not taken into account in the initial estimate of the fair value at the grant date. They are taken into account by adjusting the number of equity instruments included in the measurement of the transaction, so that the amount recognised for services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. On a cumulative basis, no expense is recognised for equity instruments that do not vest because of a failure to satisfy non-market performance or service conditions.

Notes on the Financial Statements (continued)

Where an award has been modified, as a minimum the expense of the original award continues to be recognised as if it had not been modified. Where the effect of a modification is to increase the fair value of an award or increase the number of equity instruments, the incremental fair value of the award or incremental fair value of the extra equity instruments is recognised in addition to the expense of the original grant, measured at the date of modification, over the modified vesting period.

A cancellation that occurs during the vesting period is treated as an acceleration of vesting, and recognised immediately for the amount that would otherwise have been recognised for services over the vesting period.

(v) Foreign currencies

Items included in the financial statements of each of the group's entities are measured using the currency of the primary economic environment in which the entity operates ('the functional currency').

Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured at historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined. Any exchange component of a gain or loss on a non-monetary item is recognised in other comprehensive income if the gain or loss on the non-monetary item is recognised in other comprehensive income. Any exchange component of a gain or loss on a non-monetary item is recognised in the income statement.

In the consolidated financial statements, the assets, including related goodwill where applicable, and liabilities of branches, subsidiaries, joint ventures and associates whose functional currency is not sterling, are translated into the group's presentational currency at the rate of exchange ruling at the balance sheet date. The results of branches, subsidiaries, joint ventures and associates whose function currency is not sterling are translated into sterling at the average rates of exchange for the reporting period. Exchange differences arising from the retranslation of opening foreign currency net investments, and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period end, are recognised in other comprehensive income. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate financial statements. In consolidated financial statements these exchange differences are recognised in other comprehensive income. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in other comprehensive income are recognised in the income statement.

(w) Provisions

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

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security, are possible obligations that arise from past events whose existence will be confirmed only by the occurrence, or non-occurrence, of one or more uncertain future events not wholly within the control of the group; or are present obligations that have arisen from past events but are not recognised because it not probable that settlement will require outflow of economic benefits, or because the amount of the obligations cannot be reliably measured. Contingent liabilities are not recognised in the financial statements but are disclosed unless the probability of settlement is remote.

(x) Financial guarantee contracts

Liabilities under financial guarantee contracts not classified as insurance contracts are recorded initially at their fair value, which is generally the fee received or receivable. Subsequently, the financial guarantee liabilities are measured at the higher of the initial fair value, less cumulative amortisation, and the best estimate of the expenditure required to settle the obligations.

HSBC Bank plc has issued financial guarantees to other group entities. Where it has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the group may elect to account for guarantees as insurance contracts. This election is made on a contract by contract basis, but the election for each contract is irrevocable. Where these guarantees have been classified as insurance contracts, they are measured and recognised as insurance liabilities.

(y) Insurance contracts

Through its insurance subsidiaries, the group issues contracts to customers that contain insurance risk, financial risk or a combination thereof. A contract under which the group accepts significant insurance risk from another party by agreeing to compensate that party on the occurrence of a specified uncertain future event is classified as an insurance contract. An insurance contract may also transfer financial risk, but is accounted for as an insurance contract if the insurance risk is significant. While investment contracts with discretionary participation features are financial instruments, they continue to be treated as insurance contracts as permitted by IFRS 4.

Insurance contracts are accounted for as follows:

Premiums

Gross insurance premiums for non-life insurance business are reported as income over the term of the insurance contract based on the proportion of risks borne during the accounting period. The unearned premium (the proportion of the business underwritten in the accounting year relating to the period of risk after the balance sheet date) is calculated on a daily or monthly pro rata basis.

Premiums for life assurance are accounted for when receivable, except in unit-linked insurance contracts where premiums are accounted for when liabilities are established.

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

Claims and reinsurance recoveries

Gross insurance claims for non-life insurance contracts include paid claims and movements in outstanding claims liabilities.

Gross insurance claims for life insurance contracts reflect the total cost of claims arising during the year, including claim handling costs and any policyholder bonuses allocated in anticipation of a bonus declaration. Claims arising in the year include maturities, surrenders and death claims.

Maturity claims are recognised when due for payment. Surrenders are recognised when paid or at an earlier date on which, following notification, the policy ceases to be included within the calculation of the related insurance liabilities. Death claims are recognised when notified.

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

Liabilities under insurance contracts

Outstanding claims liabilities for non-life insurance contracts are based on the estimated ultimate cost of all claims incurred but not settled at the balance sheet date, whether reported or not, together with related claim-handling costs and a reduction for the expected value of salvage and other recoveries. Liabilities for claims incurred but not reported are made on an estimated basis, using appropriate statistical techniques.

Liabilities under non-linked life insurance contracts are calculated by each life insurance operation based on local actuarial principles.

Liabilities under unit-linked life insurance contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

A liability adequacy test is carried out on insurance liabilities to ensure that the carrying amount of the liabilities is sufficient in the light of current estimates of future cash flows. When performing the liability adequacy test, all contractual cash flows are discounted and compared with the carrying value of the liability. When a shortfall is identified it is charged immediately to the income statement.

Notes on the Financial Statements (continued)

Present value of in-force long-term insurance business

The value placed on insurance contracts that are classified as long-term insurance business or long term investment contracts with discretionary participating features ("DPF") and are in force at the balance sheet date is recognised as an asset. The asset represents the present value of the shareholders' interest in the profits expected to emerge from these contracts written at the balance sheet date.

The present value of in-force long-term insurance business and long term investment contracts with DPF, referred to as 'PVIF', is determined by discounting the shareholders' interest in future profits expected to emerge from business currently in force using appropriate assumptions in assessing factors such as future mortality, lapse rates and levels of expenses and a risk discount rate that reflects the risk premium attributable to the respective contracts. The PVIF incorporates allowances for both non-market risk and the value of financial options and guarantees. The PVIF asset is presented gross of attributable tax in the balance sheet and movements in the PVIF asset are included in "Other operating income' on a gross of tax basis.

Future profit participation

Where contracts provide discretionary profit participation benefits to policyholders, liabilities for these contracts include provisions for the future discretionary benefits to policyholders. These provisions reflect actual performance of the investment portfolio to date and management expectation on the future performance in connection with the assets backing the contracts, as well as other experience factors such as mortality, lapses and operational efficiency, where appropriate. This benefit may arise from the contractual terms, regulation, or past distribution policy.

In the case of net unrealised investment gain on contracts whose discretionary benefit principally reflect the actual performance of the portfolio, the corresponding increase in the liabilities is recognised in either the income statement or other comprehensive income, following the treatment of the unrealised gains on the relevant assets. In the case of net unrealised losses, a deferred participating asset is recognised only to the extent that its recoverability is highly probable. Movement in the liabilities arising from realised gains and losses on relevant assets are recognised in the income statement.

Investment contracts

Customer liabilities under linked and certain non-linked investment contracts and the corresponding financial assets are designated at fair value. Movements in fair value are recognised in 'Net expense/income from financial instruments designated at fair value'. Premiums receivable and amounts withdrawn are accounted for as increases or decreases in the liability recorded in respect of investment contracts.

Liabilities under linked investment contracts are at least equivalent to the surrender or transfer value which is calculated by reference to the value of the relevant underlying funds or indices.

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

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

(z) Debt securities in issue and deposits by customers and banks

Financial liabilities are recognised when the group enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and initially measured at fair value, which is normally the proceeds received net of directly attributable transaction costs incurred. Subsequent measurement of financial liabilities, other than those measured at fair value through profit or loss and financial guarantees, is at amortised cost, using the effective interest rate method to amortise the difference between proceeds received, net of directly attributable transaction costs incurred, and the redemption amount over the expected life of the instrument.

(aa) Share capital and other equity instruments

Shares are classified as equity when there is no contractual obligation to transfer cash or other financial assets. Incremental costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax.

Notes on the Financial Statements (continued)

(bb)Cash and cash equivalents

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

3 Use of assumptions, estimates and judgement

The results of the group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its consolidated financial statements. The accounting policies used in the preparation of the consolidated financial statements are described in detail in Note 2.

When preparing the financial statements, it is the Directors' responsibility under UK company law to select suitable accounting policies and to make judgements and estimates that are reasonable and prudent.

The accounting policies that are deemed critical to the group's results and financial position, in terms of the materiality of the items to which the policy is applied, or which involve a high degree of judgement including the use of assumptions and estimation, are disclosed below:

Impairment of loans and advances

The group's accounting policy for losses arising from the impairment of customer loans and advances is described in Note 2(g). Further information can be found in Note 37 'Risk Management'. Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at balance sheet date.

Management is required to exercise judgement in making assumptions and estimations when calculating loan impairment allowances on both individually and collectively assessed loans and advances. The most significant judgemental area is the calculation of collective impairment allowances.

The group uses two alternative methods to calculate collective impairment allowances on homogeneous groups of loans that are not considered individually significant:

- When appropriate empirical information is available, the group uses roll-rate methodology. This methodology employs statistical analysis of historical data and experience of delinquency and default to estimate the likelihood that loans will progress through the various stages of delinquency and ultimately prove irrecoverable. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio; and
- In other cases, when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, the group adopts a formulaic approach which allocates progressively higher percentage loss rates the longer a customer's loan is overdue. Loss rates are based on historical experience.

Both methodologies are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis because of the large number of individually insignificant loans in the portfolio.

In addition, the use of statistically assessed historical information is supplemented with significant management judgement to assess whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience. In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio. In certain circumstances, historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, where there have been changes in economic, regulatory or behavioural conditions such that the most recent trends in the portfolio risk factors are not fully reflected in the statistical models. In these circumstances, such risk factors are taken into account when calculating the appropriate levels of impairment allowances, by adjusting the impairment allowances derived solely from historical loss experience.

This key area of judgement is subject to uncertainty and is highly sensitive to factors such as loan portfolio growth, product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features, economic conditions such as national and local trends in housing markets, the level of interest rates, portfolio seasoning, account management policies and practices, changes in laws and regulations, and other factors that can affect customer payment patterns. Different factors are applied in different regions and countries to reflect different economic conditions and laws and regulations. The assumptions underlying this judgement are highly subjective. The methodology and the assumptions used in calculating impairment losses are reviewed regularly in the light of differences between loss estimates and actual loss experience. For example, roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

The total amount of the group's impairment allowances on homogeneous groups of loans is inherently uncertain because it is highly sensitive to changes in economic and credit conditions across a large number of geographical areas. Economic and credit conditions within geographical areas are influenced by many factors with a high degree of interdependency so that there is no one single factor to which the group's loan impairment allowances as a whole are particularly sensitive. It is possible that the outcomes within the next financial year could be different from the assumptions built into the models, resulting in a material adjustment to the carrying amount of loans and advances.

Goodwill impairment

The group's accounting policy for goodwill is described in Note 2(p). The process of identifying and evaluating goodwill impairment is inherently uncertain because it requires significant management judgement in making a series of estimations, the results of which are highly sensitive to the assumptions used. The review of goodwill impairment represents management's best estimate of the factors below:

- the future cash flows of the cash-generating units ('CGUs') are sensitive to the cash flows projected for the periods for which detailed forecasts are available, and to assumptions regarding the long-term pattern of sustainable cash flows thereafter. Forecasts are compared with actual performance and verifiable economic data in future years; however, the cash flow forecasts necessarily and appropriately reflect management's view of future business prospects at the time of the assessment; and
- the discount rate used to discount the future expected cash flows is based on the cost of capital assigned to an individual CGU, and can have a significant effect on the CGU's valuation. The cost of capital percentage is generally derived from a Capital Asset Pricing Model, which incorporates inputs reflecting a number of financial and economic variables, including the risk-free interest rate in the country concerned and a premium to reflect the inherent risk of the business being evaluated. These variables are subject to fluctuations in external market rates and economic conditions outside of management's control and are therefore established on the basis of significant management judgement and are subject to uncertainty.

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

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

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

Note 21 includes details of the CGUs with significant balances of goodwill, states the key assumptions used to assess the goodwill in each CGU for impairment, and provides a discussion of the sensitivity of the carrying value of goodwill to changes in key assumptions.

Valuation of financial instruments

The group's accounting policy for valuation of financial instruments is described in Note 2(d) on the Financial Statement. The best evidence of fair value is a quoted price in an actively traded market. In the event that the market for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable. Valuation techniques that rely to a greater extent on unobservable inputs require a higher level of management judgement to calculate a fair value than those based wholly on observable inputs.

Valuation techniques used to calculate fair values include comparisons with similar financial instruments for which market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Valuation techniques incorporate assumptions that other market participants would use in their valuations, including assumptions about interest rate yield curves, exchange rates, volatilities, and prepayment and default rates. When valuing instruments by reference to comparable instruments, management takes into account the maturity, structure and rating of the instrument with which the position held is being compared.

The main assumptions and estimates which management considers when applying a model with valuation techniques are:

- the likelihood and expected timing of future cash flows on the instrument. These cash flows are usually governed by the terms of the instrument, although management judgement may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt. Future cash flows may be sensitive to changes in market rates;
- selecting an appropriate discount rate for the instrument. Management bases the determination of this rate on its assessment of what a market participant would regard as the appropriate spread of the rate for the instrument over the appropriate risk-free rate; and
- judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products.

When applying a model with unobservable inputs, estimates are made to reflect uncertainties in fair values resulting from a lack of market data inputs, for example, as a result of illiquidity in the market. For these instruments, the fair value measurement is less reliable. Inputs into valuations based on unobservable data are inherently uncertain because there are little or no current market data available from which to determine the level at which an arm’s length transaction would occur under normal business conditions. However, in most cases there are some market data available on which to base a determination of fair value, for example historical data, and the fair values of most financial instruments will be based on some market observable inputs even where the unobservable inputs are significant.

Disclosure of types and amounts of fair value adjustments made in determining the fair value of financial instruments measured at fair value using valuation techniques is provided in Note 31. In addition a sensitivity analysis of fair value for financial instruments with significant unobservable inputs to reasonably possibly alternative assumption and a range of assumption can be found in Note 31. Given the uncertainty and subjective nature of valuing financial instruments at fair value, it is possible that the outcomes within the next financial year could differ from the assumptions used, and this would result in a material adjustment to the carrying amount of financial instruments measured at fair value.

Impairment of available-for-sale financial assets

The group’s accounting policy for impairment on available-for-sale financial assets is described in Note 2(j) on the Financial Statements.

Management is required to exercise judgement in determining whether there is objective evidence that an impairment loss has occurred. Once an impairment has been identified, the amount of impairment is measured in relation to the fair value of the asset. More information on assumptions and estimates requiring management judgement relating to the determination of fair values of financial instruments is provided above in ‘Valuation of financial instruments’.

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

The most significant judgements concern more complex instruments, such as asset-backed securities (‘ABSs’), where it is necessary to consider factors such as the estimated future cash flows on underlying pools of collateral, the extent and depth of market price declines and changes in credit ratings. The review of estimated future cash flows on underlying collateral is subject to estimation uncertainties where the assessment is based on historical information on

Notes on the Financial Statements (continued)

pools of assets, and judgement is required to determine whether historical performance is likely to be representative of current economic and credit conditions.

There is no single factor to which the group's charge for impairment of available-for-sale debt securities is particularly sensitive, because of the range of different types of securities held, the range of geographical areas in which those securities are held, and the wide range of factors which can affect the occurrence of loss events and the cash flows of securities, including different types of collateral.

It is reasonably possible that outcomes in the next financial year could be different from the assumptions and estimates used in identifying impairment on available-for-sale debt securities, as a result of which, evidence of impairment may be identified in available-for-sale debt securities which had previously been determined not to be impaired. It is possible that this could result in the recognition of material impairment losses in the next financial year.

Pensions

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

Share-based payments

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

Consolidation

The circumstances under which the group consolidates special purpose entities are outlined in Note 1(c) and disclosed in Note 37 'Risk Management'.

4 Net earned insurance premiums

	Non-life insurance £m	Life insurance (non-linked) £m	Life insurance (linked) £m	Investment contracts with discretionary participation features £m	Total £m
2009					
Gross written premiums	**275**	**551**	**198**	**1,784**	**2,808**
Movement in unearned premiums	**143**	**(43)**	**–**	**–**	**100**
Gross earned premiums	**418**	**508**	**198**	**1,784**	**2,908**
Gross written premiums ceded to reinsurers	**(43)**	**(134)**	**(6)**	**–**	**(183)**
Reinsurers' share of movement in unearned premiums	**(10)**	**1**	**–**	**–**	**(9)**
Reinsurers' share of gross earned premiums	**(53)**	**(133)**	**(6)**	**–**	**(192)**
Net earned insurance premiums	**365**	**375**	**192**	**1,784**	**2,716**
2008					
Gross written premiums	418	1,252	238	1,500	3,408
Movement in unearned premiums	42	(84)	–	–	(42)
Gross earned premiums	460	1,168	238	1,500	3,366
Gross written premiums ceded to reinsurers	(63)	(423)	(3)	–	(489)
Reinsurers' share of movement in unearned premiums	(2)	16	–	–	14
Reinsurers' share of gross earned premiums	(65)	(407)	(3)	–	(475)
Net earned insurance premiums	395	761	235	1,500	2,891

Notes on the Financial Statements (continued)

5 Net insurance claims incurred and movement in liabilities to policyholders

	Non-life insurance £m	Life insurance (non-linked) £m	Life insurance (linked) £m	Investment contracts with discretionary participation features £m	Total £m
2009					
Claims, benefits and surrenders paid	**358**	**802**	**134**	**1,154**	**2,448**
Movement in liabilities	**159**	**(561)**	**266**	**1,331**	**1,195**
Gross claims incurred and movement in liabilities	**517**	**241**	**400**	**2,485**	**3,643**
Reinsurers' share of claims, benefits and surrenders paid	**(45)**	**(79)**	**(5)**	**–**	**(129)**
Reinsurers' share of movement in liabilities	**1**	**35**	**(10)**	**–**	**26**
Reinsurers' share of claims incurred and movement in liabilities	**(44)**	**(44)**	**(15)**	**–**	**(103)**
Net insurance claims incurred and movement in liabilities to policyholders	**473**	**197**	**385**	**2,485**	**3,540**
2008					
Claims, benefits and surrenders paid	318	374	135	1,047	1,874
Movement in liabilities	(8)	682	(189)	(138)	347
Gross claims incurred and movement in liabilities	310	1,056	(54)	909	2,221
Reinsurers' share of claims, benefits and surrenders paid	(46)	(83)	(7)	–	(136)
Reinsurers' share of movement in liabilities	42	(313)	21	–	(250)
Reinsurers' share of claims incurred and movement in liabilities	(4)	(396)	14	–	(386)
Net insurance claims incurred and movement in liabilities to policyholders	306	660	(40)	909	1,835

Notes on the Financial Statements (continued)

6 Net operating income

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

	2009 £m	2008 £m
Income		
Interest recognised on impaired financial assets	**53**	21
Fees earned on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	**3,065**	2,997
Fees earned on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	**684**	751
Expense		
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	**4,325**	12,968
Fees payable on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	**614**	606
Fees payable on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	**2**	21
Gains/(losses)		
(Loss)/gain on disposal of assets held for sale	**(11)**	53
Impairment of available-for-sale equity shares	**(164)**	(282)
Gain on disposal or settlement of loans and advances	**8**	–
Gain on financial liabilities measured at amortised cost	**110**	15
Gains on disposal of property, plant and equipment, intangible assets and non-financial investments:		
– Gain on disposal of French regional banks (see note 23)	**–**	644
– Gain on disposal of HSBC Merchant Services LLP	**180**	215
– Other	**33**	60
– Gain on disposal of 8 Canada Square (see note 22)	**353**	–
Gain on financing 8 Canada Square (see note 22)	**–**	265
Loan impairment charge and other credit risk provisions		
Net impairment charge on loans and advances	**(2,619)**	(1,716)
Net impairment of available-for-sale debt securities	**(745)**	(147)
Net reversal/(impairment) in respect of other credit risk provisions	**–**	2
	(3,364)	(1,861)

7 Employee compensation and benefits

Total employee compensation

	The group		The bank	
	2009 £m	2008 £m	2009 £m	2008 £m
Wages and salaries	**3,853**	3,758	**2,025**	1,985
Social security costs	**542**	495	**201**	197
Post-employment benefits	**57**	245	**(60)**	178
	4,452	4,498	**2,166**	2,360

The average number of persons employed by the group during the year was as follows[1]:

	2009	2008
UK Retail	**41,969**	44,107
Continental Europe Retail	**17,827**	19,740
Global Banking and Markets	**10,597**	11,592
Private Banking	**5,436**	5,345
Other[2]	**6,467**	6,708
Total	**82,296**	87,492

1 *This disclosure reflects the organisation of the group's segments from 1 January 2009, as described in Note 12.*
2 *Employees included within 'Other' are employees of central functions who provide services to a number of the group business segments.*

Notes on the Financial Statements (continued)

Both the UK and French governments announced in late 2009 their intention to introduce one-off taxes in respect of certain bonuses payable by banks and banking groups. In both countries the tax, a liability of the employer, is to be levied at 50 per cent on bonuses, whether in cash or shares, awarded in a certain period and over a threshold amount.

Our current best estimate of these taxes in respect of our UK and French business is £219 million in the UK and €30 million in France. The liability for these taxes will be recognised in 2010 once the enabling legislation has been enacted. The taxes will be payable in 2010.

Post-employment benefit plans

Income statement charge

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Defined benefit pension plans				
– HSBC Bank (UK) Pension Scheme	**(116)**	140	**(116)**	140
– Other plans	**31**	3	**2**	–
Defined contribution pension plans	**136**	110	**48**	30
	51	253	**(66)**	170
Defined benefit healthcare plans	**6**	(8)	**6**	8
	57	245	**(60)**	178

Defined benefit post-employment benefit plans

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

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Defined benefit pension plans				
– HSBC Bank (UK) Pension Scheme	**2,354**	269	**2,354**	269
– Other plans	**171**	265	**17**	15
Defined benefit healthcare plans	**153**	130	**153**	130
	2,678	664	**2,524**	414

Pension plans

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

Defined benefit pension arrangements for bank employees are provided by the HSBC Bank (UK) Pension Scheme (the ‘Scheme’), the assets of which are held in a separate trust fund. The Pension Scheme is administered by a corporate trustee, HSBC Bank Pension Trust (UK) Limited (the ‘Trustee’), whose Board is comprised of 13 Directors, four of whom are elected by employees and two by pensioners. The Trustee Directors of the Pension Scheme are required to act in the best interest of the Scheme's beneficiaries.

Healthcare benefit plans

The group provides post-employment healthcare benefits under plans in the United Kingdom, which are unfunded. Post-employment healthcare benefit plans are accounted for in the same manner as pension plans. The plans are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the defined benefit obligation and related current service cost vary according to the economic conditions of the countries in which they are situated. The group’s total healthcare cost for the year was a cost of £6 million (2008: credit of £8 million).

Notes on the Financial Statements (continued)

Post-employment defined benefit plans' principal actuarial assumptions

The principal actuarial financial assumptions used to calculate the group's obligations under its defined benefit pension and post-employment healthcare plans at 31 December 2009 were as follows. These assumptions will also form the basis for measuring periodic costs under the plans in 2010:

	Discount rate %	Inflation rate %	Rate of increase for pensions in payment – pensioners %	Rate of increase for pensions in payment – active members and deferred pensioners %	Deferred revaluation %	Rate of pay increase %	Healthcare cost trend rates %
UK	**5.70**	**3.70**	**3.50**	**3.50**	**3.70**	**4.20**	**7.70**
France	**5.50**	**2.00**	**2.00**	**2.00**	**2.00**	**3.00**	**n/a**
Switzerland	**3.25**	**1.50**	**n/a**	**n/a**	**n/a**	**2.50**	**n/a**
Germany	**5.50**	**2.00**	**2.00**	**2.00**	**2.00**	**3.00**	**n/a**

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

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

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

The mortality tables and average life expectancy at 65 used at 31 December 2009 were as follows:

	Mortality table	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
		Aged 65	**Aged 45**	**Aged 65**	**Aged 45**
UK	SAPS S1[1]	**22.3**	**24.2**	**23.3**	**25.2**
France	TG 05	**23.2**	**26.0**	**26.7**	**29.6**
Switzerland	BVG 2005	**17.9**	**17.9**	**21.0**	**21.0**
Germany	Heubeck 2005 G	**18.3**	**21.0**	**22.4**	**25.0**

1 *Adjusted SAPS S1 with medium cohort improvements and a 1 per cent minimum annual improvement.*

Notes on the Financial Statements (continued)

The mortality tables and average life expectancy at 65 used at 31 December 2008 were as follows:

	Mortality table	Life expectancy at age 65 for a male member currently:		Life expectancy at age 65 for a female member currently:	
		Aged 65	Aged 45	Aged 65	Aged 45
UK	PA92[1]	20.80	22.80	24.10	26.20
France	TG 05	23.10	25.90	26.60	29.40
Switzerland	BVG 2005	17.90	17.90	20.98	20.98
Germany	Heubeck 2005 G	18.00	20.70	22.10	24.70

1 *PA92 with standard improvements to 2005 and medium cohort with 1 per cent minimum annual improvement thereafter.*

Actuarial assumption sensitivities

The discount rate is sensitive to changes in market conditions arising during the reporting period. The mortality rates used are sensitive to experience from the plan member profile. The following table shows the effect of changes in these and the other key assumptions on the principal plan:

	HSBC Bank (UK) Pension Scheme	
	2009	2008
	£m	£m
Discount rate		
Change in pension obligation at year end from a 25bps increase	**(542)**	(383)
Change in pension obligation at year end from a 25bps decrease	**583**	408
Change in following year pension cost from a 25bps increase	**(8)**	(6)
Change in following year pension cost from a 25bps decrease	**8**	7
Rate of inflation		
Change in pension obligation at year end from a 25bps increase	**594**	360
Change in pension obligation at year end from a 25bps decrease	**(559)**	(338)
Change in following year pension cost from a 25bps increase	**40**	31
Change in following year pension cost from a 25bps decrease	**(39)**	(28)
Rate of increase for pensions in payment and deferred revaluation		
Change in pension obligation at year end from a 25bps increase	**493**	239
Change in pension obligation at year end from a 25bps decrease	**(472)**	(225)
Change in following year pension cost from a 25bps increase	**31**	20
Change in following year pension cost from a 25bps decrease	**(30)**	(16)
Rate of pay increase		
Change in pension obligation at year end from a 25bps increase	**120**	118
Change in pension obligation at year end from a 25bps decrease	**(107)**	(115)
Change in following year pension cost from a 25bps increase	**11**	11
Change in following year pension cost from a 25bps decrease	**(10)**	(10)
Investment return		
Change in following year pension cost from a 25bps increase[1]	**(27)**	(25)
Change in following year pension cost from a 25bps decrease[1]	**27**	25
Mortality		
Change in pension obligation from each additional year of longevity assumed	**300**	250

1 *Prior period balances have been re-presented on a consistent basis with the current year presentation.*

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

	Other plans	
	2009	2008
	£m	£m
Increase in pension obligation from each additional year of longevity assumed	**12**	13

Notes on the Financial Statements (continued)

Defined benefit pension plans

Value recognised on the balance sheet

	HSBC Bank (UK) Pension Scheme			
	2009		2008	
	Expected rates of return	**Value**	Expected rates of return	Value
	%	**£m**	%	£m
Fair value of plan assets		**10,908**		10,191
Equities	**8.4**	**1,707**	8.1	1,536
Bonds	**5.3**	**7,762**	5.7	7,541
Property	**7.7**	**926**	6.9	812
Other	**5.3**	**513**	4.2	302
Defined benefit obligation (funded)		**(13,262)**		(10,460)
Net liability[1]		**(2,354)**		(269)

	Other plans			
	2009		2008	
	Expected rates of return[2]	**Value**	Expected rates of return[2]	Value
	%	**£m**	%	£m
Fair value of plan assets		**649**		617
Equities	**7.4**	**216**	7.4	128
Bonds	**4.0**	**312**	4.2	368
Property	**5.4**	**16**	5.3	13
Other	**4.6**	**105**	5.0	108
Defined benefit obligation		**(805)**		(889)
Present value of funded obligations		**(681)**		(750)
Present value of unfunded obligations		**(124)**		(139)
Effect of limit on plan surpluses		**(21)**		–
Unrecognised past service cost		**6**		7
Net liability[1]		**(171)**		(265)

1 *£2,371 million of the net liability for defined benefit pension plans relates to the bank (2008: £284 million).*
2 *The expected rates of return are weighted on the basis of the fair value of the plan assets.*

The principal plan has entered into derivative transactions with the bank to manage the risks arising from its portfolio. These derivatives comprise interest rate (London Interbank Offered Rate – 'LIBOR') swaps and inflation (UK Retail Prices Index – 'RPI') swaps. Under the terms of these swaps, the plan is committed to making LIBOR-related interest payments in exchange for cash flows paid into the Scheme based on a projection of the future benefit payments to the Scheme members. Further details of these swap arrangements are included in Note 41 'Related party transactions'.

Notes on the Financial Statements (continued)

Changes in the present value of defined benefit obligations

	2009		2008	
	HSBC Bank (UK) Pension Scheme £m	**Other plans £m**	HSBC Bank (UK) Pension Scheme £m	Other plans £m
At 1 January	**10,460**	**889**	11,719	643
Current service cost	**168**	**31**	211	23
Interest cost	**651**	**32**	670	27
Contributions by employees	**3**	**9**	–	20
Actuarial (gains)/losses	**2,861**	**(40)**	(1,664)	53
Benefits paid	**(559)**	**(57)**	(476)	(43)
Past service cost				
– vested immediately	**–**	**2**	–	5
– unvested benefits	**–**	**–**	–	6
Acquisitions	**–**	**–**	–	2
Reduction in liabilities resulting from curtailments	**–**	**(4)**	–	–
Liabilities extinguished on settlements	**(322)**	**–**	–	(40)
Exchange differences	**–**	**(57)**	–	193
At 31 December	**13,262**	**805**	10,460	889

Changes in the fair value of plan assets

	2009		2008	
	HSBC Bank (UK) Pension Scheme £m	**Other plans £m**	HSBC Bank (UK) Pension Scheme £m	Other plans £m
At 1 January	**10,191**	**617**	11,316	557
Expected return on plan assets	**613**	**30**	741	31
Normal contributions by the group	**236**	**22**	252	21
Contributions by employees	**3**	**9**	–	20
Experience gains/(losses)	**424**	**41**	(1,643)	(130)
Benefits paid	**(559)**	**(33)**	(475)	(33)
Assets distributed on settlements	**–**	**–**	–	(19)
Exchange differences	**–**	**(37)**	–	170
At 31 December	**10,908**	**649**	10,191	617

The actual return on plan assets for the year ended 31 December 2009 was a positive return £1,108 million (2008: negative return of £1,001 million). The group expects to make £217 million of contributions to defined benefit pension plans during 2010.

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

	2009		2008	
	HSBC Bank (UK) Pension Scheme £m	**Other plans £m**	HSBC Bank (UK) Pension Scheme £m	Other plans £m
Current service cost	**168**	**31**	211	23
Interest cost	**651**	**32**	670	27
Expected return on plan assets	**(613)**	**(30)**	(741)	(31)
Past service cost	**–**	**2**	–	5
Gains on curtailments	**–**	**(4)**	–	–
Gains on settlements	**(322)**	**–**	–	(21)
Total (gain)/ expense	**(116)**	**31**	140	3

Notes on the Financial Statements (continued)

Total net actuarial (losses)/gains

	2009		2008	
	HSBC Bank (UK) Pension Scheme £m	**Other plans £m**	HSBC Bank (UK) Pension Scheme £m	Other plans £m
Experience (losses)/gains on plan liabilities	**(143)**	**15**	(7)	(6)
Experience gains/(losses) on plan assets	**424**	**41**	(1,643)	(130)
(Losses)/gains from changes in actuarial assumptions	**(2,718)**	**25**	1,671	(47)
Total net actuarial gains/(losses)	**(2,437)**	**81**	21	(183)

Total net actuarial losses recognised in equity since transition to IFRSs are £1,783 million. The total effect of the limit on plan surpluses recognised within actuarial losses in other comprehensive income during 2009 was a loss of £20 million (2008: gain of £25 million).

UK regulation requires pension schemes be valued formally every three years and a funding plan agreed between the trustee and scheme sponsor. The most recent triennial actuarial valuation of the UK Scheme performed by the Scheme Actuary on behalf of the Trustee has been carried out as at 31 December 2008. At that date, the market value of the Scheme's assets was £10,191 million. The market value of the plan represented 76 per cent of the amount expected to be required, on the basis of the assumptions adopted, to provide the benefits accrued to members after allowing for expected future increases in earnings, and the resulting deficit amounted to £3,200 million. The method adopted for this valuation was the projected unit method.

The expected cash flows from the plan were projected by reference to the UK Retail Prices Index ('RPI') swap break-even curve at 31 December 2008. Salary increases were assumed to be 0.5 per cent per annum above RPI and inflationary pension increases, subject to a minimum of 0 per cent per annum and a maximum of 5 per cent per annum (maximum of 3 per cent per annum in respect of service accrued since 1 July 2009) were assumed to be in line with RPI. The projected cash flows were discounted at the LIBOR swap curve at 31 December 2008 plus a margin for the expected return on the investment strategy of 190 basis points per annum.

The mortality experience of the Scheme's pensioners over the three year period since the previous valuation was analysed and the mortality assumption set on the basis of this, using the SAPS S1 series of tables with adjustment for the specific mortality experience of the Scheme. Allowance for future improvements in longevity was made in line with the medium cohort effect with minimum improvements of 1.75% for males and 1.25% for females.

The bank has agreed with the Trustee to reduce the deficit of the Scheme by meeting a schedule of additional future funding payments, as set out below, unless a mutually agreed alternative is adopted by 30 June 2010:

	£m
2009	nil
2010	nil
2011	nil
2012	465
2013	465
2014	465
2015	630
2016	630
2017	630
2018	630

The payments of £465 million in each of 2012, 2013 and 2014 reflect the funding payments agreed following the 2005 triennial valuation process.

The group considers that the contribution set out above, together with investment returns at an expected level of 240 basis points above the LIBOR swap curve, would be sufficient to meet the deficit as at 31 December 2009 over the agreed period. At each subsequent actuarial valuation, the group has agreed with the Trustees that any shortfall in investment returns relative to this expected level, subject to a maximum of 50 basis points per annum, will be eliminated by payment of equal cash instalments over the remaining years to the end of this recovery plan period.

The bank will also make ongoing contributions to the Scheme in respect of future benefit accrual for defined benefit section members at the rate of 34 per cent of pensionable salaries from April 2010 until the completion of the next

Notes on the Financial Statements (continued)

actuarial valuation, to be calculated as at 31 December 2011. During 2009, the bank paid contributions at the rate of 38 per cent of pensionable salaries.

As part of the 31 December 2008 valuation, calculations were also carried out as to the amount of assets that might be needed to meet the liabilities if the Scheme was discontinued and the members' benefits bought out with an insurance company (although in practice this may not be possible for a plan of this size) or the Trustee continued to run the plan without the support of the bank. The amount required under this approach was estimated to be £19,400 million as at 31 December 2008. In estimating the solvency position for this purpose, a more prudent assumption about future mortality was made than for the assessment of the ongoing position and it was assumed that the Trustee would alter the investment strategy to be an appropriately matched portfolio of cash and interest and inflation swaps. An explicit allowance for expenses was also included.

Summary

	HSBC Bank (UK) Pension Scheme				
	2009	2008	2007	2006	2005
	£m	£m	£m	£m	£m
Defined benefit obligation	**(13,262)**	(10,460)	(11,719)	(12,392)	(11,961)
Fair value of plan assets	**10,908**	10,191	11,316	10,485	10,107
Effect of limit on plan surpluses	**–**	–	–	–	–
Net deficit	**(2,354)**	(269)	(403)	(1,907)	(1,854)
Experience gains/(losses) on plan liabilities	**(143)**	(7)	(30)	300	40
Experience gains/(losses) on plan assets	**424**	(1,643)	6	–	905
Gains/(losses) from changes in actuarial assumptions	**(2,718)**	1,671	1,238	(298)	(1,166)
Total net actuarial gains/(losses)	**(2,437)**	21	1,214	2	(221)

	Other plans				
	2009	2008	2007	2006	2005
	£m	£m	£m	£m	£m
Defined benefit obligation	**(805)**	(889)	(643)	(627)	(601)
Fair value of plan assets	**649**	617	557	460	404
Effect of limit on plan surpluses	**(21)**	–	(21)	2	–
Net deficit	**(177)**	(272)	(107)	(165)	(197)
Experience gains/(losses) on plan liabilities	**15**	(6)	(4)	1	3
Experience gains/(losses) on plan assets	**41**	(130)	3	7	9
Gains/(losses) from changes in actuarial assumptions	**25**	(47)	53	14	(71)
Total net actuarial gains/(losses)	**81**	(183)	52	22	(59)

Defined benefit healthcare plans

Liability recognised on the balance sheet

	2009	2008
	£m	£m
Present value of unfunded obligations	**153**	130
Net liability[1]	**153**	130

1 *£153 million of the net liability for defined benefit healthcare plans relates to the bank (2008: £130 million).*

Notes on the Financial Statements (continued)

Changes in the present value of defined benefit obligations

	2009 £m	2008 £m
At 1 January	**130**	164
Interest cost	**6**	9
Actuarial gains	**20**	(8)
Benefits paid	**(3)**	(21)
Liabilities extinguished on settlements	**–**	(17)
Exchange differences	**–**	3
At 31 December	**153**	130

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

	2009 £m	2008 £m
Interest cost	**6**	(8)
Total expense	**6**	(8)

Total net actuarial (losses)/gains

	Year ended 31 December	
	2009 £m	2008 £m
Experience gains/(losses) on plan liabilities	**4**	(5)
(Losses)/gains from changes in actuarial assumptions	**(24)**	13
Total net actuarial (losses)/gains	**(20)**	8

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 2009:

	1% increase £m	1% decrease £m
Increase/(decrease) of the aggregate of the current service cost and interest cost	**1**	**(1)**
Increase/(decrease) of defined benefit obligation	**20**	**(16)**

Post-employment benefit plans (the bank)

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

Notes on the Financial Statements (continued)

Directors' emoluments

The aggregate emoluments of the Directors of the bank, computed in accordance with Part I of Schedule 5 of the Companies Act 2006 were:

	2009 £000	2008 £000
Fees	**335**	452
Salaries and other emoluments	**1,114**	2,706
Bonuses[1]	**1,628**	3,430
	3,077	6,588
Gains on the exercise of share options	**–**	13
Vesting of Restricted Share Plan awards	**248**	1,621

1 *2009 includes the sum of £1,176,800 (2008: £2,357,019) deferred into shares which are not subject to performance conditions but are subject to a restricted period.*

No awards were made to Directors under long-term incentive plans in respect of qualifying services rendered in 2009 (2008: no awards).

Retirement benefits accrue to one Director under a defined benefit scheme and to one Director under a money purchase scheme. There were no contributions during the year to money purchase arrangements in respect of Directors' qualifying services (2008: £65,000).

In addition, there were payments under retirement benefit agreements with former Directors of £771,849 (2008: £742,874), including payments in respect of unfunded pension obligations to former Directors of £653,137 (2008: £628,946). The provision as at 31 December 2009 in respect of unfunded pension obligations to former Directors amounted to £10,806,455 (2008: £8,071,356).

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

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

	2009 £000	2008 £000
Fees	**–**	–
Salaries and other emoluments	**483**	608
Bonuses[1]	**1,000**	1,493

1 *2009 includes the sum of £0.8 million (2008: £1.1 million) deferred into shares which are not subject to performance conditions but are subject to a restricted period.*

The highest paid Director received 16,291 shares as the result of awards under long-term incentive plans that vested during the year. The highest paid Director did not exercise any share options over HSBC Holdings plc ordinary shares during the year.

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

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

Notes on the Financial Statements (continued)

8 Auditors' remuneration

Auditors' remuneration in relation to the statutory audit amounted to £10.2 million (2008: £9.8 million).

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

	2009 **£m**	2008 £m
Audit fees for HSBC Bank plc statutory audit:		
– fees relating to current year	**2.3**	2.3
– fees relating to prior year	**0.1**	0.2
	2.4	2.5
Fees payable to KPMG for other services provided to the group		
Audit-related services:		
– audit of the group's subsidiaries, pursuant to legislation	**7.5**	7.1
– audit of pension schemes associated with the group, pursuant to legislation	**0.4**	0.3
– other services pursuant to legislation	**4.5**	5.4
Tax services	**0.4**	0.4
Other services:		
– services relating to information technology	**0.2**	0.2
– services relating to corporate finance transactions	**–**	0.2
– all other services	**0.7**	1.4
	13.7	15.0
Total fees payable	**16.1**	17.5

'Audit fees for HSBC Bank plc statutory audit' is fees payable to KPMG Audit plc for the statutory audit of the consolidated financial statements of the group and the separate financial statements of HSBC Bank plc. It excludes amounts payable for the statutory audit of HSBC Bank plc's subsidiaries, which have been included in 'Fees payable to KPMG for other services provided to the group'.

Fees payable to KPMG for non-audit services for HSBC Bank plc are not disclosed separately because such fees are disclosed on a consolidated basis for the group.

9 Share-based payments

During 2009, £191 million was charged to the income statement in respect of equity-settled share-based payment transactions (2008: £225 million). This expense, which was computed from the fair values of the share-based payment transactions when contracted, arose under employee share awards made in accordance with the HSBC Group's reward structures.

Calculation of fair values

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

Notes on the Financial Statements (continued)

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

2009	1-year Savings-Related Share Option Plans	3-year Savings-Related Share Option Plans	5-year Savings-Related Share Option Plans
Risk-free interest rate[1] (%)	**0.7**	**2.1**	**2.4**
Expected life[2] (years)	**1**	**3**	**5**
Expected volatility[3] (%)	**50**	**35**	**30**
Share price at grant date (£)	**4.65**	**4.65**	**4.65**
2008			
Risk-free interest rate[1] (%)	4.5	4.5	4.5
Expected life[2] (years)	1	3	5
Expected volatility[3] (%)	25	25	25
Share price at grant date (£)	8.80	8.80	8.80

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

The expected US dollar denominated dividend yield was determined to be 4.5 per cent per annum in line with consensus analyst forecasts. Prior to 2009, HSBC adopted a dividend growth model and incorporated expected dividends into the valuation model for share options and awards. In 2008, the expected dividend growth was determined to be 7 per cent for the first year and 8 per cent thereafter.

The HSBC Share Plan

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

Performance Share awards

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

	2009 Number (000's)	2008 Number (000's)
Outstanding at 1 January	**1,228**	2,184
Adjustment for rights issue	**156**	–
Granted in the year	**–**	167
Released in the year	**(354)**	(809)
Forfeited in the year	**(830)**	(314)
Outstanding at 31 December[1]	**200**	1,228

1 *The above table includes the bank employee awards of 111,349 (2008: 809,522).*

No performance shares were awarded by HSBC in 2009. The weighted average fair value of shares awarded by the group for Performance Share Awards in 2008 was £8.56.

Notes on the Financial Statements (continued)

Restricted share awards

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

	2009 Number (000's)	2008 Number (000's)
Outstanding at 1 January	**42,881**	29,590
Adjustment for rights issue	**9,343**	–
Granted in the year	**48,750**	25,202
Released in the year	**(19,997)**	(9,328)
Forfeited in the year	**(9,197)**	(2,583)
Outstanding at 31 December	**71,780**	42,881

The weighted average fair value of shares awarded by the group for Restricted Share Awards in 2009 was £4.00 (2008: £8.56).

Share options

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

	2009		2008	
	Number (000's)	**Weighted average exercise price £**	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	**300**	**8.89**	525	8.85
Adjustment for rights issue	**44**	**7.75**	–	–
Forfeited in the year	**(258)**	**7.66**	(225)	8.79
Outstanding at 31 December	**86**	**7.99**	300	8.89

No options were granted in 2009 apart from those to compensate for the rights issue (2008:Nil). The weighted average remaining contractual life of options outstanding at the balance sheet date was 5.8 years. (2008: 2.1 years). All of the options were exercisable.

Savings-related share option plans

Savings-related share option plans invite eligible employees to enter into savings contracts to save up to £250 per month, with the option to use the savings to acquire shares. The aim of the plans is to align the interests of all employees with the creation of shareholder value. The options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or the fifth anniversary of the commencement of three-year or five-year contracts, respectively. The exercise price is set at 20 per cent (2008: 20 per cent) discount to the market value immediately preceding the date of invitation.

Notes on the Financial Statements (continued)

	2009		2008	
	Number (000's)	**Weighted average exercise price £**	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	**37,115**	**6.94**	41,029	6.59
Adjustment for rights issue	**4,276**	**7.00**	–	–
Granted in the year	**64,018**	**3.30**	13,718	6.82
Exercised in the year	**(3,116)**	**5.49**	(13,273)	5.73
Transferred in the year	**(23,476)**	**6.25**	(1,404)	7.20
Expired in the year	**(1,477)**	**6.33**	(2,955)	7.02
Outstanding at 31 December[1,2]	**77,340**	**5.24**	37,115	6.94

1 *The above table includes the bank employee options of 33,404,227 outstanding at 1 January 2009 (2008: 34,569,476), 57,743,478 options granted in the year (2008: 12,085,353) and 69,911,144 options outstanding at 31 December 2009 (2008: 33,404,227).*
2 *The weighted average exercise price for bank employees at 1 January 2009 was £6.94 (2008: £6.57) and at 31 December 2009 was £5.19 (2008: £6.94).*

The weighted average fair value of options granted during the year was £1.37 (2008: £2.17). The weighted average share price at the dates the share options were exercised was £5.86 (2008: £7.99). 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

	2009	2008
Exercise price range (£)	**£5.34-£9.77**	£5.35-£8.02
Weighted average remaining contractual life (years)	**3.10**	2.19
Of which exercisable:		
– number (000's)	**4,007**	605
– weighted average exercise price (£)	**6.23**	5.91

The bank

	2009	2008
Exercise price range (£)	**£5.34-£9.77**	£5.35-£8.02
Weighted average remaining contractual life (years)	**3.12**	2.26
Of which exercisable:		
– number (000's)	**3,793**	485
– weighted average exercise price (£)	**6.21**	5.83

HSBC Holdings Restricted Share Plan 2000

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

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

	2009 Number (000's)	2008 Number (000's)
Outstanding at 1 January	–	1,052
Granted in the year[1]	–	23
Released in the year	–	(985)
Transferred in the year	–	(90)
Outstanding at 31 December	–	–

1 *Additions during the prior year comprised reinvested scrip dividends.*

Notes on the Financial Statements (continued)

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

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

	2009 Number (000's)	2008 Number (000's)
Outstanding at 1 January	**153**	6,111
Adjustment for rights issue	**21**	–
Additions during the year[1]	**3**	223
Released in the year	**(164)**	(5,896)
Forfeited in the year	–	(304)
Transferred in the year	**15**	19
Outstanding at 31 December[2]	**28**	153

1 *Additions during the year comprised reinvested scrip dividends.*
2 *The above table includes bank employee shares of 85,051 outstanding at 1 January 2009 (2008: 3,569,950), nil shares granted in the year (2008: nil) and 27,868 outstanding at 31 December 2009 (2008: 85,051).*

No shares were awarded by the group for the HSBC Holdings Restricted Share Plan 2000 in 2009 or 2008.

The weighted average remaining vesting period as at 31 December 2009 was 3 months (2008: 5 months).

The HSBC Holdings Group Share Option Plan

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

	2009		2008	
	Number (000's)	**Weighted average exercise price £**	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	**40,223**	**7.87**	42,222	7.86
Adjustment for rights issue	**6,014**	**7.86**	–	–
Exercised in the year	**(779)**	**6.26**	(1,596)	7.16
Transferred in the year	**661**	**7.94**	2,059	7.78
Forfeited and expired in the year	**(1,727)**	**7.34**	(2,462)	8.09
Outstanding at 31 December	**44,392**	**6.85**	40,223	7.87

The weighted average share price at the date the share options were exercised was £6.85 (2008: £7.87). No share options were awarded by the group for the Group Share Option Plan in 2009 (2008: nil). The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

Notes on the Financial Statements (continued)

The group

	2009		2008	
Exercise price range (£)	**£6.00-£6.99**	**£7.00-£7.99**	£6.00-£8.00	£8.01-£10.00
Number (000's)	**13,934**	**30,458**	12,611	27,612
Weighted average exercise price (£)	**6.02**	**7.23**	6.91	8.30
Of which exercisable:				
– number (000's)	**13,934**	**30,458**	12,611	27,612
– weighted average exercise price (£)	**6.02**	**7.23**	6.91	8.30

The bank

	2009		2008	
Exercise price range (£)	**£6.00-£6.99**	**£7.00-£7.99**	£6.00-£8.00	£8.01-£10.00
Number (000's)	**6,823**	**14,568**	6,169	13,165
Weighted average exercise price (£)	**6.02**	**7.22**	6.91	8.29
Of which exercisable:				
– number (000's)	**6,823**	**14,568**	6,169	13,165
– weighted average exercise price (£)	**6.02**	**7.22**	6.91	8.29

HSBC France and subsidiary company plans

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

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

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

	2009		2008	
	Number (000's)	**Exercise price €**	Number (000's)	Exercise price €
Outstanding at 1 January	**604**	**142.50**	604	142.50
Exercised in the year	**-**	**142.50**	–	142.50
Outstanding and exercisable at 31 December	**604**	**142.50**	604	142.50

The weighted average remaining contractual life for options outstanding at the balance sheet date was 4 months (2008: 1.3 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 ordinary shares exchanged under such arrangements in 2009 was 70,257 (2008: 12,810).

Pre-IFRS 2 awards

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

Notes on the Financial Statements (continued)

The HSBC Holdings Group Share Option Plan

	2009		2008	
	Number (000's)	**Weighted average exercise price £**	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	**30,942**	**8.30**	34,411	8.20
Adjustment for rights issue	**4,626**	**8.31**	–	–
Exercised in the year	**(773)**	**7.44**	(2,281)	6.92
Transferred in the year	**881**	**8.38**	368	8.51
Expired in the year	**(3,514)**	**6.08**	(1,556)	8.20
Outstanding at 31 December[1, 2]	**32,162**	**7.38**	30,942	8.30

1 *The above includes the bank employee awards of 17,857,524 options outstanding at 1 January 2009 (2008: 20,236,879), and 17,324,442 options outstanding at 31 December 2009 (2008: 17,857,524).*

2 *The weighted average exercise price for bank employees was £8.17 at 1 January 2009 (2008: £8.02) and £7.35 at 31 December 2009 (2008: £8.17).*

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

	2009		2008	
Exercise price range (£)	**£5.56-£6.50**	**£6.51-£8.40**	£6.38-£7.46	£7.47-£9.54
Number (000's)	**2,553**	**29,609**	4,801	26,142
Weighted average exercise price (£)	**6.50**	**7.46**	6.92	8.56
Of which exercisable:				
– number (000's)	**2,553**	**29,609**	4,801	26,142
– weighted average exercise price (£)	**6.50**	**7.46**	6.92	8.56

The bank

	2009		2008	
Exercise price range (£)	**£5.56-£6.50**	**£6.51-£8.40**	£6.38-£7.46	£7.47-£9.54
Number (000's)	**2,002**	**15,322**	4,240	13,618
Weighted average exercise price (£)	**6.50**	**7.46**	6.92	8.56
Of which exercisable:				
– number (000's)	**2,001**	**15,322**	4,240	13,618
– weighted average exercise price (£)	**6.50**	**7.46**	6.92	8.56

Savings-Related Share Option Plan

	2009		2008	
	Number (000's)	**Weighted average exercise price £**	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	–	–	103	6.32
Exercised in the year	–	–	(85)	6.32
Transferred in the year	–	–	2	6.59
Expired in the year	–	–	(20)	6.32
Outstanding at 31 December[1]	–	–	–	–

1 *The weighted average exercise price for bank employees was nil at 1 January 2009 (2008: £6.32) and nil at 31 December 2009 (2008: nil).*

Notes on the Financial Statements (continued)

10 Tax expense

	2009	2008
	£m	£m
Current taxation		
UK corporation tax charge – on current year profit	**446**	592
UK corporation tax charge – adjustments in respect of prior years	**14**	(22)
Overseas tax – on current year profit	**409**	298
Overseas tax – adjustment in respect of prior years	**(4)**	1
	865	869
Deferred taxation		
Origination and reversal of temporary differences	**(24)**	(16)
Effect of changes in the tax rates	**(3)**	–
Adjustment in respect of prior years	**18**	(10)
	(9)	(26)
Tax expense	**856**	843

The UK corporation tax rate applying to HSBC Bank plc and its subsidiaries was 28 per cent (2008: 30 per cent to 31 March 2008 and 28 per cent thereafter). Other overseas subsidiaries and overseas branches provided for taxation at the appropriate rates in the countries in which they operate.

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

	2009		2008	
		Percentage of overall tax charge		Percentage of overall tax charge
	£m	**%**	£m	%
Taxation at UK corporate tax rate of 28% (2008: 28.5 %)[1]	**1,124**	**28.0**	1,244	28.5
Effect of taxing overseas profit in principal locations at different rates	**(50)**	**(1.2)**	(51)	(1.2)
Tax-free gains	**(116)**	**(2.9)**	(333)	(7.6)
Adjustment in respect of prior period liabilities	**28**	**0.7**	(31)	(0.7)
Effect of profits in associates and joint ventures	**(4)**	**(0.1)**	(2)	–
Effect of previously unrecognised temporary differences	**(4)**	**(0.1)**	(27)	(0.6)
Release of deferred tax consequent on the disposal of the group's London headquarters building	**(90)**	**(2.3)**	–	–
Deferred tax temporary difference not provided	**9**	**0.2**		
Other items	**(41)**	**(1.0)**	43	0.9
Overall tax expense	**856**	**21.3**	843	19.3

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

In addition to the amount charged to the income statement, the aggregate amount of current and deferred taxation relating to items that are taken directly to equity was a £414 million increase in equity (2008: £438 million increase in equity).

Notes on the Financial Statements (continued)

Movement in deferred taxation during the year

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
At 1 January	**(330)**	(252)	**136**	513
Income statement credit/(charge)	**9**	26	**(79)**	(223)
Other comprehensive income:				
– available-for-sale investments	**(147)**	121	**–**	2
– cash flow hedges	**(19)**	(151)	**29**	(153)
– share-based payments	**5**	5	**5**	5
– actuarial gains and losses	**676**	26	**688**	(9)
Disposal of subsidiary	**–**	(44)	**–**	–
Loss of future deduction on restructuring of a partnership interest	**–**	(52)	**–**	–
Foreign exchange and other adjustments	**3**	(9)	**(2)**	1
At 31 December	**197**	(330)	**777**	136

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

	The group		The bank	
	2009	2008[2]	**2009**	2008[2]
	£m	£m	**£m**	£m
Deferred tax assets				
Retirement benefits	**735**	194	**698**	135
Loan impairment allowances	**116**	137	**44**	56
Unused tax losses	**–**	3	**–**	–
Property, plant and equipment	**76**	9	**65**	–
Available-for-sale investments	**13**	116	**–**	–
Cash flow hedges	**10**	61	**–**	–
Share-based payments	**63**	40	**46**	24
Other temporary differences	**298**	238	**69**	133
	1,311	798	**922**	348
Deferred tax liabilities				
Assets leased to customers	**438**	499	**–**	–
Revaluation of property	**78**	82	**11**	11
Property, plant and equipment	**2**	39	**–**	37
Available-for-sale investments	**77**	16	**1**	2
Cash flow hedges	**132**	160	**131**	160
Other temporary differences	**387**	332	**2**	2
	1,114	1,128	**145**	212
Net deferred tax asset/(liability) before offsetting balances within countries	**197**	(330)	**777**	136

2 *Prior period balances have been re-presented on a consistent basis with the current year presentation.*

For the group, the amount of temporary differences for which no deferred tax asset is recognised in the balance sheet is £36 million (2008: £61 million). This amount is in respect of unrealised capital losses where the recoverability of potential benefits is not considered likely.

For the bank, there are no temporary differences for which no deferred tax asset is recognised in the balance sheet (2008: £55 million). The comparative amount was in respect of unrealised capital losses where the recoverability of potential benefits was not considered likely.

Notes on the Financial Statements (continued)

After netting off balances within countries, the balances as disclosed in the accounts are as follows:

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Deferred tax assets	**355**	113	**779**	138
Deferred tax liabilities	**(158)**	(443)	**(2)**	(2)
	197	(330)	**777**	136

Deferred tax is not recognised in respect of the group's investments in subsidiaries and branches where remittance is not contemplated, and for associates and interests in joint ventures where it has been determined that no additional tax will arise. The aggregate amount of temporary differences associated with such investments is nil (2008: £7,477 million). Following the change in the UK tax treatment of dividends on 1 July 2009, no UK tax is expected to arise on distributions from group entities and no temporary difference exists except where withholding tax or other foreign tax could arise on the investments. No meaningful amount of temporary differences associated with such investments can be disclosed.

11 Dividends

Dividends to shareholders of the parent company were as follows:

	2009		2008	
Dividends declared on ordinary shares	**£ per share**	**Total £m**	£ per share	Total £m
Second interim dividend in respect of previous year	**–**	**–**	1.25	1,000
First interim dividend in respect of current year	**0.55**	**441**	1.04	825
Second interim dividend in respect of current year	**0.63**	**500**	1.30	1,037
	1.18	**941**	3.59	2,862

	2009		2008	
Dividends on preference shares classified as equity	**£ per share**	**Total £m**	£ per share	Total £m
Dividend on HSBC Bank plc non-cumulative third dollar preference shares	**1.13**	**40**	1.17	41
	1.13	**40**	1.17	41

	2009	2008
Coupons on capital securities classified as equity	**£m**	£m
Coupon in respect of the first quarter of the year	**11**	18
Coupon in respect of the second quarter of the year	**66**	18
Coupon in respect of the third quarter of the year	**5**	17
Coupon in respect of the fourth quarter of the year	**4**	18
	86	71

12 Segment analysis

The factors used to identify the group's reporting segment are discussed in "Accounting Policies" on page 43.

UK Retail Banking

Retail Banking comprises two customer groups, Personal Financial Services ('PFS') and Commercial Banking ('CMB'). UK Personal Financial Services provides current accounts, savings, personal loans, mortgages, cards, financial planning, as well as life and general insurance to UK personal customers through a variety of distribution channels under various HSBC brands, including first direct, Marks & Spencer Money and partnership card™. UK Commercial Banking provides a wide range of products and services to commercial organisations, from sole proprietors to quoted companies. These include current and savings accounts, payments, electronic banking, trade finance, loans, overdrafts, asset finance, foreign exchange and other treasury and capital markets instruments, wealth management services and general insurance.

Continental Europe Retail Banking

Continental Europe Retail Banking provides a comprehensive range of retail financial services to local and expatriate personal and commercial customers in Europe. The principal Retail Banking operations are in France, Turkey, Germany and Malta, with a growing PFS network in Russia and Poland which supports an existing extensive Commercial Banking network across the region.

Global Banking and Markets

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

Private Banking

Private Banking reflects the operations of HSBC Private Banking Holdings (Suisse) SA and its subsidiaries. Private Banking helps individuals and families meet their complex international financial needs by offering product leadership in areas such as credit, hedge funds advisory, estate planning, and investment advice.

Other

Activities or transactions which do not relate directly to the business segments are reported in Other. The main items reported under Other include gain on sale of the French regional banks in 2008, movements in the fair value of own debt, certain central funding costs and the gain in respect of the sale of HSBC's London headquarters.

Notes on the Financial Statements (continued)

Profit/ (loss) for the year

	Year ended 31 December 2009						
	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter Segment £m	Total £m
Net interest income	3,361	1,681	2,849	815	(192)	(423)	8,091
Net fee income	1,913	423	1,060	626	55	–	4,077
Net trading income	28	28	1,972	210	(35)	423	2,626
Net (expense)/income from financial instruments designated at fair value	181	509	227	–	(374)	–	543
Gains less losses from financial investments[1]	(1)	15	39	(1)	(125)	–	(73)
Dividend income	2	2	19	6	–	–	29
Net earned insurance premiums	468	2,250	(1)	–	(1)	–	2,716
Other operating income	311	49	424	23	349	(63)	1,093
Total operating income	**6,263**	**4,957**	**6,589**	**1,679**	**(323)**	**(63)**	**19,102**
Net insurance claims incurred and movement in liabilities to policyholders	(720)	(2,819)	–	–	(1)	–	(3,540)
Net operating income before loan impairment charges and other credit risk provisions	**5,543**	**2,138**	**6,589**	**1,679**	**(324)**	**(63)**	**15,562**
Loan impairment charges and other credit risk provisions[1]	(1,600)	(338)	(1,405)	(19)	(2)	–	(3,364)
Net operating income	**3,943**	**1,800**	**5,184**	**1,660**	**(326)**	**(63)**	**12,198**
Employee compensation and benefits	(1,011)	(843)	(1,452)	(629)	(517)	–	(4,452)
General and administrative expenses	(1,675)	(646)	(1,021)	(279)	444	63	(3,114)
Depreciation and impairment of property, plant and equipment[1]	(187)	(97)	(174)	(23)	(1)	–	(482)
Amortisation and impairment of intangible assets[1]	(95)	(17)	(27)	(1)	(10)	–	(150)
Total operating expenses	**(2,968)**	**(1,603)**	**(2,674)**	**(932)**	**(84)**	**63**	**(8,198)**
Operating profit	**975**	**197**	**2,510**	**728**	**(410)**	**–**	**4,000**
Share of profit in associates and joint ventures	13	–	1	–	–	–	14
Profit before tax	**988**	**197**	**2,511**	**728**	**(410)**	**–**	**4,014**
Tax expense	(192)	(20)	(531)	(86)	(27)	–	(856)
Profit for the year	**796**	**177**	**1,980**	**642**	**(437)**	**–**	**3,158**

1 *Significant non-cash item.*

Notes on the Financial Statements (continued)

	Year ended 31 December 2008						
	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter Segment £m	Total £m
Net interest income	3,692	1,505	1,963	746	(108)	(2,101)	5,697
Net fee income	1,917	532	845	627	36	–	3,957
Net trading income	61	11	318	212	264	2,101	2,967
Net (expense)/income from financial instruments designated at fair value	(129)	(885)	(377)	–	294	–	(1,097)
Gains less losses from financial investments[2]	133	83	(18)	17	(133)	–	82
Dividend income	59	8	14	3	1	–	85
Net earned insurance premiums	1,376	1,516	–	–	(1)	–	2,891
Other operating income	375	55	271	29	921	(58)	1,593
Total operating income	7,484	2,825	3,016	1,634	1,274	(58)	16,175
Net insurance claims incurred and movement in liabilities to policyholders	(1,044)	(791)	–	–	–	–	(1,835)
Net operating income before loan impairment charges and other credit risk provisions	6,440	2,034	3,016	1,634	1,274	(58)	14,340
Loan impairment charges and other credit risk provisions[2]	(1,095)	(279)	(453)	(31)	(3)	–	(1,861)
Net operating income	5,345	1,755	2,563	1,603	1,271	(58)	12,479
Employee compensation and benefits	(1,325)	(827)	(1,209)	(571)	(566)	–	(4,498)
General and administrative expenses	(1,653)	(599)	(1,038)	(287)	470	58	(3,049)
Depreciation and impairment of property, plant and equipment[2]	(166)	(82)	(174)	(17)	(27)	–	(466)
Amortisation and impairment of intangible assets[2]	(70)	(11)	(21)	(2)	(5)	–	(109)
Total operating expenses	(3,214)	(1,519)	(2,442)	(877)	(128)	58	(8,122)
Operating profit	2,131	236	121	726	1,143	–	4,357
Share of profit in associates and joint ventures	8	–	1	–	–	–	9
Profit before tax	2,139	236	122	726	1,143	–	4,366
Tax expense	(387)	(21)	(38)	(85)	(312)	–	(843)
Profit for the year	1,752	215	84	641	831	–	3,523

2 *Significant non-cash item.*

Notes on the Financial Statements (continued)

Other information about the profit/(loss) for the year

	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter Segment £m	Total £m
Year ended 31 December 2009							
Net operating income:	**3,943**	**1,800**	**5,184**	**1,660**	**(326)**	**(63)**	**12,198**
External	**4,004**	**1,760**	**5,384**	**1,311**	**(261)**	**–**	**12,198**
Inter-segment	**(61)**	**40**	**(200)**	**349**	**(65)**	**(63)**	**–**
Year ended 31 December 2008							
Net operating income:	5,345	1,755	2,563	1,603	1,271	(58)	12,479
External	4,498	1,768	3,968	1,080	1,165	–	12,479
Inter-segment	847	(13)	(1,405)	523	(106)	(58)	–

Performance ratios

	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter Segment £m	Total £m
Year ended 31 December 2009							
Share of the group's profit before tax	**988**	**197**	**2,511**	**728**	**(410)**	**–**	**4,014**
Cost efficiency ratio	**53.55%**	**74.98%**	**40.58%**	**55.51%**	**–**	**–**	**52.68%**
Year ended 31 December 2008							
Share of the group's profit before tax	2,139	236	122	726	1,143	–	4,366
Cost efficiency ratio	49.91%	74.68%	80.97%	53.67%	–	–	56.64%

Balance sheet information

	UK Retail £m	Continental Europe Retail £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter Segment £m	Total £m
Year ended 31 December 2009							
Loans and advances to customers (net)	**111,251**	**33,136**	**110,580**	**19,091**	**601**	**–**	**274,659**
Investment in associates and joint venture	**31**	**3**	**35**	**1**	**9**	**–**	**79**
Total assets	**152,935**	**61,628**	**578,994**	**69,514**	**12,650**	**(123,793)**	**751,928**
Customer accounts	**134,707**	**30,102**	**113,602**	**54,482**	**3**	**–**	**332,896**
Total liabilities	**144,306**	**51,807**	**570,874**	**62,252**	**15,959**	**(121,698)**	**723,500**
Capital expenditure incurred[3]	**343**	**74**	**313**	**14**	**31**	–	**775**
Year ended 31 December 2008							
Loans and advances to customers (net)	106,516	38,578	131,149	21,604	457	–	298,304
Investment in associates and joint venture	31	3	36	2	1	–	73
Total assets	145,753	69,928	781,992	88,676	5,187	(167,305)	924,231
Customer accounts	129,108	33,784	140,813	66,049	126	–	369,880
Total liabilities	139,584	58,255	737,775	81,306	13,454	(126,804)	903,570
Capital expenditure incurred[3]	418	139	366	21	14	–	958

3 *Expenditure incurred on property, plant and equipment and other intangible assets. Excludes assets acquired as part of business combination and goodwill.*

Notes on the Financial Statements (continued)

Other financial information

Net operating income by customer group and global business

	Personal Financial Services £m	Commercial Banking £m	Global Banking and Markets £m	Private Banking £m	Other £m	Inter Segment £m	Total £m
Year ended 31 December 2009							
Net operating income:	**3,441**	**2,302**	**5,184**	**1,660**	**(326)**	**(63)**	**12,198**
External	**3,544**	**2,220**	**5,384**	**1,311**	**(261)**	**-**	**12,198**
Inter-segment	**(103)**	**82**	**(200)**	**349**	**(65)**	**(63)**	**-**
Year ended 31 December 2008							
Net operating income:	4,139	2,961	2,563	1,603	1,271	(58)	12,479
External	3,173	3,093	3,968	1,080	1,165	-	12,479
Inter-segment	966	(132)	(1,405)	523	(106)	(58)	-

Information by country

	31 December 2009		31 December 2008	
	External net operating income[4] £m	**Non-current assets[5] £m**	External net operating income[4] £m	Non-current assets[5] £m
United Kingdom	**7,594**	**5,327**	7,744	5,251
France	**2,119**	**6,579**	2,743	7,405
Switzerland	**512**	**2,590**	341	2,767
Other countries	**1,973**	**1,001**	1,651	1,099
TOTAL	**12,198**	**15,497**	12,479	16,522

4 *Net operating income is attributed to countries on the basis of the customers' location.*
5 *Non current assets consist of property, plant and equipment, goodwill, other intangible assets and certain other assets expected to be recovered more than twelve months after the reporting period.*

13 Analysis of financial assets and liabilities by measurement basis

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

Notes on the Financial Statements (continued)

The group

	At 31 December 2009								
	Held for trading £m	Designated at fair value £m	Held-to-maturity securities £m	Loans and receivables £m	Available-for-sale securities £m	Financial assets and liabilities at amortised cost £m	Derivatives designated as fair value hedging instruments £m	Derivatives designated as cash flow hedging instruments £m	Total £m
Financial assets									
Cash and balances at central banks	–	–	–	–	–	14,274	–	–	14,274
Items in the course of collection from other banks	–	–	–	–	–	2,082	–	–	2,082
Trading assets	165,008	–	–	–	–	–	–	–	165,008
Financial assets designated at fair value	–	16,435	–	–	–	–	–	–	16,435
Derivatives	116,845	–	–	–	–	–	55	1,616	118,516
Loans and advances to banks	–	–	–	46,994	–	–	–	–	46,994
Loans and advances to customers	–	–	–	274,659	–	–	–	–	274,659
Financial investments	–	–	4,851	–	81,844	–	–	–	86,695
Other assets	–	–	–	–	–	6,282	–	–	6,282
Accrued income	–	–	–	–	–	3,167	–	–	3,167
Total financial assets	281,853	16,435	4,851	321,653	81,844	25,805	55	1,616	734,112
Total non-financial assets									17,816
Total assets									751,928
Financial liabilities									
Deposits by banks	–	–	–	–	–	57,729	–	–	57,729
Customer accounts	–	–	–	–	–	332,896	–	–	332,896
Items in the course of transmission to other banks	–	–	–	–	–	1,477	–	–	1,477
Trading liabilities	118,881	–	–	–	–	–	–	–	118,881
Financial liabilities designated at fair value	–	18,164	–	–	–	–	–	–	18,164
Derivatives	117,331	–	–	–	–	–	399	959	118,689
Debt securities in issue	–	–	–	–	–	39,340	–	–	39,340
Other liabilities	–	–	–	–	–	5,294	–	–	5,294
Accruals	–	–	–	–	–	3,291	–	–	3,291
Subordinated liabilities	–	–	–	–	–	6,799	–	–	6,799
Total financial liabilities	236,212	18,164	–	–	–	446,826	399	959	702,560
Total non-financial liabilities									20,940
Total liabilities									723,500

Notes on the Financial Statements (continued)

The group

	At 31 December 2008								
	Held for trading £m	Designated at fair value £m	Held-to-maturity securities £m	Loans and receivables £m	Available-for-sale securities £m	Financial assets and liabilities at amortised cost £m	Derivatives designated as fair value hedging instruments £m	Derivatives designated as cash flow hedging instruments £m	Total £m
Financial assets									
Cash and balances at central banks	–	–	–	–	–	9,470	–	–	9,470
Items in the course of collection from other banks	–	–	–	–	–	1,917	–	–	1,917
Trading assets	172,026	–	–	–	–	–	–	–	172,026
Financial assets designated at fair value	–	13,895	–	–	–	–	–	–	13,895
Derivatives	241,132	–	–	–	–	–	87	1,865	243,084
Loans and advances to banks	–	–	–	50,719	–	–	–	–	50,719
Loans and advances to customers	–	–	–	298,304	–	–	–	–	298,304
Financial investments	–	–	25	–	103,486	–	–	–	103,511
Other assets	–	–	–	–	–	7,337	–	–	7,337
Accrued income	–	–	–	–	–	5,279	–	–	5,279
Total financial assets	413,158	13,895	25	349,023	103,486	24,003	87	1,865	905,542
Total non-financial assets									18,689
Total assets									924,231
Financial liabilities									
Deposits by banks	–	–	–	–	–	61,431	–	–	61,431
Customer accounts	–	–	–	–	–	369,880	–	–	369,880
Items in the course of transmission to other banks	–	–	–	–	–	1,802	–	–	1,802
Trading liabilities	124,450	–	–	–	–	–	–	–	124,450
Financial liabilities designated at fair value	–	15,184	–	–	–	–	–	–	15,184
Derivatives	239,394	–	–	–	–	–	432	1,205	241,031
Debt securities in issue	–	–	–	–	–	52,308	–	–	52,308
Other liabilities	–	–	–	–	–	6,565	–	–	6,565
Accruals	–	–	–	–	–	4,930	–	–	4,930
Subordinated liabilities	–	–	–	–	–	7,259	–	–	7,259
Total financial liabilities	363,844	15,184	–	–	–	504,175	432	1,205	884,840
Total non-financial liabilities									18,730
Total liabilities									903,570

Notes on the Financial Statements (continued)

The bank

	At 31 December 2009								
	Held for trading £m	Designated at fair value £m	Held-to-maturity securities £m	Loans and receivables £m	Available-for-sale securities £m	Financial assets and liabilities at amortised cost £m	Derivatives designated as fair value hedging instruments £m	Derivatives designated as cash flow hedging instruments £m	Total £m
Financial assets									
Cash and balances at central banks	–	–	–	–	–	13,130	–	–	13,130
Items in the course of collection from other banks	–	–	–	–	–	1,071	–	–	1,071
Trading assets	123,957	–	–	–	–	–	–	–	123,957
Financial assets designated at fair value	–	6,592	–	–	–	–	–	–	6,592
Derivatives	99,734	–	–	–	–	–	24	1,042	100,800
Loans and advances to banks	–	–	–	20,729	–	–	–	–	20,729
Loans and advances to customers	–	–	–	208,669	–	–	–	–	208,669
Financial investments	–	–	–	–	27,389	–	–	–	27,389
Other assets	–	–	–	–	–	3,501	–	–	3,501
Accrued income	–	–	–	–	–	1,195	–	–	1,195
Total financial assets	223,691	6,592	–	229,398	27,389	18,897	24	1,042	507,033
Total non-financial assets									18,937
Total assets									525,970
Financial liabilities									
Deposits by banks	–	–	–	–	–	39,346	–	–	39,346
Customer accounts	–	–	–	–	–	223,652	–	–	223,652
Items in the course of transmission to other banks	–	–	–	–	–	595	–	–	595
Trading liabilities	96,821	–	–	–	–	–	–	–	96,821
Financial liabilities designated at fair value	–	10,675	–	–	–	–	–	–	10,675
Derivatives	100,673	–	–	–	–	–	1	487	101,161
Debt securities in issue	–	–	–	–	–	14,636	–	–	14,636
Other liabilities	–	–	–	–	–	2,513	–	–	2,513
Accruals	–	–	–	–	–	1,601	–	–	1,601
Subordinated liabilities	–	–	–	–	–	6,955	–	–	6,955
Total financial liabilities	197,494	10,675	–	–	–	289,298	1	487	497,955
Total non-financial liabilities									3,084
Total liabilities									501,039

Notes on the Financial Statements (continued)

The bank

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

14 Reclassification of financial assets

Reclassification from Available for Sale to Held to Maturity

On 7 January 2009, the group reclassified £6.0 billion of financial assets from the available for sale category to the held to maturity category. The reclassification was made as a result of the change in intention to hold the assets until maturity.

Reclassification from Held for Trading to Loans and Receivables/Available for Sale

In October 2008, the group and the bank reclassified £5.0 billion and £0.2 billion of financial assets classified as held for trading assets into the loans and receivables and available for sale categories respectively, with effect from 1 July 2008. During November and December 2008, the group and the bank reclassified £0.9 billion and £1.4 billion of financial assets classified as held for trading into loans and receivables and available for sale respectively. These latter reclassifications took effect prospectively.

The reclassifications were made as a result of significant reduction in market liquidity for these assets, and a change in the group's intention to hold the assets for the foreseeable future or to maturity. These circumstances form part of the wider context of market turmoil and are considered a rare event and, as such, the reclassification is permitted under the amendment to IAS 39. On the date of reclassification, the fair value of the asset is deemed to be the asset's new amortised cost, and the assets are thereafter tested for impairment.

	At 31 December 2009		At 31 December 2008	
	Carrying amount	**Fair value**	Carrying amount	Fair value
	£m	**£m**	£m	£m
Reclassification to loans and receivables				
ABSs	**3,872**	**2,994**	4,292	3,207
Trading loans – commercial mortgage loans	**341**	**312**	403	383
Leverage finance and syndicated loans	**2,346**	**2,183**	2,432	1,877
	6,559	**5,489**	7,127	5,467
Reclassification to available for sale				
Corporate debt and other securities	**847**	**847**	1,592	1,592
	7,406	**6,336**	8,719	7,059

If these reclassifications had not been made, the group's profit before tax in 2009 would have been increased by £587 million from £4,014 million to £ 4,601 million (2008: a reduction of £1,793 million from £4,366 million to £2,573 million). The changes in group profit would have been entirely in the Global Banking & Markets segment.

The following table shows the fair value gains and losses recognised in the income statement from the date of reclassification. The effect on the income statement pre reclassification for 2008 was a loss of £618 million.

	Effect on income statement for 2009			Effect on income statement for 2008		
	Recorded in the income statement	**Assuming no reclassification**	**Net effect of reclassification**	Recorded in the income statement	Assuming no reclassification	Net effect of reclassification
	£m	**£m**	**£m**	£m	£m	£m
Financial asset reclassified to loans and receivables						
ABS	**229**	**361**	**(132)**	167	(918)	1,085
Trading loans – commercial mortgage loans	**19**	**9**	**10**	11	(9)	20
Leverage finance and syndicated loans	**179**	**540**	**(361)**	77	(478)	555
	427	**910**	**(483)**	255	(1,405)	1,660
Financial assets reclassified to available for sale						
Corporate debt and other securities	**76**	**180**	**(104)**	13	(120)	133
	503	**1,090**	**(587)**	268	(1,525)	1,793

Notes on the Financial Statements (continued)

15 Trading assets

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Trading assets:				
– which may be repledged or resold by counterparties	**55,528**	50,364	**24,013**	16,903
– not subject to repledge or resale by counterparties	**109,480**	121,662	**99,944**	113,302
	165,008	172,026	**123,957**	130,205
Treasury and other eligible bills	**789**	21	**741**	7
Debt securities	**75,566**	77,241	**35,314**	32,132
Equity securities	**19,404**	13,126	**18,793**	11,050
Loans and advances to banks	**30,857**	37,898	**34,111**	45,299
Loans and advances to customers	**38,392**	43,740	**34,998**	41,717
	165,008	172,026	**123,957**	130,205

Included within the above figures for the group are debt securities issued by banks and other financial institutions of £21,952 million (2008: £24,371 million), of which £3,740 million (2008: £831 million) are guaranteed by various governments.

Included within the above figures for the bank are debt securities issued by banks and other financial institutions of £11,752 million (2008: £14,140 million), of which £1,113 million (2008: £37 million) are guaranteed by various governments.

16 Financial assets designated at fair value through profit or loss

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Financial assets designated at fair value:				
– not subject to repledge or resale by counterparties	**16,435**	13,895	**6,592**	4,592
Treasury and other eligible bills	**35**	43	**–**	–
Debt securities	**8,706**	7,380	**6,515**	4,514
Equity securities	**6,955**	5,822	**–**	–
Loans and advances to banks	**214**	153	**77**	78
Loans and advances to customers	**525**	497	**–**	–
	16,435	13,895	**6,592**	4,592

Notes on the Financial Statements (continued)

17 Derivatives

Fair values of derivatives by product contract type held

The group

	At 31 December 2009					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange	**25,056**	**–**	**25,056**	**(25,713)**	**(9)**	**(25,722)**
Interest rate	**114,875**	**1,671**	**116,546**	**(114,452)**	**(1,349)**	**(115,801)**
Equity	**9,388**	**–**	**9,388**	**(10,487)**	**–**	**(10,487)**
Credit	**8,345**	**–**	**8,345**	**(7,563)**	**–**	**(7,563)**
Commodity and other	**348**	**–**	**348**	**(272)**	**–**	**(272)**
Gross total fair values	**158,012**	**1,671**	**159,683**	**(158,487)**	**(1,358)**	**(159,845)**
Netting			**(41,167)**			**41,156**
Total			**118,516**			**(118,689)**

	At 31 December 2008					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange	59,121	11	59,132	(59,891)	(10)	(59,901)
Interest rate	179,467	1,941	181,408	(177,398)	(1,627)	(179,025)
Equity	11,260	–	11,260	(12,383)	–	(12,383)
Credit	29,972	–	29,972	(28,331)	–	(28,331)
Commodity and other	621	–	621	(695)	–	(695)
Gross total fair values	280,441	1,952	282,393	(278,698)	(1,637)	(280,335)
Netting			(39,309)			39,304
Total			243,084			(241,031)

The bank

	At 31 December 2009					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange	**24,479**	**–**	**24,479**	**(25,757)**	**–**	**(25,757)**
Interest rate	**89,253**	**1,066**	**90,319**	**(87,984)**	**(488)**	**(88,472)**
Equity	**8,240**	**–**	**8,240**	**(10,144)**	**–**	**(10,144)**
Credit	**8,350**	**–**	**8,350**	**(7,449)**	**–**	**(7,449)**
Commodity and other	**451**	**–**	**451**	**(378)**	**–**	**(378)**
Gross total fair values	**130,773**	**1,066**	**131,839**	**(131,712)**	**(488)**	**(132,200)**
Netting			**(31,039)**			**31,039**
Total			**100,800**			**(101,161)**

	At 31 December 2008					
	Assets			Liabilities		
	Trading £m	Hedging £m	Total £m	Trading £m	Hedging £m	Total £m
Foreign exchange	58,265	–	58,265	(59,163)	–	(59,163)
Interest rate	140,700	1,370	142,070	(139,759)	(698)	(140,457)
Equity	1,134	–	1,134	(3,575)	–	(3,575)
Credit	29,667	–	29,667	(27,988)	–	(27,988)
Commodity and other	864	–	864	(936)	–	(936)
Gross total fair values	230,630	1,370	232,000	(231,421)	(698)	(232,119)
Netting			(34,872)			34,872
Total			197,128			(197,247)

Notes on the Financial Statements (continued)

Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge the group's own risks. Derivatives (except for derivatives which are designated as effective hedging instruments as defined in IAS 39) are held for trading. The held for trading classification includes two types of derivatives: those used in sales and trading activities, and those used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second category includes derivatives managed in conjunction with financial instruments designated at fair value. These activities are described more fully below.

The group's derivative activities give rise to significant open positions in portfolios of derivatives. These positions are managed constantly to ensure that they remain within acceptable risk levels, with matching deals being used to achieve this where necessary. When entering into derivative transactions, the group employs the same credit risk management procedures to assess and approve potential credit exposures that are used for traditional lending.

Trading derivatives

Most of the group's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in currency rates, interest rates, equity prices or other market parameters. Trading includes market-making, positioning and arbitrage activities. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume; positioning means managing market risk positions in the expectation of benefiting from favourable movements in prices, rates or indices; arbitrage involves identifying and profiting from price differentials between markets and products.

As mentioned above, other derivatives classified as held-for-trading include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge effectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value.

Gains and losses from changes in the fair value of derivatives, including the contractual interest, that do not qualify for hedge accounting are reported in 'Net trading income', except for derivatives managed in conjunction with financial instruments designated at fair value, where gains and losses are reported in 'Net income from financial instruments designated at fair value', together with the gains and losses on the hedged items. Where the derivatives are managed with debt securities in issue, the contractual interest is shown in 'interest expense' together with the interest payable on the issued debt.

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

	At 31 December			
	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Foreign exchange	**1,250,874**	1,490,980	**1,204,294**	1,366,091
Interest rate	**7,428,567**	6,971,748	**5,587,747**	4,860,786
Equity	**162,637**	133,737	**144,659**	23,059
Credit	**400,712**	655,423	**403,569**	659,262
Commodity	**22,666**	28,937	**21,947**	28,550
Total derivatives	**9,265,456**	9,280,825	**7,362,216**	6,937,748

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

Derivatives valued using models with unobservable inputs

The difference between the fair value at initial recognition (the transaction price) and the value that would have been derived had valuation techniques used for subsequent measurement been applied at initial recognition, less subsequent releases, is as follows.

Notes on the Financial Statements (continued)

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Unamortised balance at 1 January	**98**	90	**54**	59
Deferral on new transactions[1]	**85**	123	**76**	37
Recognised in the income statement during the period:				
– amortisation	**(47)**	(46)	**(14)**	(16)
– subsequent to unobservable inputs becoming observable	**(11)**	(47)	**(10)**	(7)
– maturity or termination, or offsetting derivative	**(21)**	(32)	**(8)**	(19)
Exchange differences	**(3)**	11	**(2)**	1
Risk hedged	**–**	(1)	**–**	(1)
Unamortised balance at 31 December[2]	**101**	98	**96**	54

1 *The bank 2009 balance includes £40m on an intra-group business transfer to the bank.*
2 *This amount is yet to be recognised in the income statement.*

Hedging instruments

The group uses derivatives (principally interest rate swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the group to optimise the overall cost to the group of accessing debt capital markets, and to mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities.

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

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

	The group			
	At 31 December 2009		At 31 December 2008	
	Cash flow hedge	**Fair value hedge**	Cash flow hedge	Fair value hedge
	£m	**£m**	£m	£m
Exchange rate	**182**	**444**	197	585
Interest rate	**97,749**	**11,083**	92,661	6,478

	The bank			
	At 31 December 2009		At 31 December 2008	
	Cash flow hedge	**Fair value hedge**	Cash flow hedge	Fair value hedge
	£m	**£m**	£m	£m
Interest rate	**47,038**	**1,398**	43,810	943

Fair value hedges

The group's fair value hedges principally consist of interest rate swaps that are used to protect against changes in the fair value of fixed-rate long-term financial instruments due to movements in market interest rates. For qualifying fair value hedges, all changes in the fair value of the derivative and in the fair value of the item in relation to the risk being hedged are recognised in the income statement. If the hedge relationship is terminated, the fair value adjustment to the hedged item continues to be reported as part of the basis of the item and is amortised to the income statement as a yield adjustment over the remainder of the hedging period.

Notes on the Financial Statements (continued)

The group

	At 31 December 2009		At 31 December 2008	
	Assets	**Liabilities**	Assets	Liabilities
	£m	**£m**	£m	£m
Foreign exchange	**–**	**–**	–	(9)
Interest rate	**55**	**(399)**	87	(423)
	55	**(399)**	87	(432)

The bank

	At 31 December 2009		At 31 December 2008	
	Assets	**Liabilities**	Assets	Liabilities
	£m	**£m**	£m	£m
Interest rate	**24**	**(1)**	–	(93)
	24	**(1)**	–	(93)

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

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Gains/ (losses)				
– on hedging instruments	**7**	(189)	**45**	(49)
– on hedged items attributable to the hedged risk	**(28)**	196	**(57)**	50

The gains and losses on ineffective portions of fair value hedges are recognised immediately in 'Net trading income'.

Cash flow hedges

The group's cash flow hedges consist principally of interest rate and cross-currency swaps that are used to protect against exposures to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions. Gains and losses are initially recognised in other comprehensive income, in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement.

Fair value of derivatives designated as cash flow hedges

The group

	At 31 December 2009		At 31 December 2008	
	Assets	**Liabilities**	Assets	Liabilities
	£m	**£m**	£m	£m
Foreign exchange	**–**	**(9)**	11	(1)
Interest rate	**1,616**	**(950)**	1,854	(1,204)
	1,616	**(959)**	1,865	(1,205)

The bank

	At 31 December 2009		At 31 December 2008	
	Assets	**Liabilities**	Assets	Liabilities
	£m	**£m**	£m	£m
Interest rate	**1,042**	**(487)**	1,370	(605)

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

Notes on the Financial Statements (continued)

The group

	At 31 December 2009			
	3 months or less £m	**More than 3 months but less than 1 year £m**	**5 years or less but more than 1 year £m**	**More than 5 years £m**
Assets	**43,520**	**46,485**	**25,874**	**24**
Liabilities	**(22,353)**	**(26,413)**	**(10,906)**	**(1,631)**
Net cash inflow/(outflow) exposure	**21,167**	**20,072**	**14,968**	**(1,607)**

	At 31 December 2008			
	3 months or less £m	More than 3 months but less than 1 year £m	5 years or less but more than 1 year £m	More than 5 years £m
Assets	41,517	32,994	29,743	42
Liabilities	(20,624)	(20,985)	(18,170)	(1,836)
Net cash inflow/(outflow) exposure	20,893	12,009	11,573	(1,794)

The bank

	At 31 December 2009			
	3 months or less £m	**More than 3 months but less than 1 year £m**	**5 years or less but more than 1 year £m**	**More than 5 years £m**
Assets	**35,006**	**32,478**	**20,190**	**–**
Liabilities	**(12,371)**	**(10,790)**	**(7,691)**	**(735)**
Net cash inflow/(outflow) exposure	**22,635**	**21,688**	**12,499**	**(735)**

	At 31 December 2008			
	3 months or less £m	More than 3 months but less than 1 year £m	5 years or less but more than 1 year £m	More than 5 years £m
Assets	28,892	26,477	22,777	41
Liabilities	(12,825)	(12,707)	(11,350)	(190)
Net cash inflow/(outflow) exposure	16,067	13,770	11,427	(149)

The gains and losses on ineffective portions of such derivatives are recognised immediately in ‘Net trading income’. During the year to 31 December 2009, a loss of £4 million (2008: loss of £3 million) was recognised due to hedge ineffectiveness.

Notes on the Financial Statements (continued)

18 Financial investments

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Financial investments:				
– which may be repledged or resold by counterparties	**5,718**	6,558	**2,852**	5,843
– not subject to repledge or resale by counterparties	**80,977**	96,953	**24,537**	40,765
	86,695	103,511	**27,389**	46,608

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Treasury and other eligible bills	**2,349**	10,562	**799**	9,818
– available-for-sale	**2,349**	10,562	**799**	9,818
– held-to-maturity	**–**	–	**–**	–
Debt securities	**82,030**	90,281	**25,653**	35,701
– available-for-sale	**77,179**	90,256	**25,653**	35,701
– held-to-maturity	**4,851**	25	**–**	–
Equity securities	**2,316**	2,668	**937**	1,089
– available-for-sale	**2,316**	2,668	**937**	1,089
Total financial investments	**86,695**	103,511	**27,389**	46,608

For the group, £14,998 million (2008: £12,364 million), and for the bank, £10,045 million (2008: £10,607 million), of the debt securities issued by banks and other financial institutions are guaranteed by various governments.

19 Repurchase agreements and securities lending agreements

The group enters into transactions in the normal course of business by which it transfers recognised financial assets directly to third parties or to special purpose entities. These transfers may give rise to full or partial derecognition of the financial assets concerned.

Transfers that do not qualify for derecognition

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

The group

	2009		2008	
	Carrying amount of assets	**Carrying amount of associated liabilities**	Carrying amount of assets	Carrying amount of associated liabilities
	£m	**£m**	£m	£m
Nature of transaction				
Repurchase agreements	**57,124**	**57,388**	53,965	52,531
Securities lending agreements	**4,087**	**4,087**	2,989	2,977
Total	**61,211**	**61,475**	56,954	55,508

Notes on the Financial Statements (continued)

The bank

	2009		2008	
	Carrying amount of assets £m	**Carrying amount of associated liabilities £m**	Carrying amount of assets £m	Carrying amount of associated liabilities £m
Nature of transaction				
Repurchase agreements	**22,778**	**23,048**	19,993	18,655
Securities lending agreements	**4,087**	**4,087**	2,753	2,753
Total	**26,865**	**27,135**	22,746	21,408

20 Interests in associates and joint ventures

Principal associates of the group

	At 31 December 2009 Carrying amount £m	At 31 December 2008 Carrying amount £m
VocaLink Holdings Ltd	**54**	39
	54	39

	At 31 December 2009			
	Country of incorporation	**Principal activity**	**The group's interest in equity capital**	**Issued equity capital**
VocaLink Holdings Ltd	England	Electronic payments and transaction services	15.22%	£133m

Summarised aggregate financial information on associates

The group's share of:

	2009 £m	2008 £m
Assets	**92**	44
Liabilities	**65**	36
Revenue	**57**	26
Profit after tax	**(1)**	(2)

Interests in significant joint ventures

	At 31 December 2009		
	Principal activity	**The group's interest in equity capital**	**Issued equity capital/ Partnership equity interest**
Vaultex UK Limited	Cash management	50%	£10m
Holmwoods Termtime Credit Limited	Investment Holdings and management	50%	£1

On 12 June 2009 the bank sold its remaining 49% stake in HSBC Merchant Services LLP to Global Payments Inc, the joint venture partner. The joint venture commenced in 2008 when the bank and Global Payments Inc commenced the card processing joint venture, with the bank acquiring a 49% stake.

Notes on the Financial Statements (continued)

The group's share of:

	2009 £m	2008 £m
Current assets	**130**	159
Non current assets	**13**	17
Current liabilities	**125**	149
Non current liabilities	**10**	10
Income	**51**	83
Expense	**(49)**	(69)

21 Goodwill and intangible assets

	The group		The bank	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Goodwill	**10,015**	10,649	**299**	296
Present value of in-force long-term assurance business ('PVIF')	**630**	579	**–**	–
Other intangible assets	**554**	552	**333**	302
	11,199	11,780	**632**	598

Goodwill

The group

	2009 £m	2008 £m
Gross amount and Carrying amount		
At 1 January	**10,649**	8,974
Additions	**157**	6
Disposals[1]	**–**	(747)
Exchange differences	**(762)**	2,419
Other changes	**(29)**	(3)
At 31 December	**10,015**	10,649

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

The bank

	2009 £m	2008 £m
Gross amount and Carrying amount		
At 1 January	**296**	291
Additions	**3**	–
Other changes	**–**	5
At 31 December	**299**	296

During 2009, no goodwill impairment was recognised (2008: nil). Impairment testing in respect of goodwill is performed annually by comparing the recoverable amount of cash-generating units ('CGUs') determined as at 1 July 2009 based on a value-in-use calculation. That calculation uses cash flow estimates based on management's cash flow projections, extrapolated in perpetuity using a nominal long-term growth rate based on current market assessments of GDP and inflation for the countries within which the CGU operates. Cash flows are extrapolated in perpetuity due to the long-term perspective within the group of the business units making up the CGUs. The discount rate used is based on the cost of capital the group allocates to investments in the countries within which the CGU operates.

The cost of capital assigned to an individual CGU and used to discount its future cash flows can have a significant effect on its valuation. The cost of capital percentage is generally derived from an appropriate capital asset pricing model, which itself depends on inputs reflecting a number of financial and economic variables including the risk-free rate in the country concerned and a premium or discount to reflect the inherent risk of the business being evaluated.

Notes on the Financial Statements (continued)

These variables are established on the basis of management judgement and current market assessments of economic variables.

The review of goodwill impairment represents management's best estimates of the factors set out in Note 3. These values are sensitive to the cash flows projected for the periods for which detailed forecasts are available, and to assumptions regarding the long-term sustainable pattern of cash flows thereafter. While the acceptable range within which underlying assumptions can be applied is governed by the requirement for resulting forecasts to be compared with actual performance and verifiable economic data in future years, the cash flow forecasts necessarily and appropriately reflect management's view of future business prospects. The process of identifying and evaluating goodwill impairment is inherently uncertain because it requires significant management judgement in making a series of estimations, the results of which are highly sensitive to the assumptions used.

As a result of adopting IFRS 8, the group has reallocated goodwill across the new segments based on their relative net asset values. The following CGUs include in their carrying value goodwill that is a significant proportion of total goodwill reported by the group. These CGUs do not carry on their balance sheet any intangible assets with indefinite useful lives, other than goodwill.

	Goodwill at 1 July 2009 £m	Discount rate %	Nominal growth rate beyond initial cash flow projections %
Global Banking and Markets	**5,604**	**11.0**	**3.6**
Private Banking	**2,865**	**9.0**	**2.7**
Total goodwill in the CGUs listed above	**8,469**		

As at 1 July 2009, aggregate goodwill of £1,214 million (1 July 2008: £694 million) had been allocated to CGUs that were not considered individually significant. These CGUs do not carry on their balance sheets any significant intangible assets with indefinite useful lives other than goodwill.

Nominal long-term growth rate: external data that reflects the market's assessment of GDP and inflation for the countries within which the CGU operates. The rates used for 2008 and 2009 are taken as an average of the last 10 years.

Discount rate: the discount rate used to discount the cash flows is based on the cost of capital assigned to each CGU, which is derived using a Capital Asset Pricing Model ('CAPM'). The CAPM depends on inputs reflecting a number of financial and economic variables including the risk-free rate in the country concerned and a premium to reflect the inherent risk of the business being evaluated. These variables are based on the market's assessment of the economic variables and management's judgement. In addition, for the purposes of testing goodwill for impairment, management supplements this process by comparing the discount rates derived using the internally generated CAPM with cost of capital rates produced by external sources. The group uses the externally-sourced cost of capital rates where, in management's judgement, those rates reflect more accurately the current market and economic conditions.

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

Movement on the PVIF

The group

	2009 £m	2008 £m
At 1 January	**579**	444
Addition from current year new business	**104**	105
Movement from in-force business (including investment return variances and changes in investment assumptions)	**(34)**	(94)
Exchange differences and other movements	**(19)**	124
At 31 December	**630**	579

Notes on the Financial Statements (continued)

PVIF-specific assumptions

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

	2009		2008	
	France	**UK Life**	France	UK Life
Risk free rate	**3.46%**	**3.50%**	4.03%	4.30%
Risk discount rate	**8.00%**	**7.00%**	8.00%	8.00%
Expenses inflation	**2.00%**	**3.50%**	2.00%	3.50%

The PVIF represents the value of the shareholders' interest in the in-force business of the life insurance operations. The calculation of the PVIF is based upon assumptions that take into account risk and uncertainty. To project these cash flows, a variety of assumptions regarding future experience is made by each insurance operation which reflects local market conditions and management's judgement of local future trends.

Other intangible assets

The analysis of the movement of other intangible assets, was follows:

The group

	Trade Names £m	Internally generated software £m	Purchased Software £m	Customer/ merchant relation-ships £m	Other £m	Total £m
Cost						
At 1 January 2009	**16**	**949**	**160**	**209**	**12**	**1,346**
Additions[1]	**–**	**135**	**17**	**–**	**10**	**162**
Amounts written-off	**–**	**(3)**	**(1)**	**–**	**–**	**(4)**
Exchange differences	**(1)**	**(10)**	**(12)**	**(1)**	**(1)**	**(25)**
Other changes	**–**	**–**	**(2)**	**(1)**	**–**	**(3)**
At 31 December 2009	**15**	**1,071**	**162**	**207**	**21**	**1,476**
Accumulated amortisation and impairment						
At 1 January 2009	**(8)**	**(624)**	**(90)**	**(71)**	**(1)**	**(794)**
Amortisation charge for the year[2]	**(2)**	**(103)**	**(20)**	**(21)**	**(1)**	**(147)**
Impairment charge for the year[2]	**–**	**–**	**(3)**	**–**	**–**	**(3)**
Amounts written-off		**3**	**1**	**–**	**–**	**4**
Exchange differences	**1**	**10**	**7**	**–**	**–**	**18**
Other changes	**(2)**	**2**	**–**	**1**	**(1)**	**–**
At 31 December 2009	**(11)**	**(712)**	**(105)**	**(91)**	**(3)**	**(922)**
Net carrying amount at 31 December 2009	**4**	**359**	**57**	**116**	**18**	**554**
Cost						
At 1 January 2008	15	788	78	204	12	1,097
Additions[1]	–	148	20	2	6	176
Acquisition of subsidiaries	–	–	33	–	–	33
Disposals	–	(20)	(3)	(1)	(3)	(27)
Exchange differences	1	33	35	4	1	74
Other changes	–	–	(3)	–	(4)	(7)
At 31 December 2008	16	949	160	209	12	1,346
Accumulated amortisation and impairment						
At 1 January 2008	(7)	(526)	(51)	(52)	(2)	(638)
Amortisation charge for the year[2]	(1)	(75)	(15)	(18)	–	(109)
Disposals	–	7	3	–	1	11
Exchange differences	–	(33)	(20)	(1)	–	(54)
Other changes	–	3	(7)	–	–	(4)
At 31 December 2008	(8)	(624)	(90)	(71)	(1)	(794)
Net carrying amount at 31 December 2008	8	325	70	138	11	552

1 *At 31 December 2009, the group did not have any contractual commitments to acquire intangible assets (2008: nil).*
2 *The amortisation and impairment charges for the year are recognised within the income statement under 'Amortisation and impairment of intangible assets'.*

Notes on the Financial Statements (continued)

The bank

	Internally generated software £m	Other £m	Total £m
Cost			
At 1 January 2009	**780**	**–**	**780**
Additions[1]	**125**	**5**	**130**
Amounts written-off	**(3)**	**–**	**(3)**
At 31 December 2009	**902**	**5**	**907**
Accumulated amortisation and impairment			
At 1 January 2009	**(478)**	**–**	**(478)**
Amortisation charge for the year[2]	**(95)**	**–**	**(95)**
Impairment charge for the year[2]	**–**	**(4)**	**(4)**
Amounts written-off	**3**	**–**	**3**
At 31 December 2009	**(570)**	**(4)**	**(574)**
Net carrying amount at 31 December 2009	**332**	**1**	**333**
Cost			
At 1 January 2008	668	3	671
Additions[1]	132	–	132
Disposals	(20)	(3)	(23)
At 31 December 2008	780	–	780
Accumulated amortisation and impairment			
At 1 January 2008	(420)	(2)	(422)
Amortisation charge for the year[2]	(68)	–	(68)
Disposals	7	2	9
Other changes	3	–	3
At 31 December 2008	(478)	–	(478)
Net carrying amount at 31 December 2008	302	–	302

1 *At 31 December 2009, the bank did not have any contractual commitments to acquire intangible assets (2008: nil).*
2 *The amortisation and impairment charges for the year are recognised within the income statement under 'Amortisation and impairment of intangible assets'.*

Notes on the Financial Statements (continued)

22 Property, plant and equipment

The group

	Freehold land and buildings[4] £m	Long leasehold land and buildings £m	Short leasehold land and buildings £m	Equipment, fixtures and fittings[1] £m	Equipment on operating leases £m	Total[2] £m
Cost or fair value						
At 1 January 2009	**1,044**	**323**	**453**	**3,323**	**3,117**	**8,260**
Additions at cost[3]	**117**	**3**	**38**	**268**	**187**	**613**
Reclassified to held for sale	**(243)**	**–**	**–**	**(38)**	**–**	**(281)**
Fair value adjustments	**(5)**	**–**	**–**	**–**	**–**	**(5)**
Disposals	**(29)**	**(295)**	**(7)**	**(218)**	**(77)**	**(626)**
Exchange differences	**(42)**	**(5)**	**8**	**(84)**	**–**	**(123)**
At 31 December 2009	**842**	**26**	**492**	**3,251**	**3,227**	**7,838**
Accumulated depreciation and impairment						
At 1 January 2009	**(119)**	**(33)**	**(204)**	**(2,157)**	**(1,050)**	**(3,563)**
Depreciation charge for the year	**(19)**	**(7)**	**(39)**	**(298)**	**(107)**	**(470)**
Reclassified to held for sale	**17**	**–**	**–**	**18**	**–**	**35**
Disposals	**7**	**28**	**6**	**162**	**1**	**204**
Impairment losses recognised	**(9)**	**–**	**(1)**	**(2)**	**–**	**(12)**
Exchange differences	**4**	**1**	**1**	**52**	**–**	**58**
At 31 December 2009	**(119)**	**(11)**	**(237)**	**(2,225)**	**(1,156)**	**(3,748)**
Net carrying amount at 31 December 2009	**723**	**15**	**255**	**1,026**	**2,071**	**4,090**

1 *Including assets held on finance leases with a carrying amount of £151 million (2008: £139 million).*
2 *Including assets with a carrying amount of £160 million (2008: £143 million) pledged as security for liabilities.*
3 *At 31 December 2009, the group had £232 million (2008: £367 million) of contractual commitments to acquire property, plant and equipment.*
4 *Including the investment properties on page 109.*

Notes on the Financial Statements (continued)

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

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 2009	**322**	**328**	**373**	**2,408**	**3,431**
Additions at cost[1]	**111**	**1**	**22**	**178**	**312**
Reclassified from held for sale	**1**	**–**	**–**	**(1)**	**–**
Disposals	**(7)**	**(295)**	**(5)**	**(173)**	**(480)**
Exchange differences	**4**	**(5)**	**15**	**(1)**	**13**
At 31 December 2009	**431**	**29**	**405**	**2,411**	**3,276**
Accumulated depreciation and impairment					
At 1 January 2009	**(63)**	**(33)**	**(169)**	**(1,651)**	**(1,916)**
Depreciation charge for the year	**(8)**	**(7)**	**(29)**	**(183)**	**(227)**
Disposals	**2**	**28**	**3**	**122**	**155**
Impairment losses recognised	**(5)**	**–**	**(1)**	**(3)**	**(9)**
Exchange differences	**–**	**1**	**(1)**	**1**	**1**
At 31 December 2009	**(74)**	**(11)**	**(197)**	**(1,714)**	**(1,996)**
Net carrying amount at 31 December 2009	**357**	**18**	**208**	**697**	**1,280**

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

1 *At 31 December 2009, the bank had £42 million (2008: £84 million) of contractual commitments to acquire property, plant and equipment.*

On 13 November 2009, the group entered into a contract for the sale and leaseback of the building and long leasehold land comprising 8 Canada Square, London to the National Pension Service of Korea ('NPS') for £772.5 million in cash. The transaction was effected through the sale of the bank's 100 per cent shareholding in Project Maple II B.V. '(PMII') to a wholly-owned subsidiary of NPS, PMII being the legal owner of the building and long leasehold interest in 8 Canada Square.

Under the terms of the agreement, the group is leasing the building back from PMII and retains full control of occupancy for the remaining 17.5 years of the existing 20 year leaseback period at a current annual rent of £46.3 million, with annual upward-only rent reviews linked to the UK Retail Prices Index (‘RPI’) and subject to an annual maximum and minimum increase of 6 per cent and 2.5 per cent respectively.

On completion of the transaction on 30 November 2009, 'Property, plant and equipment' of £307 million and 'Prepayments and accrued income' (representing the long leasehold on the land) of £106 million were derecognised from the group's balance sheet. A gain of £353 million was recognised in the group's operating profit for the year, within 'Other operating income'.

On 31 May 2007, the group had entered into a previous contract for the sale and leaseback of 8 Canada Square to Metrovacesa; however the group had retained a significant interest by virtue of a bridging loan provided to Metrovacesa preventing immediate recognition of the sale. As a result, at 31 December 2007 the net proceeds received were recognised as deferred income on the balance sheet and these net proceeds were released to the income statement only when the group took back ownership on 4 December 2008 by acquiring PMII, the subsidiary of Metrovacesa which legally owned 8 Canada Square. The impact on the group's operating profit for the year ended 31 December 2008 was a net gain of £244 million, comprising a gain of £265 million included within 'Other operating income' and a charge of £21 million included within 'Depreciation and impairment of property, plant and equipment'.

Notes on the Financial Statements (continued)

Investment properties

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

The group

	Freehold land and buildings[1] £m
Fair value	
At 1 January 2009	**105**
Fair value adjustments	**(5)**
Exchange and other changes	**(14)**
At 31 December 2009	**86**
Fair value	
At 1 January 2008	152
Additions at cost	21
Fair value adjustments	(5)
Exchange and other changes	(63)
At 31 December 2008	105

1 *Included in 'Property, plant and equipment' on page 106.*

Investment properties are valued on an open market value basis as at 31 December each year by independent professional valuers who have recent experience in the location and type of properties.

Included within 'Other operating income' was rental income of £3 million (2008: £2 million) earned by the group on its investment properties. Direct operating expenses of £nil (2008: nil) incurred in respect of the investment properties during the year were recognised in 'General and administrative expenses'. Direct operating expenses arising in respect of investment properties that did not generate rental income during the year amounted to £ nil million (2008: nil). Net exchange differences on translation of investment properties were £10 million (2008: £67 million).

The bank

The bank had no investment properties at 31 December 2009 or 2008.

Group properties leased to customers

The group properties leased to customers included £6 million at 31 December 2009 (2008: £4 million) let under operating leases, net of accumulated depreciation of £11 million (2008: £6 million). None was held by the bank.

Notes on the Financial Statements (continued)

23 Investments in subsidiaries

Principal subsidiary undertakings of HSBC Bank plc

	Country of Incorporation or registration	HSBC Bank plc's interest in equity capital %	Share class
HSBC France	France	99.99	Ordinary €5.00
HSBC Asset Finance (UK) Limited	England	100.00	Ordinary £1
HSBC Bank A.S.	Turkey	100.00	A-Common TRL1
			B-Common TRL1
HSBC Bank International Limited	Jersey	99.87	Ordinary £1
HSBC Bank Malta p.l.c.	Malta	68.25	Ordinary €0.30
HSBC Invoice Finance (UK) Limited	England	100.00	Ordinary £1
HSBC Life (UK) Limited	England	100.00	Ordinary £1
HSBC Rail (UK) Limited	England	100.00	Ordinary £1
HSBC Private Bank (C.I.) Limited	Guernsey	99.87	Ordinary US$1
			Preference US$0.10
HSBC Private Bank (Suisse) S.A.	Switzerland	99.87	Ordinary CHF1,000
HSBC Private Bank (UK) Limited	England	99.87	Ordinary £10
HSBC Trinkhaus & Burkhardt AG	Germany	78.60	Shares of no par value
HSBC Trust Company (UK) Limited	England	100.00	Ordinary £5
Marks and Spencer Retail Financial Services Holdings Limited	England	100.00	Ordinary £1

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

	Carrying value of total consolidated assets £bn	Nature of SPE
Barion Funding Limited	2.7	Securities investment conduit
Bryant Park Funding LLC	2.3	Conduit
Malachite Funding Limited	2.7	Securities investment conduit
Mazarin Funding Limited	7.0	Securities investment conduit
Metrix Funding plc	2.3	Securitisation vehicle
Metrix Securities plc	2.6	Securitisation vehicle
Regency Assets Limited	4.2	Conduit
Solitaire Funding Limited	8.0	Securities investment conduit
Turquoise Receivables Trustee Ltd	0.3	Securitisation vehicle

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

Acquisitions

The group made acquisitions of subsidiary undertakings, and increased its investment in existing subsidiary undertakings, during 2009. These transactions were accounted for by applying the purchase method and goodwill of £157 million arose (2008: £6 million).

Disposals

On 1 December 2009, the group completed the sale of HSBC Actuaries and Consultants Limited to Jardine Lloyd Thompson UK Holdings Ltd for £27.2 million. On 30 November 2009, the aggregate total asset attribute to HSBC Actuaries and Consultants Limited were £15 million, and the entity generated a net loss after tax of £3 million for the period to 30 November 2009. The group's pre-tax profit on sale was £12 million.

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

Notes on the Financial Statements (continued)

24 Other assets

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Bullion	**778**	570	**688**	423
Assets held for sale	**297**	70	**40**	56
Reinsurers' share of liabilities under insurance contracts	**407**	618	**–**	–
Endorsements and acceptances	**352**	370	**191**	224
Other accounts	**6,179**	7,174	**3,311**	2,934
	8,013	8,802	**4,230**	3,637

Assets held for sale

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Non-current assets held for sale				
Property, plant and equipment	**294**	62	**40**	56
Financial assets	**1**	7	**–**	–
Other	**2**	1	**–**	–
Total assets classified as held for sale	**297**	70	**40**	56

On 21 December 2009, the group entered into a contract for the sale of 103 Champs Elysées and 15 Rue Vernet in Paris for a combined consideration of EUR 400 million. Under the terms of the arrangement, the group will lease the buildings back for a period of 9 years. The carrying amount included in assets held for sale at 31 December 2009 was EUR 257 million (£228 million). The transaction completed on 25 February 2010. Neither a gain nor a loss was recognised on reclassifying these assets as held for sale during the year.

Also included within property plant and equipment classified as held for sale is repossessed property that had been pledged as collateral by customers. These repossessed assets are expected to be disposed of within 12 months of acquisition.

25 Trading liabilities

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Deposits by banks	**29,661**	43,882	**36,723**	46,928
Customer accounts	**29,038**	29,347	**24,900**	25,039
Other debt securities in issue	**19,306**	15,677	**16,088**	12,152
Other liabilities – net short positions	**40,876**	35,544	**19,110**	14,270
	118,881	124,450	**96,821**	98,389

26 Financial liabilities designated at fair value

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Deposits by banks	**3,911**	4,357	**3,749**	4,162
Liabilities to customers under investment contracts	**4,039**	3,641	**–**	–
Debt securities in issue	**6,597**	3,584	**3,304**	1,658
Subordinated liabilities	**3,363**	3,374	**3,622**	3,609
Preference shares	**254**	228	**–**	–
	18,164	15,184	**10,675**	9,429

The carrying amount at 31 December 2009 of financial liabilities designated at fair value was £194 million higher for the group (2008: £491 million higher) (the bank: 2009: £48 million lower; 2008: £439 million higher) than the contractual amount at maturity. At 31 December 2009, the accumulated amount of change in fair value attributable to

Notes on the Financial Statements (continued)

changes in credit risk was a gain of £233 million for the group (2008: £672 million gain) (the bank: 2009: £323 million gain; 2008: £623 million gain).

27 Other liabilities

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Amounts due to investors in funds consolidated by the group	**491**	782	**–**	–
Obligations under finance leases	**291**	332	**–**	–
Endorsements and acceptances	**352**	367	**191**	224
Share based payment liability to HSBC Holdings	**221**	199	**123**	100
Other liabilities	**4,512**	5,217	**2,322**	2,839
	5,867	6,897	**2,636**	3,163

28 Liabilities under insurance contracts

	At 31 December 2009		
	Gross	**Reinsurers' share**	**Net**
	£m	**£m**	**£m**
Non-life insurance liabilities			
Unearned premium provision	**168**	**(9)**	**159**
Notified claims	**342**	**(89)**	**253**
Claims incurred but not reported	**201**	**(12)**	**189**
Other	**48**	**(2)**	**46**
	759	**(112)**	**647**
Life insurance liabilities to policyholders			
Life (non-linked)	**1,506**	**(278)**	**1,228**
Investment contracts with discretionary participation features[1]	**12,930**	**–**	**12,930**
Life (linked)	**1,310**	**(17)**	**1,293**
	15,746	**(295)**	**15,451**
Total liabilities under insurance contracts	**16,505**	**(407)**	**16,098**

	At 31 December 2008		
	Gross	Reinsurers' share	Net
	£m	£m	£m
Non-life insurance liabilities			
Unearned premium provision	445	(71)	374
Notified claims	345	(109)	236
Claims incurred but not reported	77	(19)	58
Other	16	(1)	15
	883	(200)	683
Life insurance liabilities to policyholders			
Life (non-linked)	2,031	(411)	1,620
Investment contracts with discretionary participation features[1]	12,157	–	12,157
Life (linked)	1,061	(7)	1,054
	15,249	(418)	14,831
Total liabilities under insurance contracts	16,132	(618)	15,514

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.*

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

Notes on the Financial Statements (continued)

Non-life insurance liabilities

	2009 Gross £m	2009 Reinsurers' share £m	2009 Net £m
Unearned premium reserve ('UPR')			
At 1 January	**445**	**(71)**	**374**
Changes in UPR recognised as (income)/expense	**(143)**	**10**	**(133)**
– gross written premiums	**275**	**(43)**	**232**
– gross earned premiums	**(418)**	**53**	**(365)**
Exchange differences and other movements	**(134)**	**52**	**(82)**
At 31 December	**168**	**(9)**	**159**
Notified and incurred but not reported claims			
At 1 January	**422**	**(128)**	**294**
– notified claims	**345**	**(109)**	**236**
– claims incurred but not reported	**77**	**(19)**	**58**
Claims paid in current year	**(358)**	**45**	**(313)**
Claims incurred in respect of current year	**277**	**(44)**	**233**
Claims incurred in respect of prior years	**240**	**–**	**240**
Exchange differences and other movements	**(38)**	**26**	**(12)**
At 31 December	**543**	**(101)**	**442**
– notified claims	**342**	**(89)**	**253**
– claims incurred but not reported	**201**	**(12)**	**189**
Other	**48**	**(2)**	**46**
Total non-life insurance liabilities	**759**	**(112)**	**647**

	2008 Gross £m	2008 Reinsurers' share £m	2008 Net £m
Unearned premium reserve ('UPR')			
At 1 January	387	(48)	339
Changes in UPR recognised as (income)/expense	(42)	2	(40)
– gross written premiums	418	(63)	355
– gross earned premiums	(460)	65	(395)
Exchange differences and other movements	100	(25)	75
At 31 December	445	(71)	374
Notified and incurred but not reported claims			
At 1 January	413	(144)	269
– notified claims	301	(129)	172
– claims incurred but not reported	112	(15)	97
Claims paid in current year	(318)	46	(272)
Claims incurred in respect of current year	152	(43)	109
Claims incurred in respect of prior years	66	(1)	65
Exchange differences and other movements	109	14	123
At 31 December	422	(128)	294
– notified claims	345	(109)	236
– claims incurred but not reported	77	(19)	58
Other	16	(1)	15
Total non-life insurance liabilities	883	(200)	683

Notes on the Financial Statements (continued)

Life insurance liabilities to policyholders

	2009		
	Gross £m	**Reinsurers' share £m**	**Net £m**
Life (non-linked)			
At 1 January	**2,031**	**(411)**	**1,620**
Benefits paid	**(802)**	**79**	**(723)**
Increase in liabilities to policyholders	**241**	**(44)**	**197**
Exchange differences and other movements	**36**	**98**	**134**
At 31 December	**1,506**	**(278)**	**1,228**
Investment contracts with discretionary participation features			
At 1 January	**12,157**	**–**	**12,157**
Benefits paid	**(1,154)**	**–**	**(1,154)**
Increase in liabilities to policyholders	**2,485**	**–**	**2,485**
Exchange differences and other movements[1]	**(558)**	**–**	**(558)**
At 31 December	**12,930**	**–**	**12,930**
Life (linked)			
At 1 January	**1,061**	**(7)**	**1,054**
Benefits paid	**(134)**	**5**	**(129)**
Increase in liabilities to policyholders	**400**	**(15)**	**385**
Exchange differences and other movements[2]	**(17)**	**–**	**(17)**
At 31 December	**1,310**	**(17)**	**1,293**
Total liabilities to policyholders	**15,746**	**(295)**	**15,451**

	2008		
	Gross £m	Reinsurers' share £m	Net £m
Life (non-linked)			
At 1 January	1,128	(290)	838
Benefits paid	(374)	83	(291)
Increase in liabilities to policyholders	1,056	(396)	660
Exchange differences and other movements	221	192	413
At 31 December	2,031	(411)	1,620
Investment contracts with discretionary participation features			
At 1 January	9,447	–	9,447
Benefits paid	(1,047)	–	(1,047)
Increase in liabilities to policyholders	909	–	909
Exchange differences and other movements[1]	2,848	–	2,848
At 31 December	12,157	–	12,157
Life (linked)			
At 1 January	858	(28)	830
Benefits paid	(135)	7	(128)
Increase in liabilities to policyholders	(54)	14	(40)
Exchange differences and other movements[2]	392	–	392
At 31 December	1,061	(7)	1,054
Total liabilities to policyholders	15,249	(418)	14,831

1 *Includes movement in liabilities relating to discretionary profit participation benefits due to policyholders arising from net unrealised investment gains recognised in other comprehensive income.*
2 *Includes amounts arising under reinsurance agreements.*

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

29 Provisions

The group

	Provisions	
	2009	2008
	£m	£m
At 1 January	**428**	427
Additional provisions/increase in provisions[1]	**103**	140
Acquisition of subsidiaries	**–**	4
Provisions utilised	**(94)**	(143)
Amounts reversed	**(62)**	(39)
Exchange differences and other movements	**(7)**	39
At 31 December	**368**	428

1 *Includes unwinding of discounts of £2 million (2008: £1 million) in relation to vacant space provisions.*

Included above are:

(i) A provision of £35 million (2008: £35 million) for the possible cost of redress relating to the sale of certain personal pension plans and mortgage endowment policies and a provision for indemnity clawbacks. The provision is based on an actuarial calculation extrapolated from a sample of cases. The timing of the expenditure depends on settlement of individual claims.

(ii) Provisions of £78 million (2008: £84 million) for the estimated cost of redress in relation to provision of services to a number of trusts by a subsidiary of the bank. The bank has undertaken to reimburse the subsidiary in respect of the initial estimated cost of redress. The total provision is based on a calculation extrapolated from a sample of cases. Uncertainties arise from factors affecting the timing of notifying and reimbursing those affected.

The bank

	Provisions	
	2009	2008
	£m	£m
At 1 January	**158**	163
Additional provisions/increase in provisions[1]	**49**	30
Provisions utilised	**(19)**	(22)
Amounts reversed	**(16)**	(14)
Exchange differences and other movements	**4**	1
At 31 December	**176**	158

1 *Includes unwinding of discounts of £2 million (2008: £1 million) in relation to vacant space provisions.*

Included in the above are provisions for onerous property contracts of £38 million (2008: £27 million) relating to the discounted future costs associated with leasehold properties that have became vacant. The provisions cover rent voids while finding new tenants, shortfalls in expected rent receivable compared with rent payable, and the cost of refurbishing the buildings to attract tenants. Uncertainties arise from movements in market rents, delays in finding new tenants and the timing of rental reviews.

Notes on the Financial Statements (continued)

30 Subordinated liabilities

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Subordinated liabilities:				
– At amortised cost	**6,799**	7,259	**6,955**	7,310
Subordinated liabilities	**4,412**	4,741	**6,955**	7,310
Preference shares	**2,387**	2,518	**–**	–
– Designated at fair value	**3,617**	3,602	**3,622**	3,609
Subordinated liabilities	**3,363**	3,374	**3,622**	3,609
Preference shares	**254**	228	**–**	–
	10,416	10,861	**10,577**	10,919

Subordinated borrowings of the group

		Carrying amount	
		2009	2008
		£m	£m
US$300m	6.95% Subordinated Notes 2011	**198**	222
€250m	Floating Rate Subordinated Loan 2015	**222**	239
€600m	4.25% Callable Subordinated Notes 2016[1]	**557**	570
€800m	Callable Subordinated Floating Rate Notes 2016	**710**	765
£350m	Callable Subordinated Variable Coupon Notes 2017[2]	**375**	355
€1,000m	Floating Rate Subordinated Loan 2017	**888**	957
£500m	4.75% Callable Subordinated Notes 2020[3]	**484**	463
€500m	Callable Subordinated Floating Rate Notes 2020	**394**	389
£350m	5% Callable Subordinated Notes 2023[4]	**339**	330
£300m	6.5% Subordinated Notes 2023	**298**	299
US$300m	7.65% Subordinated Notes 2025	**192**	263
£350m	5.375% Callable Subordinated Step-up Notes 2030[5]	**327**	316
£500m	5.375% Subordinated Notes 2033	**478**	452
£390m	6.9% Subordinated Loan 2033	**390**	390
€900m	7.75% Non-cumulative Subordinated Notes 2040	**799**	861
£225m	6.25% Subordinated Notes 2041	**224**	223
£600m	4.75% Subordinated Notes 2046	**592**	592
£700m	5.844% Non-cumulative Step-up Perpetual Preferred Securities[6]	**700**	700
£300m	5.862% Non-cumulative Step-up Perpetual Preferred Securities[7]	**254**	228
US$750m	Undated Floating Rate Primary Capital Notes	**462**	514
US$500m	Undated Floating Rate Primary Capital Notes	**308**	343
US$300m	Undated Floating Rate Primary Capital Notes (Series 3)	**185**	206
£350m	7.9% Perpetual Subordinated Debt	**350**	350
£250m	7.991% Perpetual Subordinated Debt	**250**	250
	Other subordinated liabilities less than £200m	**440**	584
		10,416	10,861

1 *The interest rate on the 4.25% Callable Subordinated Notes 2016 changes in March 2011 to three month EURIBOR plus 1.05%.*
2 *The interest rate on the Callable Subordinated Variable Coupon Notes 2017 is fixed at 5.75% until June 2012. Thereafter, the rate per annum is the sum of the gross redemption yield of the then prevailing five year UK gilt plus 1.70%.*
3 *The interest rate on the 4.75% Callable Subordinated Notes 2020 changes in September 2015 to three month sterling LIBOR plus 0.82%.*
4 *The interest rate on the 5% Callable Subordinated Notes 2023 changes in March 2018 to become the rate per annum which is the sum of the gross redemption yield of the then prevailing five year UK gilt plus 1.80%.*
5 *The interest rate on the 5.375% Callable Subordinated Step-up Notes 2030 changes in November 2025 to three month sterling LIBOR plus 1.50%.*
6 *The distribution rate on the 5.844% Non-cumulative Step-up Perpetual Preferred Securities changes in November 2031 to six month sterling LIBOR plus 1.76%.*
7 *The distribution rate on the 5.862% Non-cumulative Step-up Perpetual Preferred Securities changes in April 2020 to six month sterling LIBOR plus 1.85%.*

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

31 Fair value of financial instruments

Control framework

Fair values are subject to a control framework designed to ensure that they are either determined, or validated, by a function independent of the risk-taker. To this end, ultimate responsibility for the determination of fair values lies with Finance, which reports functionally through the group's Chief Financial Officer to the HSBC Group Finance Director. Finance establishes the accounting policies and procedures governing valuation, and is responsible for ensuring that they comply with all relevant accounting standards.

For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is utilised. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the group will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, inter alia:

- the extent to which prices may be expected to represent genuine traded or tradable prices;
- the degree of similarity between financial instruments;
- the degree of consistency between different sources;
- the process followed by the pricing provider to derive the data;
- the elapsed time between the date to which the market data relates and the balance sheet date; and
- the manner in which the data was sourced.

Models provide a logical framework for the capture and processing of necessary valuation inputs. For fair values determined using a valuation model, the control framework may include, as applicable, independent development or validation of (i) the logic within valuation models; (ii) the inputs to those models; (iii) any adjustments required outside the valuation models; and, (iv) where possible, model outputs. Valuation models are subject to a process of due diligence and calibration before becoming operational and are calibrated against external market data on an ongoing basis.

The results of the independent validation process are reported to, and considered by, Valuation Committees. Valuation Committees are composed of valuation experts from several independent support functions (Product Control, Market Risk Management, Derivative Model Review Group and Finance) in addition to senior management. The members of each Valuation Committee consider the appropriateness and adequacy of the fair value adjustments and the effectiveness of valuation models. If necessary, they may require changes to model calibration or calibration procedures. The Valuation Committees are overseen by the Valuation Committee Review Group, which consists of Heads of Global Banking and Markets' Finance and Risk Functions.

Determination of fair value

Fair values are determined according to the following hierarchy:

(a) *Level 1 – quoted market price*: financial instruments with quoted prices for identical instruments in active markets.

(b) *Level 2 – valuation technique using observable inputs*: financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

(c) *Level 3 – valuation technique with significant unobservable inputs*: financial instruments valued using models where one or more significant inputs are unobservable.

The best evidence of fair value is a quoted price in an actively traded market. In the event that the market for a financial instrument is not active, a valuation technique is used. The judgement as to whether a market is active may include, but is not restricted to, the consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads. In inactive markets, obtaining assurance that the transaction price provides evidence of fair value or determining the adjustments to transaction prices that are necessary to measure the fair value of the instrument requires additional work during the valuation process.

Notes on the Financial Statements (continued)

The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them, the derivation of fair value is more judgmental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's carrying amount and/ or inception profit ("day 1 gain and loss") is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the level at which an arm's length transaction would be likely to occur. It generally does not mean that there is no market data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used). Furthermore, in some cases the majority of the fair value derived from a valuation technique with significant unobservable inputs may be attributable to the observable inputs. Consequently, the effect of uncertainty in the determining unobservable inputs will generally be restricted to uncertainty about the overall fair value of the financial instrument being measured. To help in understanding the extent and the range of this uncertainty, additional information is provided in the section headed 'Effect of changes in significant unobservable assumption to reasonably possible alternatives' below.

In certain circumstances, primarily where debt is hedged with interest rate derivatives or structured notes issued, the group uses fair value to measure the carrying value of its own debt in issue. The group records its own debt in issue at fair value, based on quoted prices in an active market for the specific instrument concerned, if available. When quoted market prices are unavailable, the own debt in issue is valued using valuation techniques, the inputs for which are either based upon quoted prices in an inactive market for the instrument, or are estimated by comparison with quoted prices in an active market for similar instruments. In both cases, the fair value includes the effect of applying the credit spread which is appropriate to the group's liabilities. For all issued debt securities, discounted cash flow modelling is used to separate the change in fair value that may be attributed to the group's credit spread movements from movements in other market factors such as benchmark interest rates or foreign exchange rates. Specifically, the change in fair value of issued debt securities attributable to the group's own credit spread is computed as follows: for each security at each reporting date, an externally verifiable price is obtained or a price is derived using credit spreads for similar securities for the same issuer. Then, using discounted cash flow, each security is valued using a risk-free discount curve. The difference in the valuations is attributable to the group's own credit spread. This methodology is applied consistently across all securities.

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and are measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the group issues structured notes. These market spreads are significantly smaller than credit spreads observed for plain vanilla debt or in the credit default swap markets.

Gains and losses arising from changes in the credit spread of liabilities issued by the group reverse over the contractual life of the debt, provided that the debt is not repaid early. All net positions in non-derivative financial instruments, and all derivative portfolios, are valued at bid or offer prices as appropriate. Long positions are marked at bid prices; short positions are marked at offer prices.

The fair value of a portfolio of financial instruments quoted in an active market is calculated as the product of the number of units and its quoted price and no block discounts are made.

Transaction costs are not included in the fair value calculation, nor are the future costs of administering the OTC derivative portfolio. These, along with trade origination costs such as brokerage fees and post-trade costs, are included either in fee expense or in operating expenses.

A detailed description of the valuation techniques applied to instruments of particular interest follows:

- *Private equity*

  The group's private equity positions are generally classified as available for sale and are not traded in active markets. In the absence of an active market, an investment's fair value is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership. The exercise of judgment is required because of uncertainties inherent in estimating fair value for private equity investments.

Notes on the Financial Statements (continued)

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

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

  Illiquidity and a lack of transparency in the market for asset- backed securities has resulted in less observable data being available. While quoted market prices are generally used to determine the fair value of these securities, valuation models are used to substantiate the reliability of the limited market data available and to identify whether any adjustments to quoted market prices are required.

  In the absence of quoted market prices, fair value is determined using valuation techniques based on the calculation of the present value of expected future cash flows of the assets. The inputs to these valuation techniques are derived from observable market data and, where relevant, assumptions in respect of unobservable inputs. In respect of ABSs' and mortgages, the assumptions may include prepayment speeds, default rates and loss severity based on collateral type, and performance as appropriate. The valuation output is benchmarked for consistency against observable data for securities of a similar nature.

- *Derivatives*

  OTC (i.e. non-exchange traded) derivatives are valued using valuation models. Valuation models calculate the present value of expected future cash flows, based upon 'no-arbitrage' principles. For many vanilla derivative products, such as interest rate swaps and European options, the modeling approaches used are standard across the industry. For more complex derivative products, there may be some differences in market practice. Inputs to valuation models are determined from observable market data wherever possible, including prices available from exchanges, dealers, brokers or providers of consensus pricing. Certain inputs may not be observable in the market directly, but can be determined from observable prices via model calibration procedures. Finally, some inputs are not observable, but can generally be estimated from historical data or other sources. Examples of inputs that are generally observable include foreign exchange spot and forward rates, benchmark interest rate curves and volatility surfaces for commonly traded option products. Examples of inputs that may be unobservable include volatility surfaces, in whole or in part, for less commonly traded option products, and correlations between market factors such as foreign exchange rates, interest rates and equity prices.

- *Loans including leveraged loans and loans held for securitisation*

  Loans held at fair value are valued from broker quotes and/or market data consensus providers when available. In the absence of an observable market, the fair value is determined using valuation techniques including discounted cash flow models, which incorporate assumptions regarding an appropriate credit spread for the loan derived from other market instruments issued by the same or comparable entities.

- *Structured notes*

  The fair value of structured notes using a valuation technique is derived from the fair value of the underlying debt security as described above, and the fair value of the embedded derivative is determined as described in the paragraph above on derivatives.

Bases of valuing financial assets and liabilities measured at fair value

The table below provides an analysis of the various bases described above which have been deployed for valuing financial assets and financial liabilities measured at fair value in the consolidated financial statements. The movement in the balances of assets and liabilities measured at fair value with significant unobservable inputs was mainly attributable to a decrease in the fair value of derivative assets, loans held for securitisation and the disposal of securities in other portfolios.

Notes on the Financial Statements (continued)

The group

	Level 1 Quoted market price £m	Valuation techniques: Level 2 using observable inputs £m	Valuation techniques: Level 3 with significant non-observable inputs £m	Total £m
At 31 December 2009				
Assets				
Trading assets	**107,883**	**55,615**	**1,510**	**165,008**
Financial assets designated at fair value	**10,870**	**5,565**	**–**	**16,435**
Derivatives	**795**	**116,121**	**1,600**	**118,516**
Financial investments: available-for-sale	**33,163**	**50,258**	**3,274**	**86,695**
Liabilities				
Trading liabilities	**60,735**	**55,362**	**2,784**	**118,881**
Financial liabilities at fair value	**6,694**	**11,470**	**–**	**18,164**
Derivatives	**714**	**114,963**	**3,012**	**118,689**
At 31 December 2008				
Assets				
Trading assets	100,829	69,001	2,196	172,026
Financial assets designated at fair value	7,530	6,365	–	13,895
Derivatives	4,866	236,090	2,128	243,084
Financial investments: available-for-sale	38,201	60,942	4,368	103,511
Liabilities				
Trading liabilities	58,226	63,815	2,409	124,450
Financial liabilities at fair value	4,174	11,010	–	15,184
Derivatives	6,093	233,961	977	241,031

The bank

	Level 1 Quoted market price £m	Valuation techniques: Level 2 using observable inputs £m	Valuation techniques: Level 3 with significant non-observable inputs £m	Total £m
At 31 December 2009				
Assets				
Trading assets	**57,888**	**63,383**	**2,686**	**123,957**
Financial assets designated at fair value	**2,820**	**3,772**	**–**	**6,592**
Derivatives	**246**	**99,030**	**1,524**	**100,800**
Financial investments: available-for-sale	**9,463**	**15,248**	**2,678**	**27,389**
Liabilities				
Trading liabilities	**32,093**	**61,944**	**2,784**	**96,821**
Financial liabilities at fair value	**3,298**	**7,377**	**–**	**10,675**
Derivatives	**173**	**97,767**	**3,221**	**101,161**
At 31 December 2008				
Assets				
Trading assets	50,175	77,834	2,196	130,205
Financial assets designated at fair value	424	4,168	–	4,592
Derivatives	270	194,901	1,957	197,128
Financial investments: available-for-sale	21,416	23,040	2,152	46,608
Liabilities				
Trading liabilities	38,274	57,706	2,409	98,389
Financial liabilities at fair value	1,658	7,771	–	9,429
Derivatives	564	195,836	847	197,247

Notes on the Financial Statements (continued)

Financial instruments measured at fair value using a valuation technique with significant unobservable inputs – Level 3

The group

	Assets				Liabilities		
	Available for sale £m	Held for Trading £m	Designated at fair value through profit or loss £m	Derivatives £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m
At 31 December 2009							
Private equity investments	**1,115**	**–**	**–**	**–**	**–**	**–**	**–**
Asset-backed securities	**2,092**	**128**	**–**	**–**	**–**	**–**	**–**
Leverage finance	**–**	**42**	**–**	**–**	**–**	**–**	**15**
Structured notes	**–**	**–**	**–**	**–**	**2,097**	**–**	**–**
Derivatives with monolines	**–**	**–**	**–**	**164**	**–**	**–**	**–**
Other derivatives	**–**	**–**	**–**	**1,436**	**–**	**–**	**2,997**
Other portfolio	**67**	**1,340**	**–**	**–**	**687**	**–**	**–**
	3,274	**1,510**	**–**	**1,600**	**2,784**	**–**	**3,012**
At 31 December 2008							
Private equity investments	1,138	–	–	–	–	–	–
Asset-backed securities	3,018	402	–	–	–	–	–
Leverage finance	–	234	–	–	–	–	23
Structured notes	–	–	–	–	2,409	–	–
Derivatives with monolines	–	–	–	756	–	–	–
Other derivatives	–	–	–	1,372	–	–	954
Other portfolio	212	1,560	–	–	–	–	–
	4,368	2,196	–	2,128	2,409	–	977

The bank

	Assets				Liabilities		
	Available for sale £m	Held for Trading £m	Designated at fair value through profit or loss £m	Derivatives £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m
At 31 December 2009							
Private equity investments	**708**	**–**	**–**	**–**	**–**	**–**	**–**
Asset-backed securities	**1,903**	**1,304**	**–**	**–**	**–**	**–**	**–**
Leverage finance	**–**	**42**	**–**	**–**	**–**	**–**	**15**
Structured notes	**–**	**–**	**–**	**–**	**2,097**	**–**	**–**
Derivatives with monolines	**–**	**–**	**–**	**164**	**–**	**–**	**–**
Other derivatives	**–**	**–**	**–**	**1,360**	**–**	**–**	**3,206**
Other portfolio	**67**	**1,340**	**–**	**–**	**687**	**–**	**–**
	2,678	**2,686**	**–**	**1,524**	**2,784**	**–**	**3,221**
At 31 December 2008							
Private equity investments	798	–	–	–	–	–	–
Asset-backed securities	1,305	402	–	–	–	–	–
Leverage finance	–	234	–	–	–	–	23
Structured notes	–	–	–	–	2,409	–	–
Derivatives with monolines	–	–	–	756	–	–	–
Other derivatives	–	–	–	1,201	–	–	824
Other portfolio	49	1,560	–	–	–	–	–
	2,152	2,196	–	1,957	2,409	–	847

Notes on the Financial Statements (continued)

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy:

The group

	Assets				Liabilities		
	Available for sale £m	Held for Trading £m	Designated at fair value through profit or loss £m	Derivatives £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m
At 1 January 2009	4,368	2,196	–	2,128	2,409	–	977
Total gains or losses recognised in profit or loss	(80)	(36)	–	(903)	(103)	–	(279)
Total gains or losses recognised in other comprehensive income	34	–	–	–	–	–	–
Purchases	349	158	–	–	4	–	–
Issues	–	–	–	–	365	–	–
Sales	(82)	(378)	–	–	–	–	–
Settlements	(84)	(129)	–	46	(405)	–	(61)
Transfer out	(1,803)	(512)	–	(406)	(29)	–	(178)
Transfer in	685	369	–	827	617	–	2,563
Exchange differences	(113)	(158)	–	(92)	(74)	–	(10)
At 31 December 2009	3,274	1,510	–	1,600	2,784	–	3,012
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period	(81)	(41)	–	(911)	(102)	–	15

The bank

	Assets				Liabilities		
	Available for sale £m	Held for Trading £m	Designated at fair value through profit or loss £m	Derivatives £m	Held for trading £m	Designated at fair value through profit or loss £m	Derivatives £m
At 1 January 2009	2,152	2,196	–	1,957	2,409	–	847
Total gains or losses recognised in profit or loss	(34)	(36)	–	(893)	(103)	–	(312)
Total gains or losses recognised in other comprehensive income	(93)	–	–	–	–	–	–
Purchases	43	158	–	–	4	–	–
Issues	–	–	–	–	365	–	–
Sales	(55)	(378)	–	–	–	–	–
Settlements	(10)	(129)	–	44	(405)	–	(62)
Transfer out	(948)	(512)	–	(350)	(29)	–	(178)
Transfer in	1,696	1,548	–	910	617	–	2,667
Exchange differences	(73)	(161)	–	(76)	(74)	–	(2)
Other (reclassification)	–	–	–	(68)	–	–	261
At 31 December 2009	2,678	2,686	–	1,524	2,784	–	3,221
Total gains or losses recognised in profit or loss relating to those assets and liabilities held at the end of the reporting period	(31)	(42)	–	(786)	(102)	–	15

During 2009, there were no significant transfer between Level 1 and 2.

For assets and liabilities classified as held for trading, realised and unrealised gains and losses are presented in the income statement under 'Trading income excluding net interest income'. Fair value changes on long-term debt designated at fair value and related derivatives are presented in the income statement under 'Changes in fair value of

Notes on the Financial Statements (continued)

long-term debt issued and related derivatives'. The income statement line item 'Net income/(expense) from other financial instruments designated at fair value' captures fair value movements on all other financial instruments designated at fair value and related derivatives.

Realised gains and losses from available-for-sale securities are presented under 'Gains less losses of financial investments' in the income statement while unrealised gains and losses are presented in 'Fair value gains/(losses) taken to equity' within 'Available-for-sale investments' in other comprehensive income.

Effects of changes in significant unobservable assumptions to reasonably possible alternatives

As discussed above, the fair value of financial instruments are, in certain circumstances, measured using valuation techniques that incorporate assumptions that are not evidenced by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of fair values to reasonably possible alternative assumptions:

The group

	Reflected in profit/(loss)		Reflected in equity	
	Favourable changes £m	Unfavourable changes £m	Favourable changes £m	Unfavourable changes £m
At 31 December 2009				
Derivatives/trading assets/trading liabilities[1]	**292**	**(153)**	**–**	**–**
Financial assets and liabilities designated at fair value				
Financial investments: available-for-sale	**–**	**–**	**543**	**(543)**
At 31 December 2008				
Derivatives/trading assets/trading liabilities[1]	182	(250)	–	–
Financial assets and liabilities designated at fair value				
Financial investments: available-for-sale	–	–	519	(519)

The bank

	Reflected in profit/(loss)		Reflected in equity	
	Favourable changes £m	Unfavourable changes £m	Favourable changes £m	Unfavourable changes £m
At 31 December 2009				
Derivatives/trading assets/trading liabilities[1]	**415**	**(277)**	**–**	**–**
Financial assets and liabilities designated at fair value				
Financial investments: available-for-sale	**–**	**–**	**465**	**(465)**
At 31 December 2008				
Derivatives/trading assets/trading liabilities[1]	155	(239)	–	–
Financial assets and liabilities designated at fair value				
Financial investments: available-for-sale	–	–	344	(344)

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

Principal assumptions used in the valuation of financial instruments with significant unobservable inputs

	Reflected in profit or loss		Reflected in equity	
	Favourable changes £m	Unfavourable changes £m	Favourable changes £m	Unfavourable changes £m
At 31 December 2009				
Private equity investments	**–**	**–**	**112**	**(112)**
Asset-backed securities	**15**	**(16)**	**418**	**(418)**
Derivatives with monolines	**56**	**3**	**–**	**–**
Other derivatives	**101**	**(96)**	**–**	**–**
Other portfolio	**120**	**(44)**	**13**	**(13)**

	Reflected in profit or loss		Reflected in equity	
	Favourable changes £m	Unfavourable changes £m	Favourable changes £m	Unfavourable changes £m
At 31 December 2008				
Private equity investments	–	–	84	(84)
Asset-backed securities	51	(51)	433	(433)
Leverage finance	2	(2)	–	–
Derivatives with monolines	42	(180)	–	–
Other derivatives	53	16	–	–
Other portfolio	34	(33)	2	(2)

Fair values of financial instruments not carried at fair value

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

(i) Loans and advances to banks and customers

The fair value of loans and advances is based on observable market transactions, where available. In the absence of observable market transactions, fair value is estimated using discounted cash flow models. Performing loans are grouped, as far as possible, into homogeneous pools segregated by maturity and coupon rates. In general, contractual cash flows are discounted using the group's estimate of the discount rate that a market participant would use in valuing instruments with similar maturity, repricing and credit risk characteristics.

The fair value of a loan portfolio reflects both loan impairments at the balance sheet date and estimates of market participants' expectations of credit losses over the life of the loans. For impaired loans, fair value is estimated by discounting the future cash flows over the time period in which they are expected to be recovered.

(ii) *Financial investments*

The fair values of listed financial investments are determined using bid market prices. The fair values of unlisted financial investments are determined using valuation techniques that take into consideration the prices and future earnings streams of equivalent quoted securities.

(iii) *Deposits by banks and customer accounts*

For the purposes of estimating fair value, deposits by banks and customer accounts are grouped by residual maturity. Fair values are estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of a deposit repayable on demand is assumed to be the amount payable on demand at the balance sheet date.

(iv) *Debt securities in issue and subordinated liabilities*

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

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

For all classes of financial instruments, fair value represents the product of the value of a single instrument, multiplied by the number of instruments held. No block discount or premium adjustments are made. The fair values of intangible assets related to the businesses which originate and hold the financial instruments subject to fair value measurement, such as values placed on portfolios of core deposits, credit card and customer relationships, are not included above because they are not classified as financial instruments. Accordingly, an aggregation of fair value measurements does not approximate the value of the organisation as a going concern.

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

Notes on the Financial Statements (continued)

Assets	**Liabilities**
Cash and balances at central banks	Items in the course of transmission to other banks
Items in the course of collection from other banks	Endorsements and acceptances
Endorsements and acceptances	Investment contracts with discretionary participation features
Short-term receivables within 'Other assets'	Short-term payables within 'Other liabilities'
Accrued income	Accruals

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

The group

	At 31 December 2009		At 31 December 2008	
	Carrying amount £m	**Fair value £m**	Carrying amount £m	Fair value £m
Assets				
Loans and advances to banks	**46,994**	**46,970**	50,719	50,703
Loans and advances to customers	**274,659**	**269,542**	298,304	292,059
Financial investments: debt securities	**4,851**	**5,235**	25	25
Liabilities				
Deposits by banks	**57,729**	**57,730**	61,431	61,454
Customer accounts	**332,896**	**333,039**	369,880	369,857
Debt securities in issue	**39,340**	**38,702**	52,308	51,461
Subordinated liabilities	**6,799**	**6,381**	7,259	6,589

The bank

	At 31 December 2009		At 31 December 2008	
	Carrying amount £m	**Fair value £m**	Carrying amount £m	Fair value £m
Assets				
Loans and advances to banks	**20,729**	**20,729**	18,295	18,297
Loans and advances to customers	**208,669**	**203,855**	217,309	211,958
Liabilities				
Deposits by banks	**39,346**	**39,346**	54,986	54,981
Customer accounts	**223,652**	**224,363**	240,397	240,393
Debt securities in issue	**14,636**	**14,638**	8,670	8,624
Subordinated liabilities	**6,955**	**6,516**	7,310	6,623

Notes on the Financial Statements (continued)

32 Maturity analysis of assets and liabilities

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

The group

	On demand £m	Due within 3 months £m	Due between 3 and 12 months £m	Due between 1 and 5 years £m	Due after 5 years £m	Total £m
At 31 December 2009						
Deposits by banks	**14,476**	**48,265**	**8,989**	**2,203**	**705**	**74,638**
Customer accounts	**227,086**	**105,528**	**17,347**	**2,631**	**1,000**	**353,592**
Trading liabilities	**118,881**	**–**	**–**	**–**	**–**	**118,881**
Financial liabilities designated at fair value	**4,107**	**161**	**367**	**8,315**	**10,815**	**23,765**
Derivatives	**119,345**	**22**	**347**	**287**	**10**	**120,011**
Debt securities in issue	**–**	**22,290**	**8,817**	**8,962**	**228**	**40,297**
Subordinated liabilities	**27**	**47**	**79**	**1,724**	**7,610**	**9,487**
Other financial liabilities	**1,646**	**5,942**	**1,452**	**571**	**499**	**10,110**
	485,568	**182,255**	**37,398**	**24,693**	**20,867**	**750,781**
Loan commitments	**33,463**	**33,043**	**15,080**	**22,347**	**12,150**	**116,083**
Financial guarantee contracts	**–**	**6,943**	**5,418**	**3,487**	**2,144**	**17,992**
	519,031	**222,241**	**57,896**	**50,527**	**35,161**	**884,856**
At 31 December 2008						
Deposits by banks	14,375	49,561	3,521	2,510	3,129	73,096
Customer accounts	231,596	129,687	17,117	1,934	1,393	381,727
Trading liabilities	124,450	–	–	–	–	124,450
Financial liabilities designated at fair value	3,627	59	208	4,904	9,478	18,276
Derivatives	239,394	130	1,098	1,661	243	242,526
Debt securities in issue	235	25,880	18,371	9,217	2,858	56,561
Subordinated liabilities	63	69	182	1,229	9,162	10,705
Other financial liabilities	1,957	6,205	1,124	646	511	10,443
	615,697	211,591	41,621	22,101	26,774	917,784
Loan commitments	38,036	41,965	27,422	36,067	10,901	154,391
Financial guarantee contracts	–	5,310	8,173	3,592	3,218	20,293
	653,733	258,866	77,216	61,760	40,893	1,092,468

Notes on the Financial Statements (continued)

The bank

At 31 December 2009						
Deposits by banks	**12,746**	**24,554**	**1,897**	**138**	**49**	**39,384**
Customer accounts	**185,937**	**26,788**	**9,577**	**1,170**	**610**	**224,082**
Trading liabilities	**96,821**	**–**	**–**	**–**	**–**	**96,821**
Financial liabilities designated at fair value	**83**	**119**	**330**	**4,483**	**10,236**	**15,251**
Derivatives	**101,161**	**21**	**340**	**106**	**3**	**101,631**
Debt securities in issue	**–**	**4,667**	**5,733**	**4,361**	**–**	**14,761**
Subordinated liabilities	**–**	**46**	**829**	**2,227**	**4,911**	**8,013**
Other financial liabilities	**184**	**3,943**	**318**	**124**	**117**	**4,686**
	396,932	**60,138**	**19,024**	**12,609**	**15,926**	**504,629**
Loan commitments	**13,611**	**30,326**	**17,867**	**10,928**	**10,799**	**83,531**
Financial guarantee contracts	**–**	**4,654**	**4,074**	**1,992**	**1,461**	**12,181**
	410,543	**95,118**	**40,965**	**25,529**	**28,186**	**600,341**
At 31 December 2008						
Deposits by banks	12,589	40,673	1,555	152	152	55,121
Customer accounts	192,570	35,643	8,218	625	786	237,842
Trading liabilities	98,389	–	–	–	–	98,389
Financial liabilities designated at fair value	–	44	187	2,469	8,824	11,524
Derivatives	196,549	55	275	339	105	197,323
Debt securities in issue	47	6,264	2,243	394	–	8,948
Subordinated liabilities	–	60	71	2,688	6,245	9,064
Other financial liabilities	28	4,608	20	15	1	4,672
	500,172	87,347	12,569	6,682	16,113	622,883
Loan commitments	13,660	38,337	17,531	25,488	8,471	103,487
Financial guarantee contracts	–	3,808	3,896	1,844	1,484	11,032
	513,832	129,492	33,996	34,014	26,068	737,402

Trading liabilities and trading derivatives have been included in the 'On demand' time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The undiscounted cash flows on hedging derivative liabilities are classified according to their contractual maturity. The undiscounted cash flows potentially payable under financial guarantee contracts are classified on the basis of the earliest date they can be drawn down.

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

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

Notes on the Financial Statements (continued)

The group

	At 31 December 2009		
	Due within one year £m	**Due after more than one year £m**	**Total £m**
Assets			
Financial assets designated at fair value	**774**	**15,661**	**16,435**
Loans and advances to banks	**45,278**	**1,716**	**46,994**
Loans and advances to customers	**139,453**	**135,206**	**274,659**
Financial investments	**15,428**	**71,267**	**86,695**
Other financial assets	**7,565**	**2,068**	**9,633**
	208,498	**225,918**	**434,416**
Liabilities			
Deposits by banks	**56,456**	**1,273**	**57,729**
Customer accounts	**329,146**	**3,750**	**332,896**
Financial liabilities designated at fair value	**642**	**17,522**	**18,164**
Debt securities in issue	**31,286**	**8,054**	**39,340**
Other financial liabilities	**5,565**	**1,511**	**7,076**
Subordinated liabilities	**5**	**6,794**	**6,799**
	423,100	**38,904**	**462,004**

	At 31 December 2008		
	Due within one year £m	Due after more than one year £m	Total £m
Assets			
Financial assets designated at fair value	1,634	12,261	13,895
Loans and advances to banks	48,242	2,477	50,719
Loans and advances to customers	160,300	138,004	298,304
Financial investments	37,199	66,312	103,511
Other financial assets	7,954	1,757	9,711
	255,329	220,811	476,140
Liabilities			
Deposits by banks	59,517	1,914	61,431
Customer accounts	366,547	3,333	369,880
Financial liabilities designated at fair value	376	14,808	15,184
Debt securities in issue	41,115	11,193	52,308
Other financial liabilities	6,705	1,545	8,250
Subordinated liabilities	71	7,188	7,259
	474,331	39,981	514,312

Notes on the Financial Statements (continued)

The bank

	At 31 December 2009		
	Due within one year £m	**Due after more than one year £m**	**Total £m**
Assets			
Financial assets designated at fair value	**153**	**6,439**	**6,592**
Loans and advances to banks	**19,178**	**1,551**	**20,729**
Loans and advances to customers	**105,397**	**103,272**	**208,669**
Financial investments	**4,833**	**22,556**	**27,389**
Other financial assets	**3,914**	**1,588**	**5,502**
	133,475	**135,406**	**268,881**
Liabilities			
Deposits by banks	**38,455**	**891**	**39,346**
Customer accounts	**218,493**	**5,159**	**223,652**
Financial liabilities designated at fair value	**267**	**10,408**	**10,675**
Debt securities in issue	**10,316**	**4,320**	**14,636**
Other financial liabilities	**2,800**	**582**	**3,382**
Subordinated liabilities	**799**	**6,156**	**6,955**
	271,130	**27,516**	**298,646**

	At 31 December 2008		
	Due within one year £m	Due after more than one year £m	Total £m
Assets			
Financial assets designated at fair value	78	4,514	4,592
Loans and advances to banks	15,810	2,485	18,295
Loans and advances to customers	111,970	105,339	217,309
Financial investments	27,894	18,714	46,608
Other financial assets	3,254	1,531	4,785
	159,006	132,583	291,589
Liabilities			
Deposits by banks	54,215	771	54,986
Customer accounts	234,572	5,825	240,397
Financial liabilities designated at fair value	241	9,188	9,429
Debt securities in issue	8,345	325	8,670
Other financial liabilities	3,292	524	3,816
Subordinated liabilities	–	7,310	7,310
	300,665	23,943	324,608

Further discussion of the group's liquidity and funding management can be found in Note 37 'Risk management'.

33 Foreign exchange exposures

Structural foreign exchange exposures

The group's structural foreign currency exposure is represented by the net asset value of its foreign currency equity and subordinated debt investments in subsidiary undertakings, branches, joint ventures and associates.

The group's management of structural foreign currency exposures is discussed in Note 37.

Notes on the Financial Statements (continued)

Net structural currency exposures

Currency of structural exposure

	2009 £m	2008 £m
Euro	**12,743**	11,040
US dollars	**1,916**	(1,384)
Swiss francs	**1,792**	1,499
Turkish lira	**1,073**	1,032
Russian rouble	**182**	184
Others, each less than £100 million	**155**	154
Total	**17,861**	12,525

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

Financial assets pledged to secure liabilities are as follows:

	Group assets pledged at 31 December		Bank assets pledged at 31 December	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Loans and advances to banks	**3,381**	2,521	**3,168**	2,359
Loans and advances to customers	**31,901**	18,623	**22,688**	5,826
Debt securities	**108,383**	106,633	**54,635**	51,003
Equity shares	**4,173**	2,801	**4,087**	2,747
	147,838	130,578	**84,578**	61,935

These transactions are conducted under terms that are usual and customary to standard securities lending and repurchase agreements.

Collateral accepted as security for assets

The fair value of financial assets accepted as collateral that the group is permitted to sell or repledge in the absence of default is £175,084 million (2008: £137,354 million) (the bank: 2009 £95,662 million; 2008 £77,713 million). The fair value of financial assets accepted as collateral that have been sold or repledged is £100,631 million (2008: £72,569 million) (the bank: 2009 £31,189 million; 2008 £34,053 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 and other equity instruments

Authorised

The concept of authorised share capital was abolished under the UK Companies Act 2006 with effect from 1 October 2009 and amendments to the Company's Articles of Association were approved by shareholders at a General Meeting on 1 October 2009.

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

At 31 December 2008, the authorised preference share capital of HSBC Bank plc was £150 million and US$ 2.44 million, divided into 150,000,000 sterling preference shares of £1 each, 200,000,000 non-cumulative US dollar preference shares of US$ 0.01 each, 4,000,000 non-cumulative second US dollar preference shares of US$ 0.01 each and 40,000,000 non-cumulative third US dollar preference shares of US$ 0.01 each.

Notes on the Financial Statements (continued)

Issued

HSBC Bank plc ordinary shares

	Number	£m
At 1 January 2009	**796,969,104**	**797**
Shares issued	**3**	**–**
At 31 December 2009	**796,969,107**	**797**
At 1 January 2008	796,969,102	797
Shares issued	2	–
At 31 December 2008	796,969,104	797

HSBC Bank plc non-cumulative third dollar preference shares

	Number	£'000
At 1 January and 31 December 2009	**35,000,000**	**172**
At 1 January and 31 December 2008	35,000,000	172

The bank has no obligation to redeem the preference shares but may redeem them in part or in whole at any time, with the prior non-objection of the FSA. Dividends on the preference shares in issue are paid annually at the sole and absolute discretion of the Board of Directors. The Board of Directors will not declare a dividend on the preference shares in issue if payment of the dividend would cause the bank not to meet the capital adequacy requirements of the FSA or the profit of the bank available for distribution as dividends is not sufficient to enable the bank to pay in full both dividends on the preference shares in issue and dividends on any other shares that are scheduled to be paid on the same date and have an equal right to dividends or if payment of the dividend is prohibited by the rights attached to any class of shares in the capital of the bank, excluding ordinary shares. The preference shares in issue carry no rights to conversion into ordinary shares of the bank. Holders of the preference shares in issue will be able to attend any general meetings of shareholders of the bank and to vote on any resolution proposed to vary or abrogate any of the rights attaching to the preference shares or any resolution proposed to reduce the paid up capital of the preference shares. If the dividend payable on the preference shares in issue has not been paid in full for the most recent dividend period or any resolution is proposed for the winding-up of the bank or the sale of its entire business then, in such circumstances, holders of preference shares will be entitled to vote on all matters put to general meetings. In the case of unpaid dividends the holders of preference shares in issue will be entitled to attend and vote at any general meetings until such time as dividends on the preference shares have been paid in full, or a sum set aside for such payment in full, in respect of one dividend period.

All shares in issue are fully paid.

HSBC Bank plc perpetual subordinated debt

	£m
At 1 January 2009	**1,750**
Issued during the year	–
At 31 December 2009	**1,750**
At 1 January 2008	1,000
Issued during the year	750
At 31 December 2008	1,750

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

Notes on the Financial Statements (continued)

36 Notes on the cash flow statement

Non-cash items included in profit before tax

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Depreciation, amortisation and impairment	**632**	575	**336**	312
Share-based payment expense	**191**	225	**107**	129
Profit on repayment of capital in subsidiary	**–**	–	**–**	(280)
Gain on financing 8 Canada Square	**–**	(244)	**–**	(244)
Loan impairment losses gross of recoveries	**3,364**	1,861	**2,784**	1,328
Provisions raised	**40**	103	**33**	16
Impairment of financial investments	**164**	282	**65**	50
(Gain on)/charge for defined benefit plans	**(79)**	135	**(108)**	148
Accretion of discounts and amortisation of premiums	**(88)**	(204)	**(91)**	(11)
	4,224	2,733	**3,126**	1,448

Change in operating assets

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Change in prepayments and accrued income	**2,162**	455	**1,336**	896
Change in net trading securities and net derivatives	**(6,301)**	(15,976)	**(5,852)**	15,375
Change in loans and advances to banks	**8,339**	9,704	**14,389**	8,510
Change in loans and advances to customers	**22,527**	(64,643)	**7,049**	(60,016)
Change in financial assets designated at fair value	**(2,516)**	1,575	**(2,000)**	(2,004)
Change in other assets	**1,011**	(3,357)	**(518)**	(1,773)
	25,222	(72,242)	**14,404**	(39,012)

Change in operating liabilities

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Change in accruals and deferred income	**(1,703)**	(771)	**(733)**	(1,354)
Change in deposits by banks	**(3,702)**	12,645	**(15,640)**	13,925
Change in customer accounts	**(36,984)**	101,611	**(16,831)**	55,498
Change in debt securities in issue	**(12,938)**	1,695	**5,966**	553
Change in financial liabilities designated at fair value	**2,982**	(474)	**1,246**	1,347
Change in other liabilities	**(737)**	3,488	**(550)**	395
	(53,082)	118,194	**(26,542)**	70,364

Cash and cash equivalents

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Cash and balances at central banks	**14,274**	9,470	**13,130**	6,779
Items in the course of collection from other banks	**2,082**	1,917	**1,071**	692
Loans and advances to banks of one month or less	**42,076**	37,448	**24,802**	8,021
Treasury bills, other bills and certificates of deposit less than three months	**3,851**	13,822	**2,294**	13,071
Less: items in the course of transmission to other banks	**(1,477)**	(1,802)	**(595)**	(772)
Total cash and cash equivalents[1]	**60,806**	60,855	**40,702**	27,791

1 *Total cash and cash equivalents include the following amounts that are not available for use by the group: £13 million held by foreign subsidiaries and subject to foreign exchange control restrictions (2008: nil); and £1,451 million subject to other restrictions (2008: £2,175 million).*

Total interest paid by the group during the year was £7,626 million (2008: £17,126 million). Total interest received by the group during the year was £18,153 million (2008: £17,815 million). Total dividends received by the group during the year was £567 million (2008: £837 million).

Notes on the Financial Statements (continued)

37 Risk management

All the group's activities involve, to varying degrees, the analysis, evaluation, acceptance and management of risks or combinations of risks. The most important risk categories that the group is exposed to are: credit risk (including cross-border country risk), market risk, liquidity risk and insurance risk. Market risk includes foreign exchange, interest rate and equity price risks.

The management of these various risk categories is discussed below. Insurance risk is managed by the group's insurance businesses together with their own credit, liquidity and market risk functions, distinct from those covering the rest of the group due to the different nature of their activities. They remain under risk oversight at group level.

Credit risk

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

Credit risk management

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

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

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

- Formulating and recording detailed credit policies and procedures, consistent with HSBC policy.
- Issuing policy guidelines to subsidiaries and offices on appetite for credit risk exposure to specified market sectors, activities and banking products.
- Undertaking independent review and objective assessment of risk. Credit Risk approves all commercial non-bank credit facilities and exposures – including those embedded in derivatives – that are originated or renewed by subsidiaries and offices over designated limits.
- Monitoring the performance and management of retail portfolios.
- Maintaining policy on large credit exposures, ensuring that concentrations of exposure by counterparty, sector or geography do not become excessive in relation to the group's capital base and remain within internal and regulatory limits.
- Maintaining and developing the governance and operation of HSBC's risk rating framework and systems, to classify exposures.
- Stress testing oversight, economic capital measurement and the refinement and reporting of key risk indicators.
- Reporting to senior executives on aspects of the Bank's credit risk portfolio. These executives, as well as the European Risk Management Committee, Audit Committee and the Board of Directors of the bank receive a variety of regular and ad hoc reports covering:
  - risk concentrations;
  - retail portfolio performance;

– specific higher-risk portfolio segments, for example, real estate, banks, and automotive sector;
– a risk map of the status of key risk areas, with associated preventive and mitigating actions;
– individual large impaired accounts, and impairment allowances/charges for all customer segments;
– country limits, cross-border exposures and related impairment allowances;
– performance of the Bank's credit rating systems employing Basel 2 metrics, and
– stress testing results and recommendations.

- Where appropriate, establishing specialist units to provide intensive management and control to support customers in financial difficulty and maximise recoveries of doubtful debts.
- Managing and directing credit risk management systems initiatives.
- Providing advice and guidance to offices and subsidiaries to promote best practice on credit-related matters such as:

– regulatory developments;
– risk modelling;
– collective impairment allowances;
– new products, and
– credit risk reporting.

- Acting on behalf of the group as the primary interface, for credit-related issues, with external parties including the Bank of England, the FSA, rating agencies, corporate analysts, trade associations etc.

Credit quality

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

A credit review and risk identification team has been established reporting directly to the European CRO, and it reviews the robustness and effectiveness of key risk measurement, monitoring and control activities.

Impairment Assessment

When impairment losses occur, the group reduces the carrying amount of loans and advances through the use of an allowance account. When impairment of available-for-sale financial assets and held-to-maturity financial investments occurs, the carrying amount of the asset is reduced directly. For further details on the accounting policy for impairment of available-for-sale debt and equity securities, see accounting policies on pages 49 and 50.

Impairment allowances may be assessed and created either for individually significant accounts or, on a collective basis, for groups of individually significant accounts for which no evidence of impairment has been individually identified or for high-volume groups of homogeneous loans that are not considered individually significant. It is the group's policy that each operating company creates allowances for impaired loans promptly and consistently.

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

Notes on the Financial Statements (continued)

Maximum exposure to credit risk

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

The group

	At 31 December 2009			At 31 December 2008		
	Maximum exposure	**Offset**	**Exposure to credit risk (net)**	Maximum exposure	Offset	Exposure to credit risk (net)
	£m	**£m**	**£m**	£m	£m	£m
Cash and balances at central banks	**14,274**	**–**	**14,274**	9,470	–	9,470
Items in the course of collection from other banks	**2,082**	**–**	**2,082**	1,917	–	1,917
Trading assets	**145,604**	**(3,800)**	**141,804**	158,900	(6,945)	151,955
– treasury and other eligible bills	**789**	**–**	**789**	21	–	21
– debt securities	**75,566**	**–**	**75,566**	77,241	–	77,241
– loans and advances to banks	**30,857**	**–**	**30,857**	37,898	–	37,898
– loans and advances to customers	**38,392**	**(3,800)**	**34,592**	43,740	(6,945)	36,795
Financial assets designated at fair value	**9,480**	**–**	**9,480**	8,073	–	8,073
– treasury and other eligible bills	**35**	**–**	**35**	43	–	43
– debt securities	**8,706**	**–**	**8,706**	7,380	–	7,380
– loans and advances to banks	**214**	**–**	**214**	153	–	153
– loans and advances to customers	**525**	**–**	**525**	497	–	497
Derivatives	**118,516**	**(81,508)**	**37,008**	243,084	(173,522)	69,562
Loans and advances held at amortised cost	**321,653**	**(52,530)**	**269,123**	349,023	(54,890)	294,133
– loans and advances to banks	**46,994**	**(67)**	**46,927**	50,719	(82)	50,637
– loans and advances to customers	**274,659**	**(52,463)**	**222,196**	298,304	(54,808)	243,496
Financial investments	**84,379**	**–**	**84,379**	100,843	–	100,843
– treasury and other similar bills	**2,349**	**–**	**2,349**	10,562	–	10,562
– debt securities	**82,030**	**–**	**82,030**	90,281	–	90,281
Other assets	**9,449**	**–**	**9,449**	12,616	–	12,616
– endorsements and acceptances	**352**	**–**	**352**	370	–	370
– accrued income and other	**9,097**	**–**	**9,097**	12,246	–	12,246
Financial guarantees	**17,992**	**–**	**17,992**	20,293	–	20,293
Loan commitments and other credit-related commitments	**116,083**	**–**	**116,083**	154,391	–	154,391
	839,512	**(137,838)**	**701,674**	1,058,610	(235,357)	823,253

Notes on the Financial Statements (continued)

The bank

	At 31 December 2009			At 31 December 2008		
	Maximum exposure	**Offset**	**Exposure to credit risk (net)**	Maximum exposure	Offset	Exposure to credit risk (net)
	£m	**£m**	**£m**	£m	£m	£m
Cash and balances at central banks	**13,130**	**–**	**13,130**	6,779	–	6,779
Items in the course of collection from other banks	**1,071**	**–**	**1,071**	692	–	692
Trading assets	**105,164**	**(3,800)**	**101,364**	119,155	(6,945)	112,210
– treasury and other eligible bills	**741**	**–**	**741**	7	–	7
– debt securities	**35,314**	**–**	**35,314**	32,132	–	32,132
– loans and advances to banks	**34,111**	**–**	**34,111**	45,299	–	45,299
– loans and advances to customers	**34,998**	**(3,800)**	**31,198**	41,717	(6,945)	34,772
Financial assets designated at fair value	**6,592**	**–**	**6,592**	4,592	–	4,592
– debt securities	**6,515**	**–**	**6,515**	4,514	–	4,514
– loans and advances to banks	**77**	**–**	**77**	78	–	78
Derivatives	**100,800**	**(52,553)**	**48,247**	197,128	(120,488)	76,640
Loans and advances held at amortised cost	**229,398**	**(38,748)**	**190,650**	235,604	(47,501)	188,103
– loans and advances to banks	**20,729**	**–**	**20,729**	18,295	–	18,295
– loans and advances to customers	**208,669**	**(38,748)**	**169,921**	217,309	(47,501)	169,808
Financial investments	**26,452**	**–**	**26,452**	45,519	–	45,519
– treasury and other similar bills	**799**	**–**	**799**	9,818	–	9,818
– debt securities	**25,653**	**–**	**25,653**	35,701	–	35,701
Other assets	**4,696**	**–**	**4,696**	5,700	–	5,700
– endorsements and acceptances	**191**	**–**	**191**	224	–	224
– accrued income and other	**4,505**	**–**	**4,505**	5,476	–	5,476
Financial guarantees	**12,181**	**–**	**12,181**	11,032	–	11,032
Loan commitments and other credit-related commitments	**83,531**	**–**	**83,531**	103,487	–	103,487
	583,015	**(95,101)**	**487,914**	729,688	(174,934)	554,754

Collateral and other credit enhancements

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

Items in the course of collection from other banks

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

Treasury, other eligible bills and debt securities

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

Derivatives

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

Loans and advances

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

The guidelines applied by operating companies in respect of the acceptability of specific classes of collateral or credit risk mitigation, and the determination of valuation parameters are subject to regular review to ensure that they are supported by empirical evidence and continue to fulfil their intended purpose. The principal collateral types employed by the group are as follows:

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

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

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

Notes on the Financial Statements (continued)

Concentrations of credit risk exposure

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

The group

	2009 %	2008 %
United Kingdom	**47**	42
France	**16**	16
Germany	**6**	6
Rest of Continental Europe	**17**	20
Continental Europe	**39**	42
United States	**6**	8
Rest of the world	**8**	8
	14	16
	100	100

The bank

	2009 %	2008 %
United Kingdom	**63**	58
France	**4**	3
Germany	**2**	2
Rest of Continental Europe	**16**	20
Continental Europe	**22**	25
United States	**4**	7
Rest of the world	**11**	10
	15	17
	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 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 2009 and 31 December 2008 was concentrated in Europe (including the United Kingdom).

Notes on the Financial Statements (continued)

Loans and advances to customers by industry sector

The group

	At 31 December 2009		At 31 December 2008	
	Gross loans and advances to customers £m	**Gross loans by industry sector as a % of total gross loans %**	Gross loans and advances to customers £m	Gross loans by industry sector as a % of total gross loans %
Personal				
Residential mortgages	**68,028**	**24.45%**	60,240	20.03%
Other personal	**33,588**	**12.07%**	38,412	12.77%
	101,616	**36.52%**	98,652	32.80%
Corporate and commercial				
Commercial, industrial and international trade	**69,211**	**24.88%**	83,163	27.65%
Commercial real estate	**20,987**	**7.54%**	22,563	7.50%
Other property-related	**3,840**	**1.38%**	5,301	1.76%
Government	**1,357**	**0.48%**	1,275	0.41%
Other commercial	**29,858**	**10.73%**	38,915	12.94%
	125,253	**45.01%**	151,217	50.26%
Financial				
Non-bank financial institutions	**47,008**	**16.89%**	45,891	15.26%
Settlement accounts	**502**	**0.18%**	754	0.25%
	47,510	**17.07%**	46,645	15.51%
Asset-backed securities reclassified	**3,872**	**1.40%**	4,292	1.43%
Total gross loans and advances	**278,251**	**100.00%**	300,806	100.00%

The bank

	At 31 December 2009		At 31 December 2008	
	Gross loans and advances to customers £m	**Gross loans by industry sector as a % of total gross loans %**	Gross loans and advances to customers £m	Gross loans by industry sector as a % of total gross loans %
Personal				
Residential mortgages	**60,642**	**28.66%**	52,230	23.88%
Other personal	**11,097**	**5.25%**	12,396	5.67%
	71,739	**33.91%**	64,626	29.55%
Corporate and commercial				
Commercial, industrial and international trade	**51,242**	**24.22%**	60,957	27.87%
Commercial real estate	**12,981**	**6.13%**	13,660	6.25%
Other property-related	**2,852**	**1.35%**	4,057	1.86%
Government	**858**	**0.41%**	757	0.35%
Other commercial	**21,115**	**9.98%**	28,428	13.00%
	89,048	**42.09%**	107,859	49.33%
Financial				
Non-bank financial institutions	**46,839**	**22.15%**	41,489	18.97%
Settlement accounts	**47**	**0.02%**	411	0.19%
	46,886	**22.17%**	41,900	19.16%
Asset-backed securities reclassified	**3,872**	**1.83%**	4,292	1.96%
Total gross loans and advances	**211,545**	**100.00%**	218,677	100.00%

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.

Notes on the Financial Statements (continued)

Renegotiated loans

Restructuring activity is designed to manage customer relationships, maximise collection opportunities and, if possible, avoid foreclosure or repossession. Such activities include extended payment arrangements, lower interest rates, approved external debt management plans, deferring foreclosure, modification, loan rewrites and/or deferral of payments pending a change in circumstances. Restructuring is most commonly applied to consumer finance portfolios.

Following restructuring, an overdue consumer account is normally reset from delinquent to current status. Restructuring policies and practices are based on indicators or criteria which, in the judgement of local management, indicate that repayment will probably continue. These policies are required to be kept under continual review and their application varies according to the nature of the market, the product, and the availability of empirically based data. Criteria vary between products, but typically include receipt of two or more qualifying payments within a certain period, a minimum lapse of time from origination before restructuring may occur, and restrictions on the number and/or frequency of successive restructurings. When empirical evidence indicates an increased propensity to default on restructured accounts, the use of roll rate methodology ensures this factor is taken into account when calculating impairment allowances.

Renegotiated loans that would otherwise be past due or impaired

The group

	At 31 December	
	2009	2008
	£m	£m
Loans and advances to customers	**1,545**	1,298

The bank

	At 31 December	
	2009	2008
	£m	£m
Loans and advances to customers	**1,423**	1,181

Credit quality of financial instruments

The five credit quality classifications set out and defined below describe the credit quality of the group’s lending, debt securities portfolio and derivatives. Since 2009, the medium classification has been subdivided into “medium-good” and medium-satisfactory” to provide further granularity. These classifications each encompass a range of more granular, internal credit rating grades assigned to wholesale and retail lending business, as well as the external rating, attributed by external agencies to debt securities. There is no direct correlation between the internal and external ratings at granular level, except to the extent each falls within a single quality classification.

Credit quality of HSBC’s debt securities and other bills

Quality classification	**External credit rating (based on ratings of Standard & Poor’s)**
Strong	A- and above
Medium - Good	BBB+ to BBB-
Medium – Satisfactory	BB+ to B+ and unrated
Sub – standard	B and below
Impaired	Impaired

Notes on the Financial Statements (continued)

Credit quality of HSBC's wholesale lending and derivatives

Quality classification	Internal credit rating	Probability of default %
Strong	CRR1 to CRR2	0 – 0.169
Medium - Good	CRR3	0.170 – 0.740
Medium – Satisfactory	CRR4 TO CRR5	0.741 – 4.914
Sub – standard	CRR6 TO CRR8	4.915 - 99.999
Impaired	CRR9 TO CRR10	100

Credit quality of HSBC's retail lending

Quality classification	Internal credit rating[1]	Expected loss %
Strong	EL1 TO EL2	0 – 0.999
Medium - Good	EL3	1.000 – 4.999
Medium – Satisfactory	EL4 TO EL5	5.000 – 19.999
Sub – standard	EL6 TO EL8	20.000 – 99.999
Impaired	EL9 TO EL10	100 or more

1 *HSBC observes the disclosure convention that, in addition to those classified as EL9 to EL10, retail accounts classified as EL1 to EL8 that are delinquent by 90 days or more are considered impaired, unless individually they have been assessed as not impaired.*

Quality classification definitions

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

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

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

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

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

Risk rating scales

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

The Customer Risk Rating ('CRR') 10-grade scale above summarises a more granular underlying 22-grade scale of obligor probability of default ('PD'). All distinct customers Group-wide are rated using one of these two PD scales, depending on the degree of sophistication of the Basel II approach adopted for the exposure.

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

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

Notes on the Financial Statements (continued)

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

Distribution of financial instruments by credit quality

The group

	31 December 2009							
	Neither past due nor impaired							
		Medium						
	Strong £m	Good £m	Satisfactory £m	Sub-Standard £m	Past due not impaired £m	Impaired £m	Impairment allowances £m	Total £m
Cash and balances at central banks	14,274	–	–	–	–	–	–	14,274
Items in the course of collection from other banks	2,082	–	–	–	–	–	–	2,082
Trading assets	115,484	13,436	16,202	482	–	–	–	145,604
– treasury and other eligible bills	747	42	–	–	–	–	–	789
– debt securities	66,516	2,781	5,877	392	–	–	–	75,566
– loans and advances to banks	22,268	5,754	2,807	28	–	–	–	30,857
– loans and advances to customers	25,953	4,859	7,518	62	–	–	–	38,392
Financial assets designated at fair value	5,217	63	4,200	–	–	–	–	9,480
– treasury and other eligible bills	35	–	–	–	–	–	–	35
– debt securities	4,450	63	4,193	–	–	–	–	8,706
– loans and advances to banks	207	–	7	–	–	–	–	214
– loans and advances to customers	525	–	–	–	–	–	–	525
Derivatives	82,706	27,368	6,465	1,977	–	–	–	118,516
Loans and advances held at amortised cost	186,225	69,142	49,533	11,625	2,154	6,623	(3,649)	321,653
– loans and advances to banks	36,545	7,546	2,443	420	–	97	(57)	46,994
– loans and advances to customers	149,680	61,596	47,090	11,205	2,154	6,526	(3,592)	274,659
Financial investments	76,591	1,790	3,260	1,336	–	1,402	–	84,379
– treasury and other eligible bills	2,345	–	–	1	–	3	–	2,349
– debt securities	74,246	1,790	3,260	1,335	–	1,399	–	82,030
Other assets	5,846	894	2,238	405	16	50		9,449
– endorsements and acceptances	190	64	98	–	–	–	–	352
– accrued income and other	5,656	830	2,140	405	16	50	–	9,097

Notes on the Financial Statements (continued)

The group

	31 December 2008							
	Neither past due nor impaired							
		Medium						
	Strong £m	Good £m	Satisfactory £m	Sub-Standard £m	Past due not impaired £m	Impaired £m	Impairment allowances £m	Total £m
Cash and balances at central banks	9,470	–	–	–	–	–	–	9,470
Items in the course of collection from other banks	1,917	–	–	–	–	–	–	1,917
Trading assets	117,335	17,614	23,208	743	–	–	–	158,900
– treasury and other eligible bills	–	21	–	–	–	–	–	21
– debt securities	66,272	1,580	9,389	–	–	–	–	77,241
– loans and advances to banks	32,006	3,480	2,412	–	–	–	–	37,898
– loans and advances to customers	19,057	12,533	11,407	743	–	–	–	43,740
Financial assets designated at fair value	1,649	1,611	4,813	–	–	–	–	8,073
– treasury and other eligible bills	22	21	–	–	–	–	–	43
– debt securities	977	1,590	4,813	–	–	–	–	7,380
– loans and advances to banks	153	–	–	–	–	–	–	153
– loans and advances to customers	497	–	–	–	–	–	–	497
Derivatives	201,340	28,406	12,930	408	–	–	–	243,084
Loans and advances held at amortised cost	195,187	73,656	65,180	11,462	2,339	3,744	(2,545)	349,023
– loans and advances to banks	41,824	5,998	2,658	240	–	42	(43)	50,719
– loans and advances to customers	153,363	67,658	62,522	11,222	2,339	3,702	(2,502)	298,304
Financial investments	94,540	1,419	4,099	521	–	264	–	100,843
– treasury and other eligible bills	10,551	–	–	11	–	–	–	10,562
– debt securities	83,989	1,419	4,099	510	–	264	–	90,281
Other assets	4,705	1,752	5,572	586	–	1	–	12,616
– endorsements and acceptances	165	186	5	13	–	1	–	370
– accrued income and other	4,540	1,566	5,567	573	–	–	–	12,246

Notes on the Financial Statements (continued)

The bank

	31 December 2009							
	Neither past due nor impaired							
		Medium						
	Strong £m	Good £m	Satisfactory £m	Sub-Standard £m	Past due not impaired £m	Impaired £m	Impairment allowances £m	Total £m
Cash and balances at central banks	13,130	–	–	–	–	–	–	13,130
Items in the course of collection from other banks	1,071	–	–	–	–	–	–	1,071
Trading assets	80,457	11,015	13,224	468	–	–	–	105,164
– treasury and other eligible bills	699	42	–	–	–	–	–	741
– debt securities	29,121	1,443	4,360	390	–	–	–	35,314
– loans and advances to banks	26,657	4,844	2,594	16	–	–	–	34,111
– loans and advances to customers	23,980	4,686	6,270	62	–	–	–	34,998
Financial assets designated at fair value	2,788	77	3,727	–	–	–	–	6,592
– debt securities	2,788	–	3,727	–	–	–	–	6,515
– loans and advances to banks	–	77	–	–	–	–	–	77
Derivatives	80,403	14,782	3,964	1,651	–	–	–	100,800
Loans and advances held at amortised cost	139,798	44,485	32,231	9,985	797	4,293	(2,191)	229,398
– loans and advances to banks	14,882	4,261	1,254	324	–	35	(27)	20,729
– loans and advances to customers	124,916	40,224	30,977	9,661	797	4,258	(2,164)	208,669
Financial investments	24,246	266	1,600	221	–	119	–	26,452
– treasury and other similar bills	799	–	–	–	–	–	–	799
– debt securities	23,447	266	1,600	221	–	119	–	25,653
Other assets	3,338	779	573	6	–	–	–	4,696
– endorsements and acceptances	33	61	97	–	–	–	–	191
– accrued income and other	3,305	718	476	6	–	–	–	4,505

Notes on the Financial Statements (continued)

The bank

	31 December 2008							
	Neither past due nor impaired							
		Medium						
	Strong £m	Good £m	Satisfactory £m	Sub-Standard £m	Past due not impaired £m	Impaired £m	Impairment allowances £m	Total £m
Cash and balances at central banks	6,779	–	–	–	–	–	–	6,779
Items in the course of collection from other banks	692	–	–	–	–	–	–	692
Trading assets	86,776	16,839	14,797	743	–	–	–	119,155
– treasury and other eligible bills	7	–	–	–	–	–	–	7
– debt securities	26,552	1,519	4,061	–	–	–	–	32,132
– loans and advances to banks	40,333	3,025	1,941	–	–	–	–	45,299
– loans and advances to customers	19,884	12,295	8,795	743	–	–	–	41,717
Financial assets designated at fair value	502	–	4,090	–	–	–	–	4,592
– debt securities	424	–	4,090	–	–	–	–	4,514
– loans and advances to banks	78	–	–	–	–	–	–	78
Derivatives	173,828	18,593	4,304	394	–	9	–	197,128
Loans and advances held at amortised cost	141,771	42,634	40,846	7,758	1,220	2,786	(1,411)	235,604
– loans and advances to banks	16,125	1,243	780	149	–	41	(43)	18,295
– loans and advances to customers	125,646	41,391	40,066	7,609	1,220	2,745	(1,368)	217,309
Financial investments	43,851	36	1,579	–	–	53	–	45,519
– treasury and other similar bills	9,818	–	–	–	–	–	–	9,818
– debt securities	34,033	36	1,579	–	–	53	–	35,701
Other assets	3,387	1,496	786	30	–	1	–	5,700
– endorsements and acceptances	34	178	–	11	–	1	–	224
– accrued income and other	3,353	1,318	786	19	–	–	–	5,476

Notes on the Financial Statements (continued)

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

Examples of exposures past due but not impaired include overdue loans fully secured by cash collateral; mortgages that are individually assessed for impairment and that are in arrears more than 90 days, but where the value of collateral is sufficient to repay both the principal debt and all potential interest for at least one year; and short-term trade facilities past due more than 90 days for technical reasons such as delays in documentation, but where there is no concern over the creditworthiness of the counterparty.

The group

	Up to 29 days £m	**30-59 days £m**	**60-89 days £m**	**90-179 days £m**	**Over 180 days £m**	**Total £m**
At 31 December 2009						
Loans and advances held at amortised costs	**1,518**	**366**	**235**	**19**	**16**	**2,154**
Other assets	**4**	**–**	**8**	**3**	**1**	**16**
	1,522	**366**	**243**	**22**	**17**	**2,170**

	Up to 29 days £m	30-59 days £m	60-89 days £m	90-179 days £m	Over 180 days £m	Total £m
At 31 December 2008						
Loans and advances held at amortised costs	1,220	437	257	198	227	2,339
	1,220	437	257	198	227	2,339

The bank

	Up to 29 days £m	**30-59 days £m**	**60-89 days £m**	**90-179 days £m**	**Over 180 days £m**	**Total £m**
At 31 December 2009						
Loans and advances held at amortised costs	**440**	**204**	**152**	**1**	**–**	**797**
	440	**204**	**152**	**1**	**–**	**797**

	Up to 29 days £m	30-59 days £m	60-89 days £m	90-179 days £m	Over 180 days £m	Total £m
At 31 December 2008						
Loans and advances held at amortised costs	555	266	191	191	17	1,220
	555	266	191	191	17	1,220

Collateral and other credit enhancements obtained

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

	The group		**The bank**	
	2009 £m	2008 £m	**2009 £m**	2008 £m
Nature of assets				
Residential property	**75**	67	**72**	67

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

Notes on the Financial Statements (continued)

Impairment allowances as a percentage of gross loans and advances to banks and customers[1]

The group

	At 31 December	
	2009	2008
	%	%
Banks		
Individually assessed impairment allowances	**0.26**	0.17
Customers		
Individually assessed impairment allowances	**0.95**	0.50
Collectively assessed impairment allowances	**0.52**	0.41
	1.73	1.08

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

The bank

	At 31 December	
	2009	2008
	%	%
Banks		
Individually assessed impairment allowances	**0.19**	0.33
Customers		
Individually assessed impairment allowances	**1.17**	0.31
Collectively assessed impairment allowances	**0.31**	0.27
	1.67	0.91

Movement in impairment allowances

The group

	Banks	**Customers**		
	Individually assessed	**Individually assessed**	**Collectively assessed**	**Total**
	£m	**£m**	**£m**	**£m**
At 1 January 2009	**43**	**1,380**	**1,122**	**2,545**
Amounts written off	**(21)**	**(440)**	**(1,119)**	**(1,580)**
Recoveries of loans and advances written off in previous years	**4**	**40**	**126**	**170**
Charge to income statement	**35**	**1,408**	**1,176**	**2,619**
Foreign exchange and other movements	**(4)**	**(76)**	**(25)**	**(105)**
At 31 December 2009	**57**	**2,312**	**1,280**	**3,649**
At 1 January 2008	3	920	873	1,796
Amounts written off	–	(222)	(928)	(1,150)
Recoveries of loans and advances written off in previous years[1]	–	22	135	157
Charge to income statement[1]	35	656	1,025	1,716
Foreign exchange and other movements	5	4	17	26
At 31 December 2008	43	1,380	1,122	2,545

The bank

	Banks	Customers		
	Individually assessed £m	Individually assessed £m	Collectively assessed £m	Total £m
At 1 January 2009	**43**	**808**	**560**	**1,411**
Amounts written off	**(20)**	**(314)**	**(964)**	**(1,298)**
Recoveries of loans and advances written off in previous years	**4**	**49**	**132**	**185**
Charge to income statement	**5**	**1,754**	**883**	**2,642**
Foreign exchange and other movements	**(4)**	**(30)**	**(3)**	**(37)**
At 31 December 2009	**28**	**2,267**	**608**	**2,903**
At 1 January 2008	3	356	478	837
Amounts written off	–	(160)	(825)	(985)
Recoveries of loans and advances written off in previous years[1]	–	19	143	162
Charge to income statement[1]	35	543	764	1,342
Foreign exchange and other movements	5	50	–	55
At 31 December 2008	43	808	560	1,411

1 *Prior period balances have been re-presented on a consistent basis with the current year presentation.*

Liquidity and funding management

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

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

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

The group adapts its liquidity and funding risk management framework in response to changes in the mix of business that it undertakes, and to changes in the nature of the markets in which it operates. The group has continuously monitored the impact of recent market events on the group's liquidity positions and introduced more conservative assumptions where justified. The liquidity and funding risk management framework will continue to evolve as the group assimilates knowledge from the recent market events.

Maturity analyses of assets and liabilities are provided in Note 32.

Policies and procedures

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

The group's liquidity and funding management process includes:

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

Primary sources of funding

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

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

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

Of total liabilities of £724 billion at 31 December 2009, funding from customers amounted to £333 billion, of which £329 billion was contractually repayable within one year.

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

Assets available to meet these liabilities, and to cover outstanding commitments to lend (£752 billion), included cash, central bank balances, items in the course of collection and treasury and other bills (£20 billion); loans to banks (£47 billion, including £45 billion repayable within one year); and loans to customers (£275 billion, including £139 billion repayable within one year). In the normal course of business, a proportion of customer loans contractually repayable within one year will be extended. In addition, the group held debt securities marketable at a value of £166 billion. Of these assets, some £108 billion of debt securities and treasury and other bills had been pledged to secure liabilities.

Advances to deposits ratio

The group emphasises the importance of core current accounts and savings accounts as a source of funds to finance lending to customers, and discourages reliance on short-term professional funding. This is achieved by placing limits on group banking entities which restrict their ability to increase loans and advances to customers without corresponding growth in current accounts and savings accounts. This measure is referred to as the 'advances to deposits' ratio. The ratio describes loans and advances to customers as a percentage of the total of core customer current and savings accounts and term funding with a remaining term to maturity in excess of one year. Loans and advances to customers which are part of reverse repurchase arrangements, and where the group receives securities which are deemed to be liquid, are excluded from the advances to deposits ratio, as are current accounts and savings accounts from customers deemed to be 'non-core'. The definition of a non-core deposit includes a consideration of the size of the customer's total deposit balances. The distinction between core and non-core deposits means that the group's measure of advances to deposits is more restrictive than that which could be inferred from the published financial statements. For example, the group consolidated advances to deposits measure at 31 December 2009 based only on published information was 82.5 per cent (2008: 82.6 per cent)

Notes on the Financial Statements (continued)

Advances to deposits ratios

	The group		The bank	
	2009	2008	**2009**	2008
	%	%	**%**	%
Year-end	**89.3**	88.9	**102.3**	106.0
Maximum	**91.7**	93.4	**107.7**	106.7
Minimum	**88.8**	86.4	**101.7**	97.5
Average	**90.1**	90.6	**105.1**	101.5

Advances to deposits ratio limits are set by the RMM.

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

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

Ratio of net liquid assets to customer liabilities

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

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

Ratio of net liquid assets to customer liabilities

	The group		The bank	
	2009	2008	**2009**	2008
	%	%	**%**	%
Year-end	**16.0**	15.4	**8.8**	7.1
Maximum	**19.4**	17.9	**13.6**	14.1
Minimum	**14.8**	12.9	**6.5**	6.9
Average	**17.3**	15.1	**10.2**	10.0

Projected cash flow scenario analyses

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

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

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

Contingent liquidity risk

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

Notes on the Financial Statements (continued)

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

	The group		The bank	
	2009	2008	**2009**	2008
	£bn	£bn	**£bn**	£bn
Conduits				
Client-originated assets[1]				
– total lines	**4.6**	3.8	**3.1**	2.1
– largest individual lines	**0.6**	0.7	**0.6**	0.7
Assets managed by the group[2]	**17.9**	23.9	**17.9**	23.9
Single-issuer liquidity facilities				
– five largest[3]	**2.8**	4.1	**2.8**	3.4
– largest market sector[4]	**4.8**	5.0	**4.8**	5.0

1 *These exposures relate to consolidated multi-seller conduits. These vehicles provide funding to group customers by issuing debt secured by a diversified pool of customer-originated assets.*
2 *These exposures relate to consolidated securities investment conduits, primarily Solitaire and Mazarin. These vehicles issue debt secured by highly-rated asset-backed securities which are managed by the group.*
3 *These figures represent the five largest committed liquidity facilities provided to customers other than those facilities to conduits.*
4 *These figures represent the total of all committed liquidity facilities provided to the largest market sector other than those facilities to conduits.*

In times of market stress, the group may choose to provide non-contractual liquidity support to certain group-sponsored vehicles or group-promoted products. This support would only be provided after careful consideration of the potential funding requirement and the impact on the entity's overall liquidity, and is not included in the group's liquidity risk measures until such time as the support becomes legally binding.

Market risk management

The objective of the group's market risk management is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with the group's status as a premier provider of financial products and services. Market risk is the risk that movements in market risk factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices will reduce the group's income or the value of its portfolios.

The group separates exposures to market risk into trading or non-trading portfolios. Trading portfolios include those positions arising from market-making, position-taking and other marked-to-market positions so designated. Non-trading portfolios include positions that arise from the interest rate management of the group's retail and commercial banking assets and liabilities, financial investments designated as available-for-sale and held-to-maturity, and exposures arising from the group's insurance operations. For market risk arising in the group's insurance business, refer to page 162.

The management of market risk is principally undertaken in Global Markets using risk limits approved by the HSBC Group Management Board. Limits are set for portfolios, products and risk types, with market liquidity being a principal factor in determining the level of limits set. Group risk, an independent unit within the Group Management Office of HSBC Holdings plc, develops HSBC's market risk management policies and measurement techniques. Each major operating entity has an independent market risk management and control function which is responsible for measuring market risk exposures in accordance with the policies defined by Group risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis.

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

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

Sensitivity analysis

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

Value at risk ('VAR')

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

The VAR models used by the group are predominantly based on historical simulation. The historical simulation models derive plausible future scenarios from historical market rate and price time series, taking account of inter-relationships between different markets and rates, for example between interest rates and foreign exchange rates. The models also incorporate the impact of option features in the underlying exposures.

The historical simulation models used by the group incorporate the following features:

- potential market movements are calculated with reference to data from the last two years;
- historical market rates and prices are calculated with reference to foreign exchange rates and commodity prices, interest rates, equity prices and the associated volatilities;
- VAR is calculated to a 99% per cent confidence level; and
- VAR is calculated for a one-day holding period.

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

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

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

Stress testing

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

The process is governed by the 'Stress Testing Review Group' forum. This co-ordinates the group's Stress testing scenarios in conjunction with the regional risk managers. Considering actual market risk exposures and market events in determining the stress scenarios to be applied at portfolio and consolidated level, as follows:

- sensitivity scenarios, which consider the impact of market movement on any single risk factor or a set of factors. For example, the impact resulting from a break of a currency peg that is unlikely to be captured within the VAR models;
- technical scenarios, which consider the largest move in each risk factor, without consideration of any underlying market correlation;

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- hypothetical scenarios, which consider potential macro economic events including the 'Global Pandemic' scenario; and
- historical scenarios, which incorporate historical observations of market movement during previous periods of stress which would not be captured within VAR.

Stress testing results provide senior management with an assessment of the financial impact such events would have on the profit of the bank. The daily losses experienced during 2009 were within the stress loss scenarios reported to senior management.

Sensitivity analysis

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

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

1 *The reporting of commodity risk is consolidated with foreign exchange risk and is not applicable to non-trading portfolios.*
2 *Non-Trading Credit Spread for AFS positions only.*

Value at risk of the trading and non-trading portfolios

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

	£m
Total	
At 31 December 2009	**53.5**
At 31 December 2008	144.5

	Average £m	Minimum £m	Maximum £m
2009	**89.6**	**49.7**	**166.1**
2008	61.2	22.5	151.6

The VAR for the overall trading and non-trading as at 31 December 2009 is lower than in 2008. The decrease has been driven primarily by the interest rate component due to reduced levels of underlying exposure in both the trading and non-trading books.

The figures in the tables above exclude non-trading credit VAR. Including non-trading credit VAR for AFS positions only, the total VAR at 31 December 2009 was £222.5 million (2008: £238.7 million).

Trading portfolios

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

Market-making and position-taking is undertaken within Global Markets. The VAR for such trading activity at 31 December 2009 was £42 million (2008: £67.7 million). This is analysed below by risk type:

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Total trading VAR by risk type

	Foreign exchange and commodity £m	Interest rate £m	Equity £m	Credit £m	Total[1] £m
At 31 December 2009	**11.0**	**34.4**	**11.3**	**25.4**	**42.0**
At 31 December 2008	17.4	44.2	11.6	27.1	67.7
Average					
2009	**12.0**	**37.1**	**7.1**	**28.5**	**48.9**
2008	10.0	25.7	8.0	26.2	35.1
Minimum					
2009	**6.4**	**24.1**	**2.9**	**14.5**	**28.4**
2008	4.2	9.2	4.0	13.7	13.0
Maximum					
2009	**33.0**	**68.6**	**13.4**	**55.3**	**85.7**
2008	57.6	103.8	20.4	63.1	80.0

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

The VAR for the overall trading activity as at 31 December 2009 is lower than in 2008. The decrease has been driven primarily by the interest rate component due to reduced levels of underlying exposure in the trading book.

Gap risk

For certain transactions which are structured so that the risk to the group is negligible under a wide range of market conditions or events, but there exists a remote possibility that a significant gap event could lead to loss. A gap event could arise from a change in market price from one level to another with no accompanying trading opportunity where the price change breaches the threshold beyond which the risk profile changes from having no open risk to having full exposure to the underlying structure. Such movements may occur for example, when adverse news announcements turn the market for a specific investment illiquid, making hedging impossible.

Given the characteristics of these transactions, they will make little or no contribution to VAR or to traditional market risk sensitivity measures. The group captures the risks for such transactions within the stress testing scenarios. Gap risk arising is monitored on an ongoing basis, and the group incurred no gap losses arising from movements in the underlying market price on such transactions in 2009.

ABS/MBS positions

The ABS/MBS exposures within the trading portfolios are managed within sensitivity and VAR limits, as described on page 152.

Non-trading portfolios

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

Interest rate risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on embedded optionality within certain product areas, such as the incidence of mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts. The prospective change in future net interest income from non-trading portfolios will be reflected in the current realisable value of these positions should they be sold or closed prior to maturity. In order to manage this risk optimally, market risk in non-trading portfolios is transferred to Global Markets or to separate books managed under the supervision of the local the ALCO.

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

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

Once market risk has been consolidated in Global Markets or ALCO managed books, the net exposure is typically managed through the use of interest rate swaps within agreed limits. The VAR for these portfolios is included within the group VAR.

Fixed-rate securities

The principal non-trading risk which is not included in the VAR reported for Global Banking and Markets arises out of Fixed Rate Subordinated Notes. The VAR related to these instruments was £30.6 million at 31 December 2009 (2008: £34.2 million); whilst the average, minimum and maximum during the year was £31.6 million, £29.4 million and £34.7 million respectively (2008: £17.7 million, £13.3 million and £34.4 million).

Equity securities held as available-for-sale

Market risk arises on equity securities held as available-for-sale. The fair value of these securities at 31 December 2009 was £2,316 million (2008: £2,668 million) and included private equity holdings of £1,125 million (2008: £1,183 million). Investments in private equity are primarily made through managed funds that are subject to limits on the amount of investment. Potential new commitments are subject to risk appraisal to ensure that industry and geographical concentrations remain within acceptable levels for the portfolio as a whole. Regular reviews are performed to substantiate the valuation of the investments within the portfolio, and Finance is responsible for reviewing the carrying value of the investments. Money market funds represented £75 million (2008: £151 million) and typically related to funds held for short-term cash management. Investments held to facilitate ongoing business, such as holdings in government-sponsored enterprises and local stock exchanges, represented £186 million (2008: £187 million).

The fair value of the constituents of equity securities held as available-for-sale can fluctuate considerably. A 10 per cent reduction in the value of the available-for-sale equities at 31 December 2009 would have reduced equity by £203 million (2008: £231 million). For details of the impairment incurred on available-for-sale equity securities see the accounting policies in Note 2(j).

Defined benefit pension scheme

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

The present value of the group's defined benefit pension schemes' liabilities was £14.1 billion at 31 December 2009 compared with £11.3 billion at 31 December 2008. Assets of the defined benefit schemes at 31 December 2009 comprised: equity investments 17 per cent (15 per cent at 31 December 2008); debt securities 70 per cent (73 per cent at 31 December 2008) and other (including property) 13 per cent (11 per cent at 31 December 2008).

Sensitivity of net interest income

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

For simulation modelling, businesses use a combination of scenarios relevant to local businesses and local markets and standard scenarios which are required throughout the group. The standard scenarios are consolidated to illustrate the combined proforma effect on the group's consolidated portfolio valuations and net interest income.

Structural foreign exchange exposures

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

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

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

Concentrations of market risk exposures

Analysis of asset backed securities

During the period a total valuation increase of £4,666 million on available for sale assets was recognised in other comprehensive income. This primarily relates to valuation gains on asset backed securities. The table shows the group's market risk exposure to asset backed securities (including those carried at fair value through profit and loss and those classified as available for sale).

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Asset Backed Securities

	31 December 2009				31 December 2008			
	Gross principal[2]	**CDS gross protection**[3]	**Net Principal exposure**[4,10]	**Carrying Amount**[5,10]	Gross principal	CDS gross protection	Net Principal exposure[10]	Carrying Amount[10]
	£ m	**£ m**	**£ m**	**£m**	£m	£m	£m	£m
– High grade[1]	**28,161**	**5,367**	**22,794**	**18,466**	38,161	(2,917)	35,244	24,917
– rated C to A	**14,696**	**564**	**14,132**	**6,832**	10,328	(409)	9,919	4,055
– not publicly rated	**121**	**–**	**121**	**62**	3,629	(3,498)	131	90
Total asset-backed securities	**42,978**	**5,931**	**37,047**	**25,360**	52,118	(6,824)	45,294	29,062

	Gross fair value movements Income statement[6]	**Gross fair value movements Other comprehensive income**[9]	**Realised gains/(losses) in the income statement**[7]	**Reclassified from equity on impairment, disposal or payment**[8]
	£m	**£m**	**£m**	**£m**
– High grade[1]	**106**	**1,671**	**26**	**783**
– rated C to A	**54**	**451**	**(200)**	**1,658**
– not publicly rated	**8**	**(13)**	**2**	**(9)**
Total asset-backed securities	**168**	**2,109**	**(172)**	**2,432**

1 *High grade assets rated AA or AAA.*
2 *The gross principal is the redemption amount on maturity or, in the case of an amortising instrument, the sum of the future redemption amounts through the residual life of the security.*
3 *A CDS is a credit default swap. CDS protection principal is the gross principal of the underlying instrument that is protected by CDSs.*
4 *Net principal exposure is the gross principal amount of assets that are not protected by CDSs. It includes assets that benefit from monoline protection, except where this protection is purchased with a CDS.*
5 *Carrying amount of the net principal exposure.*
6 *Gains and losses on the net principal exposure (see footnote 4) recognised during the year in the income statement as a result of changes in the fair value of the asset.*
7 *Realised gains and losses on the net principal exposure (see footnote 4) recognised during the year in the income statement as a result of the disposal of asset or the receipt of cash flows from assets.*
8 *Includes impairment losses recognised in the income statement in respect of the net principal amount (see footnote 4) of available-for-sale and held-to-maturity assets. Payments are receipt of the contractual cash flows on the assets.*
9 *Fair value gains and losses on the net principal exposure (see footnote 4) recognised in equity during the year as a result the changes in the fair value of available-for-sale assets.*
10 *The asset backed securities are primarily US dollar ('USD') denominated. Principal and carrying amounts are converted into sterling ('GBP') at the prevailing exchange rates at 31 December (2009: 1GBP:USD 1.623; 2008: 1GBP:USD 1.459).*

Included in the above table is carrying amount of £8,642 million held through SPEs that are consolidated by the group. Although the group includes these assets in full on its balance sheet, significant first loss risks are borne by third party investors, through the investors' holdings of capital notes subordinate to the group's holdings. Impairments losses recognised by capital note holders for the year ended 31 December 2009 amounted to £408 million (2008: £160 million).

Risk management of insurance operations

The group operates a bancassurance model which provides insurance products for customers with whom the group has a banking relationship. Many of these products are manufactured by group subsidiaries, but where the group considers it operationally more effective, third parties are engaged to manufacture insurance products for sale through the group's banking network. The group works with a limited number of market-leading partners to provide these products. These arrangements earn the group a commission. When manufacturing products, the group underwrites the insurance risk and retains the risks and rewards associated with writing insurance contracts, retaining both the underwriting profit and the commission paid by the manufacturer to the bank distribution channel within the group. Where the group chooses to manage its exposure to insurance risk through the use of third party reinsurers, the associated revenue and manufacturing profit will be passed on. The group's exposure to risks associated with manufacturing insurance contracts in its subsidiaries and its management of these risks are discussed below.

The group sells insurance products across all its customer groups, mainly utilising its retail branches, the internet and phone centres. Personal Financial Services customers attract the majority of sales and comprise the majority of policyholders. The group offers its customers a wide range of insurance and investment products, many of which complement other bank and consumer finance products.

The group's bancassurance business operates across Europe with 9 legal entities manufacturing insurance products. The majority of these insurance operations are subsidiaries of banking legal entities, which set their management control procedures. In addition to local management requirements, the insurance operations follow guidelines issued by the HSBC Group Insurance Head Office. The role of Group Insurance Head Office includes forming and communicating the strategy for Insurance, setting the control framework for monitoring and measuring insurance risk in line with Group practices, and drawing up insurance-specific policies and guidelines for inclusion in the Group Instruction Manuals.

The Regional Insurance Head Office (UK, Europe & Middle East) is headed by the Regional Chief Executive Officer ('CEO'), supported by a Deputy Regional CEO, Regional Chief Financial Officer ('CFO') and Regional Chief Risk Officer ('CRO'). The role of the Regional Insurance Head Office includes overseeing the effective implementation of HSBC policies and guidelines and monitoring and measuring Insurance Risk in line with HSBC practices.

The control framework for monitoring risk includes the HSBC Group Insurance Risk Committee, which oversees the status of the significant risk categories in the insurance operations. Five sub-committees report to the Committee, focusing on products and pricing, market and liquidity risk, credit risk, operational risk and insurance risk. The group's framework and the Regional Risk Committee mirror this HSBC framework. All insurance products, whether internally manufactured or provided by a third party manufacturer, are required to follow a detailed product approval process.

The processes and controls employed to monitor individual risks are described under their respective headings below.

Insurance risk of insurance operations

Insurance risk is a risk, other than financial risk, transferred from the holder of a contract to the issuer. The principal insurance risk faced by the group is that, over time, the combined cost of claims, benefits administration and acquisition of the contract may exceed the aggregate amount of premiums received and investment income. The cost of claims and benefits can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, if the policy has a savings element, the performance of the assets held to support the liabilities. Performance of the underlying assets is affected by changes in both interest rates and equity prices. This risk is discussed further in the Market Risk section below.

Life and non-life business insurance risks are controlled by high level policies and procedures set centrally, supplemented as appropriate with measures which take account of specific local market conditions and regulatory requirements. Specifically, the group manages its exposure to insurance risk by applying formal underwriting, reinsurance and claims-handling procedures designed to ensure compliance with regulations. This is supplemented with stress-testing. In addition, manufacturing entities are required to obtain authorisation from the HSBC Group Insurance Head Office to write certain classes of business, with restrictions applying particularly to commercial and liability non-life insurance.

The insurance contracts sold by the group relate, primarily, to core underlying banking activities, such as savings, investment or lending products. The group's manufacturing focuses on personal lines, i.e. contracts written for individuals. The focus on the higher volume, lower individual value personal lines contributes to diversifying insurance risk.

Reinsurance is also used as a means of mitigating exposure, in particular to aggregations of catastrophe risk. Although reinsurance provides a means of managing insurance risk, such contracts expose the group to counterparty risk, the risk of default by the reinsurer. This risk is discussed further in the Credit Risk section below.

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

The following tables provide an analysis of the group's insurance risk exposures by type of business.

Life business tends to be longer-term in nature than non-life business and frequently involves an element of savings and investment in the contract. Accordingly, separate tables are provided for life and non-life businesses, reflecting their distinctive risk characteristics. The life insurance risk table provides an analysis of insurance liabilities as the best available overall measure of insurance exposure, because provisions for life contracts are typically set by reference to expected future cash outflows relating to the underlying policies. The table for non life business uses written premiums as the best available measure of risk exposure because policies are typically priced by reference to the risk being underwritten.

Analysis of life insurance risk – liabilities to policyholders

	2009	2008
	£m	£m
Life (non-linked)		
Insurance contracts with DPF [1]	**695**	696
Credit life	**247**	173
Annuities	**278**	260
Term assurance and other long-term contracts	**286**	902
Total life (non-linked)	**1,506**	2,031
Life (linked)	**1,310**	1,061
Investment contracts with DPF [1, 2]	**12,930**	12,157
Insurance liabilities to policyholders	**15,746**	15,249

1 *Insurance contracts and investment contracts with discretionary participation features ('DPF') give policyholders the contractual right to receive, as a supplement to their guaranteed benefits, additional benefits that are likely to be a significant portion of the total contractual benefits, but whose amount or timing is contractually at the discretion of the group. These additional benefits are contractually based on the performance of a specified pool of contracts or assets, or the profit of the company issuing the contracts.*
2 *Although investment contracts with DPF are financial investments, the group continues to account for them as insurance contracts as permitted by IFRS 4.*

The most significant products are investment contracts with DPF issued in France, and unit-linked contracts issued in the UK.

The liabilities for long-term contracts are set by reference to a range of assumptions which include lapse and surrender rates, mortality and expense levels. These assumptions typically reflect each entity's own experience. Economic assumptions, such as investment returns and interest rates, are usually based on observable market data. Changes in underlying assumptions affect the liabilities. The sensitivity of profit after tax and shareholders' equity to changes in both economic and non-economic assumptions are considered below in 'Sensitivity of the group's insurance subsidiaries to risk factors' and 'Sensitivity to changes in non-economic assumptions'.

Insurance risk arising from life insurance depends on the type of business, and varies considerably. The principal risks are mortality, morbidity, lapse, surrender and expense levels.

The main contracts which generate exposure to mortality and morbidity risks are term assurance contracts and annuities. These risks are monitored on a regular basis, and are primarily mitigated by medical underwriting and by retaining the ability in certain cases to amend premiums in the light of experience. The risk associated with lapses and surrenders is generally mitigated through management actions such as managing the level of bonus payments to policyholders. Expense risk is generally managed through pricing. The level of expenses in the contract will be one of the factors considered when setting premium rates.

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

	2009 £m	2008 £m
Accident and health	**60**	8
Motor	**82**	190
Fire and other damage	**46**	80
Credit (non-life)	**22**	51
Marine, aviation and transport	**5**	-
Other (non-life)	**17**	26
Total net written insurance premiums	**232**	355
Net insurance claims incurred and movement in liabilities to policyholders	**(473)**	(306)

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

The above table of non-life net written insurance premiums provides an overall summary of the non life insurance activity of the group. Motor business is written predominantly in the UK, however following the decision to close to new business in the second half of 2009, the UK motor book is now in run off.

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

Financial risks of insurance operations

The group's insurance businesses are exposed to a range of financial risks, including market risk, credit risk and liquidity risk, for example when the proceeds from financial assets are not sufficient to fund the obligations arising from non-linked insurance and investment contracts. The nature and management of these risks is described below.

In addition to policies provided for HSBC-wide application through the Group Instruction Manuals, insurance manufacturing subsidiaries may implement additional risk management procedures which reflect local market conditions and regulatory requirements.

Local regulatory requirements prescribe the type, quality and concentration of assets that the group's insurance manufacturing subsidiaries must maintain to meet insurance liabilities. Within each subsidiary, ALCOs are responsible for ensuring that exposures to financial risks remain within local requirements and risk mandates (as agreed with HSBC Group Insurance Head Office), and ensure compliance with the control framework established centrally through the Group Instruction Manuals.

The following table analyses the assets held in the group's insurance manufacturing subsidiaries at 31 December 2009 by type of contract, and provides a view of the exposure to financial risk:

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Financial assets held by insurance manufacturing subsidiaries

	At 31 December 2009				
	Life linked contracts £m	**Life non-linked contracts £m**	**Non-life insurance £m**	**Other assets £m**	**Total £m**
Financial assets designated at fair value					
Treasury bills	**28**	**5**	**–**	**2**	**35**
Debt securities	**1,145**	**808**	**–**	**156**	**2,109**
Equity securities	**3,645**	**2,769**	**–**	**531**	**6,945**
	4,818	**3,582**	**–**	**689**	**9,089**
Financial investments available-for-sale:					
Treasury bills	**–**	**–**	**130**	**51**	**181**
Other eligible bills	**–**	**16**	**78**	**78**	**172**
Debt securities	**–**	**9,217**	**–**	**716**	**9,933**
Equity securities	**–**	**–**	**–**	**18**	**18**
	–	**9,233**	**208**	**863**	**10,304**
Derivatives	**185**	**89**	**–**	**1**	**275**
Other financial assets	**293**	**817**	**400**	**281**	**1,791**
	5,296	**13,721**	**608**	**1,834**	**21,459**

	At 31 December 2008				
	Life linked contracts £m	Life non-linked contracts £m	Non-life insurance £m	Other assets £m	Total £m
Financial assets designated at fair value					
Treasury bills	21	17	–	5	43
Debt securities	1,578	502	–	709	2,789
Equity securities	2,681	2,895	–	231	5,807
	4,280	3,414	–	945	8,639
Financial investments available-for-sale:					
Treasury bills	–	–	83	82	165
Other eligible bills	–	–	187	86	273
Debt securities	–	9,044	14	5	9,063
Equity securities	–	–	–	18	18
	–	9,044	284	191	9,519
Derivatives	118	42	–	17	177
Other financial assets	359	1,002	387	826	2,574
	4,757	13,502	671	1,979	20,909

The table demonstrates that for linked contracts, the group typically designates assets at fair value. For non-linked contracts, the classification of the assets is driven by the nature of the underlying contract, for example, by taking into consideration whether the benefit payable to the policyholder is determined by reference to the underlying assets.

The table also shows that approximately 56 per cent of financial assets was invested in debt securities at 31 December 2009 (2008: 57 per cent), with 32 per cent invested in equity securities (2008: 28 per cent).

In life linked insurance, premium income less charges levied is invested in a portfolio of assets. The group manages the financial risks of this product on behalf of the policyholders by holding appropriate assets in segregated funds or portfolios to which the liabilities are linked. The group typically retains some exposure to market risk as the market value of the linked assets influences the fees charged by the group and thereby affects the recoverability of expenses incurred by the group in managing the product. The assets held to support life linked liabilities represented 25 per cent of the total financial assets of the group's insurance manufacturing subsidiaries at the end of 2009 (2008: 23 per cent).

Market risk of insurance operations

Market risk includes interest rate risk, equity risk and foreign exchange risk.

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

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

The proceeds from insurance and investment products with DPF are primarily invested in bonds with a proportion allocated to equity securities in order to provide customers with the potential for enhanced returns. Subsidiaries with portfolios of such products are exposed to the risk of falls in the market price of equity securities when they cannot be fully reflected in the discretionary bonuses. An increase in market volatility could also result in an increase in the value of the guarantee to the policyholder.

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

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

The group's insurance manufacturing subsidiaries manage market risk by using some or all of the following techniques:

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

Group Insurance Head Office includes a Chief Market and Liquidity Risk Officer reporting to the Chief Risk Officer. The Regional Insurance Head Office also includes an individual responsible for market and liquidity risk.

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

The standard measures used to quantify the market risks are as follows:

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

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

The group recognises these limitations and augments its standard measures with stress tests which examine the effect of a range of market rate scenarios on the aggregate annual profits and total equity of the insurance manufacturing subsidiaries. The group's insurance manufacturing subsidiaries report the results of their stress tests every quarter to Group Insurance Head Office, where the reports are consolidated and reviewed by the Group Insurance Market and Liquidity Risk Meeting and the Group Stress Test Review Group.

The following table illustrates the effect on the aggregated profit for the year and total equity under various interest rate, equity price and credit spread scenarios. Where appropriate, the impact of the stress on the PVIF is included in the results of the stress tests. The relationship between the values of certain assets and liabilities and the risk factors may be non-linear and, therefore, the results disclosed cannot be extrapolated to measure sensitivities to different levels of stress. The sensitivities are stated before allowance for the effect of management actions which may mitigate changes in market rates, and for any factors such as policyholder behaviour that may change in response to changes in market risk.

Sensitivity of the group's insurance subsidiaries to risk factors

	2009		2008	
	Effect on profit for the year £m	**Effect on total equity £m**	Effect on profit for the year £m	Effect on total equity £m
+ 100 basis points parallel shift in yield curves	**10**	**(12)**	32	10
– 100 basis points parallel shift in yield curves	**(14)**	**10**	(38)	(17)
10 per cent increase in equity prices	**7**	**7**	3	3
10 per cent decrease in equity prices	**(7)**	**(7)**	(4)	(4)
Sensitivity to credit spread increases	**(1)**	**(5)**	(2)	(8)

The sensitivity of the net profit after tax of the group's insurance subsidiaries to the effects of increases in credit spreads is a fall of £1 million (2008: £2 million fall). The sensitivity is calculated using simplified assumptions based on a one-day movement in credit spreads over a two-year period. A confidence level of 99 per cent, consistent with the Group's VAR, has been applied. There was some volatility in credit spreads but generally credit spreads have improved during 2009.

Credit risk of insurance operations

Credit risk can give rise to losses through default and can lead to volatility in income statement and balance sheet figures through movements in credit spreads, principally on the 11.3 billion (2008: 10.7 billion) non-linked bond portfolio. The exposure of the income statement to the effect of changes in credit spreads is small (see table above). 91 per cent (2008: 89 per cent) of the financial assets held by insurance subsidiaries are classified as available for sale, and consequently any changes in the fair value of these financial investments would have no impact on the profit after tax to the extent that the financial assets are not deemed impaired.

The HSBC Group Insurance Head Office includes a Chief Credit Risk Officer reporting to the Chief Risk Officer. The Regional Insurance Head Office also includes an individual responsible for credit risk.

The exposure to credit risk products and the management of the risks associated with credit protection products are included in the analyses of life and non-life insurance risk in 'Insurance risk' above.

Management of the group's insurance manufacturing subsidiaries is responsible for the credit risk, quality and performance of their investment portfolios. Investment credit mandates and limits are set locally by the insurance manufacturing subsidiaries and approved by their local insurance ALCO and Credit Risk function before being submitted to HSBC Group Credit Risk for concurrence. The form and content of the mandates must accord with centrally-set investment credit risk guidance regarding credit quality, industry sector concentration and liquidity restrictions, but allow for local regulatory and country-specific conditions. The assessment of creditworthiness of issuers and counterparties is based primarily upon internationally recognised credit ratings and other publicly available information.

Investment credit exposures are monitored against limits by the local insurance manufacturing subsidiaries, and are aggregated by the Regional Head Office and reported to the HSBC Group Credit Risk function, the Group Insurance

Notes on the Financial Statements (continued)

Credit Risk Meeting and the Group Insurance Risk Committee. Stress testing is performed by the HSBC Group Insurance Head Office on the investment credit exposures using credit spread sensitivities and default probabilities. The stresses are reported to the HSBC Group Insurance Credit Risk Committee.

Under certain circumstances the group is able to dilute the effect of investment losses by sharing them with policyholders. However, when, for example, a contract includes a guarantee, losses which would result in a breach of the guaranteed benefits due to the policyholder are borne by the group.

A number of tools are used to manage and monitor credit risk. These include an Early Warning Report which is produced on a weekly basis to identify investments which may be at risk of future impairment. This report is circulated to senior management in Group Insurance Head Office and the Regional Chief Risk Officers, and risk reduction strategies are implemented when considered appropriate. Similarly a Watch List of investments with current credit concerns is circulated weekly.

Credit quality

The following table presents an analysis of treasury bills, other eligible bills and debt securities within the group's insurance business by measures of credit quality. The definitions of the four credit quality classifications are provided on pages 140 and 141. Only assets supporting non-linked liabilities are included in the table as financial risk on assets supporting linked liabilities is predominantly borne by the policyholder.

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

	Neither past due nor impaired						
	Strong £m	Medium £m	Sub-standard £m	Past due not impaired £m	Impaired[1] £m	Impairment allowances £m	Total £m
At 31 December 2009							
Supporting liabilities under non-linked insurance and investment contracts							
Financial assets designated at fair value	**430**	**383**	**–**	–	–	–	**813**
– treasury and other eligible bills	**5**	**–**	**–**	–	–	–	**5**
– debt securities	**425**	**383**	**–**	–	–	–	**808**
Financial investments	**9,164**	**277**	**–**	–	–	–	**9,441**
– treasury and other similar bills	**224**	**–**	**–**	–	–	–	**224**
– debt securities	**8,940**	**277**	**–**	–	–	–	**9,217**
	9,594	**660**	**–**	–	–	–	**10,254**
Supporting shareholders' funds[2]							
Financial assets designated at fair value	**79**	**79**	**–**	–	–	–	**158**
– treasury and other eligible bills	**2**	**–**	**–**	–	–	–	**2**
– debt securities	**77**	**79**	**–**	–	–	–	**156**
Financial investments	**845**	**–**	**–**	–	–	–	**845**
– treasury and other similar bills	**129**	**–**	**–**	–	–	–	**129**
– debt securities	**716**	**–**	**–**	–	–	–	**716**
	924	**79**	**–**	–	–	–	**1,003**
Total							
Financial assets designated at fair value	**509**	**462**	**–**	**–**	**–**	**–**	**971**
– treasury and other eligible bills	**7**	**–**	**–**	**–**	**–**	**–**	**7**
– debt securities	**502**	**462**	**–**	**–**	**–**	**–**	**964**
Financial investments	**10,009**	**277**	**–**	**–**	**–**	**–**	**10,286**
– treasury and other similar bills	**353**	**–**	**–**	**–**	**–**	**–**	**353**
– debt securities	**9,656**	**277**	**–**	**–**	**–**	**–**	**9,933**
	10,518	**739**	**–**	–	–	–	**11,257**

Notes on the Financial Statements (continued)

	Neither past due nor impaired						
	Strong £m	Medium £m	Sub-standard £m	Past due not impaired £m	Impaired[1] £m	Impairment allowances £m	Total £m
At 31 December 2008							
Supporting liabilities under non-linked insurance and investment contracts							
Financial assets designated at fair value	368	151	–	–	–	–	519
– treasury and other eligible bills	17	–	–	–	–	–	17
– debt securities	351	151	–	–	–	–	502
Financial investments	9,133	195	–	–	–	–	9,328
– treasury and other similar bills	270	–	–	–	–	–	270
– debt securities	8,863	195	–	–	–	–	9,058
	9,501	346	–	–	–	–	9,847
Supporting shareholders' funds[2]							
Financial assets designated at fair value	702	12	–	–	–	–	714
– treasury and other eligible bills	5	–	–	–	–	–	5
– debt securities	697	12	–	–	–	–	709
Financial investments	173	–	–	–	–	–	173
– treasury and other similar bills	168	–	–	–	–	–	168
– debt securities	5	–	–	–	–	–	5
	875	12	–	–	–	–	887
Total							
Financial assets designated at fair value	1,070	163	–	–	–	–	1,233
– treasury and other eligible bills	22	–	–	–	–	–	22
– debt securities	1,048	163	–	–	–	–	1,211
Financial investments	9,306	195	–	–	–	–	9,501
– treasury and other similar bills	438	–	–	–	–	–	438
– debt securities	8,868	195	–	–	–	–	9,063
	10,376	358	–	–	–	–	10,734

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

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

	Treasury bills £m	**Other eligible bills £m**	**Debt securities £m**	**Total £m**
At 31 December 2009				
Governments	**106**	**4**	**3,198**	**3,308**
Local authorities	**–**	**–**	**173**	**173**
Corporates and other	**82**	**168**	**7,526**	**7,776**
	188	**172**	**10,897**	**11,257**

	Treasury bills £m	**Other eligible bills £m**	**Debt securities £m**	**Total £m**
At 31 December 2008				
Governments	187	16	2,361	2,564
Local authorities	–	–	151	151
Corporates and other	–	257	7,762	8,019
	187	273	10,274	10,734

Notes on the Financial Statements (continued)

Credit risk also rises when part of the insurance risk incurred by the group is assumed by reinsurers. The credit risk exposure to reinsurers is monitored by the Regional Insurance Office and the HSBC Group Insurance Head Office and is reported quarterly to the Group Insurance Risk Committee and the Group Insurance Credit Risk Meeting. The split of liabilities ceded to reinsurers and outstanding reinsurance recoveries, analysed by credit quality, is shown below. The definitions of the four credit quality classifications are provided on pages 140 and 141. The group's exposure to third parties under the reinsurance agreements is included in this table.

Reinsurers' share of liabilities under insurance contracts

	Neither past due nor impaired						
	Strong £m	Medium £m	Sub-standard £m	Past due not Impaired £m	Impaired £m	Impairment allowances £m	Total £m
At 31 December 2009							
Linked insurance contracts	**17**	**–**	**–**	**–**	**–**	**–**	**17**
Non-linked insurance contracts	**380**	**8**	**2**	**–**	**–**	**–**	**390**
Total	**397**	**8**	**2**	**–**	**–**	**–**	**407**
Reinsurance debtors	**9**	**–**	**–**	**1**	**–**	**–**	**10**
At 31 December 2008							
Linked insurance contracts	7	–	–	–	–	–	7
Non-linked insurance contracts	602	9	–	–	–	–	611
Total	609	9	–	–	–	–	618
Reinsurance debtors	11	–	–	–	–	–	11

Liquidity risk of insurance operations

It is an inherent characteristic of almost all insurance contracts that there is uncertainty over the amount of claims liabilities that may arise, and the timing of their settlement, and this leads to liquidity risk. There is a greater spread of expected maturities for the life business where, in a large proportion of cases, the liquidity risk is borne in conjunction with policyholders (wholly in the case of unit-linked business).

To fund the cash outflows arising from claims liabilities, group's insurance manufacturing subsidiaries primarily fund cash outflows from the following sources:

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

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

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

Every quarter, the group's insurance manufacturing subsidiaries are required to complete and submit liquidity risk reports to Group Insurance Head Office for collation and review by the Group Insurance Market and Liquidity Risk Meeting. In addition, each insurance operation is required to maintain a Liquidity Contingency Plan reviewed at least annually by the relevant ALCO.

Notes on the Financial Statements (continued)

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

Expected maturity of insurance contract liabilities

	Expected cash flows (undiscounted)				
	Within 1 year £m	1-5 years £m	5-15 years £m	Over 15 years £m	Total £m
At 31 December 2009					
Non-life insurance	**396**	**336**	**27**	**–**	**759**
Life insurance (non-linked)	**364**	**600**	**445**	**268**	**1,677**
Life insurance (linked)	**90**	**248**	**562**	**628**	**1,528**
Total	**850**	**1,184**	**1,034**	**896**	**3,964**
At 31 December 2008					
Non-life insurance	456	407	19	–	882
Life insurance (non-linked)	732	618	570	301	2,221
Life insurance (linked)	80	233	475	453	1,241
Total	1,268	1,258	1,064	754	4,344

Remaining contractual maturity of investment contract liabilities

	Liabilities under investment contracts by insurance underwriting subsidiaries			
	Linked investment contracts £m	Non-linked investment contracts £m	Investment contracts with DPF £m	Total £m
At 31 December 2009				
Remaining contractual maturity:				
– due within 1 year	**287**	**–**	**–**	**287**
– due between 1 and 5 years	**558**	**–**	**–**	**558**
– due between 5 and 10 years	**400**	**–**	**–**	**400**
– due after 10 years	**1,290**	**–**	**–**	**1,290**
– undated[1]	**1,445**	**26**	**12,930**	**14,401**
Total	**3,980**	**26**	**12,930**	**16,936**
At 31 December 2008				
Remaining contractual maturity:				
– due within 1 year	117	–	–	117
– due between 1 and 5 years	419	–	–	419
– due between 5 and 10 years	330	–	–	330
– due after 10 years	1,123	–	–	1,123
– undated[1]	1,627	24	12,157	13,808
Total	3,616	24	12,157	15,797

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

Present value of in-force long-term insurance business

The group's life insurance business is accounted for using the embedded value approach which, *inter alia*, provides a comprehensive framework for the evaluation of insurance and related risks. The present value of the in-force long-term ('PVIF') asset at 31 December 2009 was £630 million (2008: 579 million). The present value of the shareholders' interest in the profits expected to emerge from the book of in-force policies at 31 December can be stress-tested to assess the ability of the life business book to withstand adverse developments. A key feature of the life insurance business is the importance of managing the assets, liabilities and risks in a coordinated fashion rather than individually. This reflects greater interdependence of these three elements for life insurance than is generally the case for non-life insurance.

The following table shows the effect on the PVIF of reasonably possible changes in the main economic assumptions, namely the risk-free and risk discount rates, across all insurance manufacturing subsidiaries.

Notes on the Financial Statements (continued)

Sensitivity of PVIF to changes in economic assumptions

	PVIF at 31 December	
	2009	2008
	£m	£m
+ 100 basis points shift in risk-free rate	**17**	15
– 100 basis points shift in risk-free rate	**(18)**	(14)
+ 100 basis points shift in risk discount rate	**(22)**	(26)
– 100 basis points shift in risk discount rate	**27**	28

Due to certain characteristics of the contracts, the relationships may be non-linear and the results of the stress-testing disclosed above should not be extrapolated to higher levels of stress. In calculating the various scenarios, all assumptions are held stable except when testing the effect of the shift in the risk-free rate, when consequential changes to investment returns, risk discount rates and bonus rates are also incorporated. The sensitivities shown are before actions that could be taken by management to mitigate effects and before consequential changes in policyholder behaviour.

Non-economic assumptions

The policyholder liabilities and PVIF are determined by reference to non-economic assumptions which include, for non-life manufacturers, claims costs and expense rates and, for life manufacturers, mortality and/or morbidity, lapse rates and expense rates. The table below shows the sensitivity of profit for the year to, and total equity at, 31 December 2009 to reasonably possible changes in these non-economic assumptions at that date across all insurance manufacturing subsidiaries, with comparatives for 2008.

The cost of claims is a risk associated with non-life insurance business. An increase in claims costs would have a negative effect on profit.

Mortality and morbidity risk is typically associated with life insurance contracts. The effect of an increase in mortality or morbidity on profit depends on the type of business being written. For a portfolio of term assurance contracts, an increase in mortality usually has a negative effect on profit as the number of claims increases. For a portfolio of annuity contracts, an increase in mortality rates typically has a positive effect on profit as the period over which the benefit is being paid to the policyholder is shortened. However, when an annuity contract includes life cover, the positive effect on profit of the increase in mortality may be offset by the benefits payable under the life insurance.

Sensitivity to lapse rates is dependent on the type of contracts being written. For insurance contracts, the cost of claims is funded by premiums received and income earned on the investment portfolio supporting the liabilities. For a portfolio of term assurance, an increase in lapse rates typically has a negative effect on profit due to the loss of future premium income on the lapsed policies. For a portfolio of annuity contracts, an increase in lapse rates has a positive effect on profit as the obligation to pay future benefits on the lapsed contracts is extinguished.

Expense rate risk is the exposure to a change in expense rates. To the extent that increased expenses cannot be passed on to policyholders, an increase in expense rates will have a negative impact on profits.

Sensitivity to changes in non-economic assumptions

	Profit for the year to 31 December 2009 £m	**Total equity at 31 December 2009 £m**	Profit for the year to 31 December 2008 £m	Total equity at 31 December 2008 £m
20 % increase in claims costs	**(69)**	**(69)**	(34)	(34)
20 % decrease in claims costs	**69**	**69**	34	34
10 % increase in mortality and/or morbidity rates	**(15)**	**(15)**	(2)	(2)
10 % decrease in mortality and/or morbidity rates	**15**	**14**	4	4
50 % increase in lapse rates	**(107)**	**(107)**	(84)	(84)
50 % decrease in lapse rates	**169**	**170**	130	130
10 % increase in expense rates	**(19)**	**(20)**	(19)	(19)
10 % decrease in expense rates	**20**	**20**	18	18

Notes on the Financial Statements (continued)

Special purpose entities (including on-and off-balance sheet arrangements)

The group enters into certain transactions with customers in the ordinary course of business which involve the establishment of special purpose entities ('SPEs') to facilitate or secure customer transactions, some of which have been included in the group's consolidated balance sheet. The group's structures that utilise SPEs are authorised centrally when they are established to ensure appropriate purpose and governance. The activities of SPEs administered by the group are closely monitored by senior management.

The group sponsors the formation of entities which are designed to accomplish certain narrow and well-defined objectives, such as securitising financial assets or affecting a lease, and this requires a form of legal structure that restricts the assets and liabilities within the structure to the single purpose for which it was established. The group consolidates these SPEs when the substance of the relationship indicates that the group controls them. In assessing control, all relevant factors are considered, including qualitative and quantitative aspects. The group re-assesses the required consolidation accounting tests whenever there is a change in the substance of the relationship between the group and an SPE. The most significant categories of SPE are discussed in more detail below.

Structured investment vehicles and conduits

Structured Investment Vehicles ('SIVs')

SIVs are SPEs which invest in diversified portfolios of interest-earning assets, generally funded through issues of commercial paper ('CP'), medium term notes ('MTN') and other senior debt to take advantage of the spread of differentials between the assets in the SIV and the funding cost. Prior to the implementation of Basel II, it was capital efficient to many bank investors to invest in highly-rated investment securities in this way. The group sponsored establishment of two SIVs, Cullinan Finance Limited ('Cullinan') and Asscher Finance Limited ('Asscher') which are now in the process of voluntary liquidation following completion of the transfer of their portfolios of investment securities and derivatives to the three new Structured investment conduits ('SIC's) established in 2008 in order to remove the risk of having to make forced asset sales. Mazarin funding Limited ('Mazarin') an asset backed CP conduit and Barion funding Limited ('Barion') a term funding vehicle were set up in respect of Cullinan; and Malachite funding Limited ('Malachite') a term funding vehicle was set up in respect of Asscher.

At 31 December 2009, all the capital notes in Cullinan and Asscher had been redeemed and replaced by capital notes in the new SICs (2008: 8.7 per cent of Asscher's capital notes remained outstanding).

Conduits

The group sponsors and manages two types of conduits which issue CP; multi-seller conduits and SICs. The group has consolidated these conduits from inception because it is exposed to the majority of risks and rewards of ownership.

Securities investment conduits

Solitaire purchases highly rated ABSs to facilitate tailored investment opportunities. The group's other SICs, Mazarin, Barion and Malachite, evolved from the restructuring of the group's sponsored SIVs as discussed above.

Multi-seller conduits

These vehicles were established for the purpose of providing access to flexible market-based sources of finance for the group's clients for example, to finance discrete pools of third-party originated trade and vehicle finance loan receivables.

Money market funds

The group has established, manages and has investments in a number of money market funds which seek to provide customers with tailored investment opportunities with a set of narrow and well-defined objectives. The group consolidates a fund when the group's holding is of sufficient size to represent the majority of the risks and rewards of ownership or when the substance of the relation indicates that the group controls the fund.

Securitisations

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

Other SPEs

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

Structured credit transactions

The group provides structured credit transactions to third party professional and institutional investors who wish to obtain exposure, sometimes on a leveraged basis, to a reference portfolio of debt instruments. In such structures, the investor receives returns referenced to the underlying portfolio by purchasing notes issued by the SPEs. The group enters into contracts with the SPEs, generally in the form of derivatives, in order to pass the required risks and rewards of the reference portfolios to the SPEs. The group's risk in relation to the derivative contracts with the SPEs is managed within the group's trading market risk framework.

Other uses of SPEs

The group participates in Public-Private Partnerships to provide financial support for infrastructure projects initiated by government authorities. The funding structure is commonly achieved through the use of SPEs. The group consolidates these SPEs when it is exposed to the majority of risks and rewards of the vehicles.

The group's Asset and Structured Finance ('ASF') business specialises in leasing and arranging finance for aircraft and other physical assets, which it is customary to ring-fence through the use of SPEs, and in structured loans and deposits, where SPEs introduce cost efficiencies. The group consolidates these SPEs when the substance of the relationship indicates that the group controls the SPE.

Third party sponsored SPEs

The group's exposure to third party sponsored SIVs, conduits and securitisations have arisen through normal banking arrangements on standard market terms.

Other off-balance sheet arrangements

Financial guarantees, letters of credit and similar undertakings

Note 38 describes various types of guarantees and discloses the maximum potential future payments under such arrangements.

Commitments to lend

The group generally has the right to change or terminate any conditions of a personal customer's overdraft, credit card or other credit line upon notification to the customer. In respect of corporate commitments to lend, in most cases the group's position will be protected through restrictions on access to funding in the event of material adverse change.

Leveraged finance transactions

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

Notes on the Financial Statements (continued)

38 Contingent liabilities, contractual commitments and guarantees

	The group		The bank	
	2009	2008	**2009**	2008
	£m	£m	**£m**	£m
Guarantees and other contingent liabilities				
Guarantees and irrevocable letters of credit pledged as collateral security	**20,971**	21,310	**13,507**	13,787
Other contingent liabilities	**32**	110	**–**	–
	21,003	21,420	**13,507**	13,787
Commitments[1]				
Documentary credits and short-term trade-related transactions	**1,515**	2,204	**495**	861
Forward asset purchases and forward forward deposits placed	**492**	493	**–**	–
Undrawn formal standby facilities, credit lines and other commitments to lend[2]	**114,076**	151,694	**83,036**	102,626
	116,083	154,391	**83,531**	103,487

1 *Excluding capital commitments, which are separately disclosed below.*
2 *Based on original contractual maturity.*

The table above discloses the nominal principal amounts of commitments, guarantees and other contingent liabilities. They are mainly credit-related instruments which include both financial and non-financial guarantees and commitments to extend credit. Nominal principal amounts represent the amounts at risk should contracts be fully drawn upon and clients default. As a significant portion of guarantees and commitments is expected to expire without being drawn upon, the total of these nominal principal amounts is not representative of future liquidity requirements.

Contingent liabilities arising from litigation against the group are disclosed in Note 40.

Financial Services Compensation Scheme

The Financial Services Compensation Scheme ('FSCS') has provided compensation to consumers following the collapse of a number of deposit takers such as Bradford & Bingley plc, Heritable Bank plc, Kaupthing Singer & Friedlander Limited, Landsbanki 'Icesave', London Scottish Bank plc and Dunfermline Building Society. The compensation paid out to consumers is currently funded through loans from the Bank of England and HM Treasury. The bank could be liable to pay a proportion of the outstanding borrowings that the FSCS has borrowed from HM Treasury which at 30 September 2009 stood at approximately £20 billion. The bank is also obligated to pay its share of forecast management expenses based on the bank's market share of deposits protected under the FSCS.

The bank has expensed £142 million to date, as at 31 December 2009, in respect of the share of forecast management expense, including interest costs, for the 2008/9, 2009/10 and 2010/11 levy years. The fee in respect of the 2008/9 levy year was paid during the second half of 2009.

At 31 December 2009, the bank had accrued £112 million in respect of the 2009/10 and 2010/11 levy years, based on the bank's estimated share of total market protected deposits at 31 December 2008 and 2009, respectively.

At 31 December 2008, the bank had accrued £86 million in respect of the 2008/9 and 2009/10 levy years, based on the bank's estimated share of total market protected deposits at 31 December 2007 and 2008, respectively.

However, the ultimate FSCS levy to the industry as a result of the 2008 (and 2009) collapses cannot currently be estimated reliably as it is dependent on various uncertain factors including the potential recoveries of assets by the FSCS and changes in the interest rate, the level of protected deposits and the population of FSCS members at the time.

Notes on the Financial Statements (continued)

Payment Protection Insurance Sales

On 1 July 2008 the Financial Ombudsman Service ('FOS') wrote to the Financial Services Authority ('FSA') to draw to its attention under the 'Wider Implications' process the issues arising from past payment protection insurance ('PPI') sales. The FOS considered that there was evidence of widespread and regular failure on the part of many firms to comply with the FSA's rules and insurance law in the sale of PPI and that, in the circumstances, simply allowing consumers individually to bring complaints was not the right way to tackle what it regarded as a systemic problem. The FOS therefore called upon the FSA to frame and implement an appropriate regulatory solution which would ensure that firms took appropriate and proportionate remedial action.

On 29 September 2009, the FSA published a Consultation Paper ('CP (09/23)') setting out proposals, and draft Rules and Guidance, on how firms should assess PPI complaints and, where they upheld such complaints, calculate redress. At the same time, it also published an open letter to eight trade associations, including the British Bankers Association, setting out what it considered to be common failings by firms in sales of PPI. When announcing the publication of CP (09/23), the FSA also reported that it had obtained agreement from firms representing 40 per cent of the market for face to face single premium PPI sales to review all such sales since July 2007. No HSBC company was included in that group of firms.

The Consultation Paper anticipated new FSA rules and guidance covering how firms should deal with PPI complaints with effect from the beginning of 2010. However, the FSA subsequently announced that, owing to the large number of responses it had received to the Consultation Paper, this date would be deferred to give it sufficient opportunity to fully consider those responses.

On 2 February 2010, the FSA stated that the course of action it will take in relation to PPI remains under consideration and that no final decision on the matter has yet been taken. The precise form and content of the FSA's final rules and guidance in relation to PPI complaint handling therefore remains unclear at this stage. In the circumstances, it is not possible for the bank to determine what impact, if any, the FSA's proposals will eventually have.

In December 2007, the bank decided to cease selling PPI (but not short-term income protection products) under its HSBC, first direct and M&S Money brands. A phased withdrawal was completed across these brands and channels in 2008.

Data Security

HSBC Private Bank (Suisse) is currently continuing to investigate a theft of client data which was widely reported in December 2009 as having been supplied to the French authorities. The theft appears to have taken place during a period preceding March 2007. The bank is working closely with the Swiss authorities and its regulator to establish the extent of data involved in the theft in order to protect the interests and rights of its clients and of the group and to further enhance its security policies and data protection practices.

Guarantees

The group provides guarantees and similar undertakings on behalf of both third party customers and other entities within the group. These guarantees are generally provided in the normal course of the group's banking business. The principal types of guarantees provided, and the maximum potential amount of future payments which the group could be required to make at 31 December, were as follows:

Notes on the Financial Statements (continued)

The group

	At 31 December 2009		At 31 December 2008	
	Guarantees in favour of third parties £m	**Guarantees by the group in favour of other group entities £m**	Guarantees in favour of third parties £m	Guarantees by the group in favour of other group entities £m
Guarantee type				
Financial guarantee contracts[1]	**10,051**	**927**	9,972	996
Standby letters of credit which are financial guarantee contracts[2]	**1,791**	**1**	791	57
Other direct credit substitutes[3]	**314**	**39**	244	3
Performance bonds[4]	**2,048**	**51**	2,395	43
Bid bonds[4]	**45**	**3**	75	2
Standby letters of credit related to particular transactions[4]	**444**	**–**	486	–
Other transaction-related guarantees[4]	**4,803**	**18**	5,891	26
Other items	**468**	**–**	439	–
Total	**19,964**	**1,039**	20,293	1,127

The bank

	At 31 December 2009		At 31 December 2008	
	Guarantees in favour of third parties £m	**Guarantees by the bank in favour of other group entities £m**	Guarantees in favour of third parties £m	Guarantees by the bank in favour of other group entities £m
Guarantee type				
Financial guarantee contracts[1]	**7,535**	**2,311**	7,057	2,693
Standby letters of credit which are financial guarantee contracts[2]	**5**	**–**	5	–
Performance bonds[4]	**734**	**48**	898	36
Bid bonds[4]	**12**	**3**	17	2
Standby letters of credit related to particular transactions[4]	**107**	**–**	76	–
Other transaction-related guarantees[4]	**2,290**	**26**	2,651	24
Other items	**436**	**–**	328	–
Total	**11,119**	**2,388**	11,032	2,755

1 *Financial guarantees contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss incurred because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. The amounts in the above table are nominal principal amounts.*
2 *Standby letters of credit which are financial guarantee contracts are irrevocable obligations on the part of the group and/or the bank to pay third parties when customers fail to make payments when due.*
3 *Other direct credit substitutes include reinsurance letters of credit and trade-related letters of credit issued without provision for the issuing entity to retain title to the underlying shipment.*
4 *Performance bonds, bid bonds, standby letters of credit and other transaction-related guarantees are undertakings by which the obligation on the group and/or the bank to make payment depends on the outcome of a future event.*

The amounts disclosed in the above table reflect the group's maximum exposure under a large number of individual guarantee undertakings. The risks and exposures arising from guarantees are captured and managed in accordance with the group's overall credit risk management policies and procedures. Guarantees with terms of more than one year are subject to the group's annual credit review process.

Other commitments

In addition to the commitments disclosed above, at 31 December 2009 the group had contractual commitments to purchase, within one year, land and buildings and other fixed assets from a number of suppliers for a value of £239 million (2008: £368 million).

The group had no contingent liabilities or commitments in relation to joint ventures or associates, incurred jointly or otherwise.

Notes on the Financial Statements (continued)

39 Lease commitments

Finance lease commitments

The group leases land and buildings (including branches) and equipment from third parties under finance lease arrangements to support its operations.

	2009			2008		
	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	**22**	**(19)**	**3**	21	(20)	1
Later than one year and no later than five years	**103**	**(77)**	**26**	97	(92)	5
Later than five years	**372**	**(110)**	**262**	504	(178)	326
	497	**(206)**	**291**	622	(290)	332

At 31 December 2009 future minimum sublease payments of £315 million (2008: £314 million) were expected to be received under non-cancellable subleases at the balance sheet date.

Operating lease commitments

At 31 December 2009, 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	
	2009 £m	2008 £m
Future minimum lease payments under non-cancellable operating leases expiring:		
– no later than one year	**173**	122
– later than one year and no later than five years	**608**	394
– later than five years	**1,182**	533
	1,963	1,049

In 2009, £113 million (2008: £105 million) was charged to ‘General and administrative expenses’ in respect of lease and sublease agreements, all of which related to minimum lease payments.

Finance lease receivables

HSBC leases a variety of assets to third parties under finance leases, including transport assets (such as aircraft), property and general plant and machinery. At the end of lease terms, assets may be sold to third parties or leased for further terms. Lessees may participate in any sales proceeds achieved. Lease rentals arising during the lease terms will either be fixed in quantum or be varied to reflect changes in, for example, tax or interest rates. Rentals are calculated to recover the cost of assets less their residual value, and earn finance income.

	2009			2008		
	Total future minimum payments £m	**Unearned finance income £m**	**Present value £m**	Total future minimum payments £m	Unearned finance income £m	Present value £m
Lease receivables:						
– no later than one year	**987**	**(111)**	**876**	1,209	(152)	1,057
– later than one year and no later than five years	**2,996**	**(486)**	**2,510**	2,829	(584)	2,245
– later than five years	**3,264**	**(951)**	**2,313**	4,367	(1,444)	2,923
	7,247	**(1,548)**	**5,699**	8,405	(2,180)	6,225

At 31 December 2009, unguaranteed residual values of £110 million (2008: £108 million) had been accrued, and the accumulated allowance for uncollectible minimum lease payments receivable amounted to £8 million (2008: £10 million).

Notes on the Financial Statements (continued)

In 2009, £51 million (2008: £22 million) was received as contingent rents and recognised in the income statement.

Operating lease receivables

The group leases a variety of different assets to third parties under operating and finance lease arrangements, including rolling stock, property, aircraft and general plant and machinery.

	Equipment	
	2009	2008
	£m	£m
Future minimum lease payments under non-cancellable operating leases expiring:		
– no later than one year	**267**	290
– later than one year and no later than five years	**565**	429
– later than five years	**276**	76
	1,108	795

In 2009, £2 million (2008: Nil) was received as contingent rents and recognised in 'Other operating income'.

At 31 December 2009, future minimum sublease payments of Nil (2008: Nil) are expected to be received under non-cancellable subleases at the balance sheet date.

40 Litigation

On 27 July 2007, the UK Office of Fair Trading ('OFT') issued High Court legal proceedings against a number of UK financial institutions, including HSBC Bank plc, to determine the legal status and enforceability of certain of the charges applied to their personal customers in relation to unauthorised overdrafts (the 'charges'). Pending the resolution of the proceedings, the Financial Services Authority ('FSA') granted firms (including HSBC Bank plc) a waiver enabling them to place relevant complaints about the charges on hold and the County Courts stayed all individual customer claims.

In a judgement given on 25 November 2009, the Supreme Court unanimously allowed the Banks' appeal against the Court of Appeal ruling given on 26 February 2009 and held that, provided the relevant charges were in plain and intelligible language, the amount of those charges could not be assessed for fairness under the Regulations by either the OFT or the Courts. This is because the charges are part of the price the customer pays for the package of banking services he receives in exchange, and hence an assessment of their amount is outside the scope of the Regulations.

While the Supreme Court left open the possibility that the terms could be challenged on some other basis HSBC Bank plc does not believe that any other realistic basis for challenge exists.

On 22 December 2009, the OFT announced that, following detailed consideration of the Supreme Court judgement, and discussions with consumer groups, campaigners, banks, the Government, the FSA and the Financial Ombudsman Service, it would not be continuing the investigation it began, in March 2007, into the fairness of unauthorised overdraft charges, as, were the investigation to continue, it would have a very limited scope and low prospects of success. The OFT also decided not to investigate the charges using certain other enforcement tools. Its initial assessment was that there were not good grounds for concluding that a collective challenge alleging breach of such other provisions generally would have good prospects of success. The OFT also confirmed that it would address its ongoing concerns, about the operation of the market for personal current accounts, by discussing the issues with banks, consumer groups and other organisations, with the aim of reporting on progress by the end of March 2010.

The Supreme Court judgment means that the legal proceedings between the OFT and the banks relating to unauthorised overdraft charges are concluded. Accordingly, the FSA confirmed, on 25 November 2009, the waiver enabling firms to place relevant charges on hold had therefore lapsed. Normal complaint handling rules therefore applied.

On 11 December 2008, Bernard L. Madoff ('Madoff') was arrested and charged in the United States District Court for the Southern District of New York with one count of securities fraud. That same day, the Securities and Exchange Commission ('SEC') filed securities fraud charges against Madoff and his firm Bernard L. Madoff Investment Securities LLC ('Madoff Securities'), a broker dealer and investment advisor registered with the SEC. The criminal complaint and SEC complaint each alleged that Madoff had informed senior Madoff Securities employees, in substance, that his investment advisory business was a fraud. On 15 December 2008, on the application of the Securities Investor Protection Corporation, the United States District Court for the Southern District of New York appointed a trustee for the liquidation of the business of Madoff Securities, and removed the liquidation proceeding to the United States Bankruptcy Court for the Southern District of New York. The Madoff Securities trustee has begun processing claims filed by investors allegedly damaged by the Madoff fraud. On 9 February 2009, on Madoff's consent, the United States District Court for the Southern District of New York entered a partial judgment in the SEC action, permanently enjoining Madoff from violating certain antifraud provisions of the U.S. securities laws, ordering Madoff to pay disgorgement, prejudgment interest and a civil penalty in amounts to be determined at a later time, and continuing certain other relief previously imposed, including a freeze on Madoff's assets. On 12 March 2009, Madoff pleaded guilty to 11 felony charges, including securities fraud, investment advisor fraud, mail fraud, wire fraud, three counts of money laundering, false statements, perjury, false filings with the SEC, and theft from an employee benefit plan. On 29 June 2009, Madoff was sentenced to 150 years in prison, The relevant US authorities are continuing their investigations into the fraud, and have bought charges against others, including several Madoff Securities employees as well as its external auditor. Some details of the fraud have come to light as a result of these and other investigations and proceedings; however, significant uncertainty remains as to the facts of the fraud and the total amount of assets that will ultimately be available for distribution by the Madoff Securities trustee.

Various non-US HSBC group companies provide custodial, administration and similar services to a number of funds incorporated outside the United States of America whose assets were invested with Madoff Securities. Based on information provided by Madoff Securities, as at 30 November 2008, the aggregate net asset value of these funds (which would include principal amounts invested and unrealised gains) was £5.2 billion.

Proceedings concerning Madoff and Madoff Securities have been issued by different plaintiffs (including funds, fund investors, and the Madoff Securities trustee) in various jurisdictions against numerous defendants and the group expects further proceedings may be brought. Various group companies have been named as defendants in suits in the United States, Ireland, Luxembourg, and other jurisdictions. All of the cases where group companies are named as a defendant are at a very early stage. The group considers that it has good defences to these claims and will continue to defend them vigorously. The group is unable to reliably estimate the liability, if any, that might arise as a result of such claims.

Various group companies have also received requests for information from various regulatory and law enforcement authorities and from the Madoff Securities trustee, in connection with the alleged fraud by Madoff. The group companies are co-operating with these requests for information.

41 Related party transactions

The ultimate parent company of the group is HSBC Holdings plc, which is incorporated in England.
Copies of the Group financial statements may be obtained from the following address:

HSBC Holdings plc
8 Canada Square
London
E14 5HQ

The group's related parties include the parent, fellow subsidiaries, associates, joint ventures, post-employment benefit plans for HSBC employees, key management personnel, close family members of Key Management Personnel and entities which are controlled, jointly controlled or significantly influenced by Key Management Personnel or their close family members.

(a) Transactions with Directors and other Key Management Personnel

Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of HSBC Bank plc and the group and includes members of the Board of Directors of HSBC Bank plc and HSBC Holdings plc and Group Managing Directors of HSBC Holdings plc.

Notes on the Financial Statements (continued)

Compensation of Key Management Personnel

The following represents the compensation paid to the Key Management Personnel of the bank in exchange for services rendered to the bank.

	2009	2008
	£000	£000
Short-term employee benefits	**1,900**	4,231
Post-employment benefits	**–**	65
Termination benefits	**–**	–
Share-based payments	**1,177**	2,357
	3,077	6,653

Shareholdings and options of Directors' and other Key Management Personnel

	Balance at 31 December 2009	Balance at 31 December 2008
Number of share options from equity participation plans held by Directors and other key management personnel (and their connected persons)	**1,033,662**	1,033,747
Number of shares held by Directors and other key management personnel (and their connected persons)	**20,094,864**	17,498,156

Transactions, arrangements and agreements including Directors and other Key Management Personnel

The table below set out transactions which fall to be disclosed under IAS 24 'Related Party Disclosures' between the group and the Key Management Personnel of both the bank and its parent company, HSBC Holdings plc, and their connected persons or controlled companies.

	2009		2008	
	Highest balance during the year[1]	**Balance at 31 December[1]**	Highest balance during the year[1]	Balance at 31 December[1]
	£000	**£000**	£000	£000
Key Management Personnel and connected persons and companies controlled by them				
Loans	**877,944**	**453,707**	103,594	49,776
Credit cards	**3,453**	**224**	452	196
Guarantees	**20,984**	**19,589**	6,753	5,684

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

The above transactions were made in the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with persons of a similar standing or, where applicable, with other employees. The transactions did not involve more than the normal risk of repayment or present other unfavourable features.

Transactions, arrangements and agreements including Directors (Companies Act 2006)

In addition to the requirements of IAS 24, particulars of transactions, arrangements and agreements entered into by HSBC Bank plc and its subsidiaries with Directors of HSBC Bank plc are required to be disclosed pursuant to section 413 of the Companies Act 2006. Under the Companies Act there is no requirement to disclose transactions with the Key Management Personnel of the bank's parent company, HSBC Holdings plc.

The table below sets out transactions which fall to be disclosed under section 413 of Companies Act 2006.

Notes on the Financial Statements (continued)

The group

	2009 Balance at 31 December £000	2008 Balance at 31 December £000
Directors		
Loans	**2,242**	1,690
Credit cards	**52**	65
Guarantees	**–**	–

(b) Transactions with other related parties

Associates and joint ventures

The group

	2009		2008	
	Highest balance during the year[1] £m	**Balance at 31 December 2009[1] £m**	Highest balance during the year[1] £m	Balance at 31 December 2008[1] £m
Amounts due from joint ventures				
– unsubordinated	**170**	**170**	202	110
Amounts due from associates				
– unsubordinated	**45**	**45**	–	–
Amounts due to joint ventures	**12**	**8**	20	12
Amounts due to associates	**–**	**–**	1	–

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

The bank

	2009		2008	
	Highest balance during the year[1] £m	**Balance at 31 December 2009[1] £m**	Highest balance during the year[1] £m	Balance at 31 December 2008[1] £m
Amounts due from joint ventures				
– unsubordinated	**170**	**170**	161	110
Amounts due from associates				
– unsubordinated	**45**	**45**	–	–
Amounts due to joint ventures	**10**	**–**	12	10
Amounts due to associates	**–**	**–**	1	–

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Notes on the Financial Statements (continued)

Transactions of the group with HSBC Holdings plc and fellow subsidiaries of HSBC Holdings plc

Transactions detailed below include amounts due to/from HSBC Holdings plc.

	2009		2008	
	Highest balance during the year[1] £m	**Balance at 31 December 2009[1] £m**	Highest balance during the year[1] £m	Balance at 31 December 2008[1] £m
Assets				
Trading assets	**53**	**39**	214	53
Financial assets designated at fair value	**28**	**20**	21	21
Loans and advances to customers	**798**	**102**	343	56
Financial investments	**68**	**63**	58	58
Liabilities				
Trading liabilities	**40**	**15**	22	17
Customer accounts	**15,020**	**8,693**	8,582	3,406
Subordinated amounts due	**3,047**	**–**	3,047	3,047
Guarantees	**–**	**–**	–	–

	For the year ended 31 December 2009 £m	For the year ended 31 December 2008 £m
Income Statement		
Interest income	**1**	1
Interest expense	**117**	117
Dividend income	**13**	6
Trading income	**5**	–
Other operating income	**17**	18
General and administrative expenses	**114**	82

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

Transactions detailed below include amounts due to/from fellow subsidiaries of HSBC Holdings plc

	2009		2008	
	Highest balance during the year[1] £m	**Balance at the year end[1] £m**	Highest balance during the year[1] £m	Balance at the year end[1] £m
Assets				
Trading assets	**8,369**	**4,473**	9,718	8,369
Derivatives	**30,669**	**11,770**	72,434	30,669
Loans and advances to banks	**9,881**	**4,093**	5,444	5,267
Loans and advances to customers	**3,252**	**1,757**	3,252	3,252
Financial investments	**7,484**	**5,685**	7,277	7,277
Other assets	**2,282**	**1,307**	7,497	212
Liabilities				
Trading liabilities	**29,662**	**10,562**	25,241	25,241
Financial liabilities designated at fair value	**34**	**34**	–	–
Deposits by banks	**8,632**	**4,176**	9,116	7,594
Customer accounts	**1,585**	**952**	1,715	559
Derivatives	**29,022**	**12,218**	70,444	29,022
Guarantees	**1,009**	**927**	996	996

Notes on the Financial Statements (continued)

	For the year ended 31 December 2009 £m	For the year ended 31 December 2008 £m
Income Statement		
Interest income	**263**	495
Interest expense	**156**	269
Fee income	**175**	81
Fee expense	**197**	188
Trading income	**42**	392
Other operating income	**13**	15
General and administrative expenses	**206**	142

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Transactions between HSBC Bank plc and its subsidiaries, HSBC Holdings plc and fellow subsidiaries of HSBC Holdings plc

Transactions detailed below include amounts due to/from HSBC Bank plc and its subsidiaries.

	2009		2008	
	Highest balance during the year[1] £m	**Balance at the year end[1] £m**	Highest balance during the year[1] £m	Balance at the year end[1] £m
Assets				
Trading assets	**34,081**	**16,390**	36,824	27,184
Derivatives	**32,375**	**20,311**	56,747	32,375
Loans and advances to banks	**6,595**	**4,046**	4,982	2,521
Loans and advances to customers	**21,106**	**21,106**	18,397	18,313
Financial investments	**2,670**	**1,680**	851	851
Liabilities				
Trading liabilities	**18,683**	**14,222**	19,690	11,479
Deposits by banks	**21,560**	**12,918**	21,560	21,560
Customer accounts	**11,849**	**11,243**	11,876	11,580
Derivatives	**33,368**	**18,255**	56,143	33,368
Subordinated amounts due	**622**	**–**	622	622
Guarantees	**2,139**	**1,474**	1,761	1,761

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

Transactions detailed below include amounts due to/from HSBC Bank plc and HSBC Holdings plc.

	2009		2008	
	Highest balance during the year[1] £m	**Balance at the year end[1] £m**	Highest balance during the year[1] £m	Balance at the year end[1] £m
Assets				
Trading assets	**53**	**39**	214	53
Loans and advances to customers	**798**	**102**	137	56
Liabilities				
Trading liabilities	**40**	**15**	22	17
Customer accounts	**15,011**	**8,378**	3,680	3,398
Subordinated amounts due	**3,047**	**–**	3,047	3,047
Guarantees	**–**	**–**	–	–

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

Notes on the Financial Statements (continued)

Transactions detailed below include amounts due to/from HSBC Bank plc and fellow subsidiaries of HSBC Holdings plc.

	2009		2008	
	Highest balance during the year[1]	**Balance at the year end[1]**	Highest balance during the year[1]	Balance at the year end[1]
	£m	**£m**	£m	£m
Assets				
Trading assets	**7,486**	**4,166**	9,258	7,486
Derivatives	**24,290**	**11,220**	43,907	23,192
Loans and advances to banks	**8,437**	**2,763**	4,557	3,662
Loans and advances to customers	**3,085**	**1,640**	3,085	3,085
Other assets	**437**	**28**	3,561	231
Liabilities				
Trading liabilities	**27,857**	**10,348**	23,613	23,613
Deposits by banks	**5,130**	**3,585**	5,980	3,146
Customer accounts	**1,371**	**819**	1,418	378
Derivatives	**21,559**	**11,435**	38,799	21,559
Guarantees	**933**	**837**	931	931

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Pension funds

At 31 December 2009, fees of £5 million (2008: £10.9 million) were earned by group companies for management services related to the group's pension funds held under management. The group's pension funds had placed deposits of £531 million (2008: £281 million) with its banking subsidiaries.

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

In the first half of 2009, a gain of £322 million was recognised by the bank following a restructuring of the basis of delivery of death in service and ill health early retirement benefits to certain UK employees. These benefits were provided by the HSBC Bank (UK) Pension Scheme (the 'Scheme') but will now be provided outside of the scheme.

The Scheme entered into swap transactions with the bank to manage the inflation and interest rate sensitivity of the liabilities. At 31 December 2009, the gross notional value of the swaps was £14,617 million (2008: £12,132 million), the swaps had a negative fair value of £647 million to the bank (2008: negative fair value of £1,220 million) and the bank had delivered collateral of £1,729 million (2008: £1,682 million) to the Scheme in respect of these swaps. All swaps were executed at prevailing market rates and within standard market bid/offer spreads.

In order to satisfy diversification requirements, the Trustee has requested special collateral provisions for the swap transactions between the bank and the Scheme. The collateral agreement stipulates that the Scheme never posts collateral to the bank. Collateral is posted to the Scheme by the bank at an amount that the Trustee is highly confident would be sufficient to replace the swaps in the event of default by the bank. Under the terms of the agreement, increases in collateral when required, are posted by the bank on a daily basis and any reductions of collateral are repaid to the bank on a monthly basis.

With the exception of the special collateral arrangements detailed above, all other aspects of the swap transactions between the bank and the Scheme are on substantially the same terms as comparable transactions with third party counterparties.

In March 2009, the group purchased the minority interests in HSBC Private Bank (Suisse) SA which was owned by HSBC Investor PBRS Corporation (Delaware) a direct subsidiary of HSBC Bank USA, National Association for a cash consideration of £247m.

Notes on the Financial Statements (continued)

42 Events after the balance sheet date

There have been no material events after the balance sheet date which would require disclosure or adjustment to the 31 December 2009 financial statements.

These accounts were approved by the Board of Directors on 1 March 2010 and authorised for issue.

HSBC BANK PLC
Incorporated in England with limited liability. Registered in England: number 14259

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