

## **PRESENTATION OF INFORMATION**

This document comprises additional information regarding HSBC Bank plc ('the bank') and its subsidiary undertakings (together 'the group'). References to 'HSBC' or 'the Group' within this document mean HSBC Holdings plc together with its subsidiaries.

## Operating and Financial Review

### Income statement data

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. The inclusion of acquisitions and disposals in the underlying results is determined in the light of events each year.

### *Profit before tax (reported basis)*

	2009 £m	2008 £m	2007 £m
Net interest income.....	8,091	5,697	3,854
Net fee income .....	4,077	3,957	4,184
Net trading income .....	2,626	2,967	3,487
Net income/(expense) from financial instruments designated at fair value .....	543	(1,097)	126
Gains less losses from financial investments.....	(73)	82	552
Dividend income .....	29	85	43
Net earned insurance premiums .....	2,716	2,891	1,921
Other operating income .....	1,093	1,593	307
<b>Total operating income .....</b>	<b>19,102</b>	<b>16,175</b>	<b>14,474</b>
Net insurance claims incurred and movement in liabilities to policyholders.....	(3,540)	(1,835)	(1,674)
<b>Net operating income before loan impairment charges and other credit risk provisions .....</b>	<b>15,562</b>	<b>14,340</b>	<b>12,800</b>
Loan impairment charges and other credit risk provisions .....	(3,364)	(1,861)	(1,043)
<b>Net operating income .....</b>	<b>12,198</b>	<b>12,479</b>	<b>11,757</b>
Total operating expenses.....	(8,198)	(8,122)	(7,741)
<b>Operating profits .....</b>	<b>4,000</b>	<b>4,357</b>	<b>4,016</b>
Share of profit in associates and joint ventures .....	14	9	47
<b>Profit before tax.....</b>	<b>4,014</b>	<b>4,366</b>	<b>4,063</b>

### *2009 compared with 2008*

#### Economic briefing

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. GDP fell by 5 per cent in 2009 – the sharpest contraction in over 60 years – after a 0.5 per cent increase in 2008. Weakness affected most sectors of the economy, and the unemployment rate hit a 13-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 moving towards the Bank

of England's 2 per cent target by the end of the year. Nominal house prices appreciated modestly during the second half of 2009, 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 throughout the economy and support expectations of future economic activity. The eurozone economy also performed poorly during 2009, with GDP falling by 4 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. Consumer spending proved relatively resilient in early 2009, boosted by a number of purchase incentive schemes, and some weakness was observed as these programmes expired. Unemployment rose to an 11-year high of 10 per cent in December 2009, while CPI temporarily turned negative during the third quarter of the year. The European Central Bank cut interest rates by 150 basis points to finish the year at 1 per cent.

Reconciliation of reported and underlying profit before tax:

2009 compared with 2008								
	2008 As Reported £m	2008 Adjust- ments £m	2008 Under- lying £m	2009 As reported £m	2009 Adjust- ments £m	2009 Under- lying £m	Reported change %	Under- lying change %
Net interest income.....	5,697	(37)	5,660	8,091	-	8,091	42	43
Net fee income.....	3,957	(33)	3,924	4,077	-	4,077	3	4
Trading income.....	2,967	-	2,967	2,626	-	2,626	(11)	(11)
Net income/(expense) from financial instruments designated at fair value.....	(1,097)	(477)	(1,574)	543	439	982	149	162
Gains less losses on financial investments.....	82	(33)	49	(73)	-	(73)	(189)	(249)
Net earned insurance premiums.....	2,891	-	2,891	2,716	-	2,716	(6)	(6)
Other operating income.....	1,678	(878)	800	1,122	(180)	942	(33)	18
Net insurance claims incurred and movement in liabilities to policyholders.....	(1,835)	-	(1,835)	(3,540)	-	(3,540)	(93)	(93)
Net operating income before loan impairment charges and credit risk provisions.....	14,340	(1,458)	12,882	15,562	259	15,821	9	23
Loan impairment charges and other credit risk provisions.....	(1,861)	3	(1,858)	(3,364)	-	(3,364)	(81)	(81)
Net operating income.....	12,479	(1,455)	11,024	12,198	259	12,457	(2)	13
Total operating expenses.....	(8,122)	39	(8,083)	(8,198)	-	(8,198)	(1)	(1)
Operating profit.....	4,357	(1,416)	2,941	4,000	259	4,259	(8)	45
Share of profit in associates and joint ventures.....	9	-	9	14	-	14	56	56
Profit on ordinary activities before tax.....	4,366	(1,416)	2,950	4,014	259	4,273	(8)	45

## Review of business performance

The group reported pre-tax profit of £4,014 million in 2009, compared with £4,366 million in 2008. These results included a £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); 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. The 2008 results also included a gain of

£644 million on disposal of the seven regional banks in France in July 2008. All of these items are adjusted so as to arrive at the underlying basis.

The commentary that follows is on an underlying basis.

On an underlying basis pre-tax profit in 2009 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 experienced during the year and a decision was taken to close to new business in September 2009 with the company now in run off.

*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 group 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 group 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 group 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 issuances 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 corporate and financial institutions restructured their balance sheets by raising share capital. As part of its wealth management strategy the group 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-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 group 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 group's *share of profit in associates and joint ventures* increased by £5 million.

## ***2008 compared with 2007***

### **Economic briefing**

GDP in the UK decelerated markedly in 2008 to 0.7 per cent from 3.0 per cent in 2007, with a technical recession of two successive quarterly contractions in GDP confirmed during the second half of the year. Weakness proved widespread across most of the economy, prompting a sharp deterioration in labour market conditions as unemployment hit a 9-year high of 6.1 per cent in November 2008. CPI inflation reached a decade-long high of 5.2 per cent in September 2008 before falling back to 3.1 per cent by the year-end, still some way above the Bank of England's 2 per cent target. House prices continued to fall throughout the year and housing activity decreased sharply. The Bank of England reduced interest rates by 350 basis points during 2008, to finish the year at 2 per cent, as policymakers sought to mitigate the worst effects of the economic slowdown.

The expansion of the eurozone economy slowed sharply in 2008, with GDP growth of 0.5 per cent following a 2.6 per cent expansion in 2007. As in the UK, conditions deteriorated markedly as the year progressed and three successive quarterly declines in GDP were recorded during 2008, confirming that the economy had entered a period of recession. Consumer spending growth proved subdued following the sharp rise in oil prices during the first half of 2008 and a progressive increase in the unemployment rate towards the year-end. Inflation remained a concern for much of 2008, hitting a peak of 4.0 per cent in July before falling rapidly to 1.6 per cent in December. The European Central Bank, having initially raised interest rates by 25 basis points in July, cut them by 175 basis points to finish the year at 2.5 per cent.

## Reconciliation of reported and underlying profit before tax:

2008 compared with 2007

	2007 as reported £m	2007 Acquisitions and disposals £m	2007 Under- lying £m	2008 as reported £m	2008 acquisitions and disposals £m	2008 Under- lying £m	Re- ported change %	Under- lying change %
Net interest income .....	3,854	(206)	3,648	5,697	(119)	5,578	48	53
Net fee income .....	4,184	(140)	4,044	3,957	(8)	3,949	(5)	(2)
Trading income .....	3,487	(2)	3,485	2,967	-	2,967	(15)	(15)
Net Income/(expense) from financial instruments designated at FV .....	126	-	126	(1,097)	300	(797)	(971)	(733)
Gains less losses on financial investments.....	552	(16)	536	82	2	84	(85)	(84)
Net earned insurance premiums.....	1,921	-	1,921	2,891	(385)	2,506	50	30
Other operating income.....	350	(5)	345	1,678	(887)	791	379	129
Net insurance claims incurred and movement in liabilities to policyholders .....	(1,674)	-	(1,674)	(1,835)	83	(1,752)	(10)	(5)
Net operating income before loan impairment charges and credit risk provisions .....	12,800	(369)	12,431	14,340	(1,014)	13,326	12	7
Loan impairment charges and other credit risk provisions.....	(1,043)	17	(1,026)	(1,861)	3	(1,858)	(78)	(81)
Net operating income .....	11,757	(352)	11,405	12,479	(1,011)	11,468	6	1
Total operating expenses.....	(7,741)	224	(7,517)	(8,122)	50	(8,072)	(5)	(7)
Operating profit.....	4,016	(128)	3,888	4,357	(961)	3,396	8	(13)
Share of profit in associates and joint ventures .....	47	(7)	40	9	-	9	(81)	(78)
Profit on ordinary activities before tax .....	4,063	(135)	3,928	4,366	(961)	3,405	7	(13)

## Review of business performance

The group reported a pre-tax profit of £4,366 million, compared with £4,063 million in 2007, an increase of 7 per cent. These results included gains of £644 million on the disposal of seven regional banks in France in July 2008, and of £215 million on the sale of the card acquiring business in the UK to a joint venture with Global Payments Inc. in June 2008. All of these items are adjusted for to arrive at the underlying basis.

The commentary that follows is on an underlying basis.

Underlying pre-tax profits fell by 23 per cent. This primarily reflected a sharp decline in Global Banking and Markets' revenues in the UK and France which was mainly attributable to the deterioration in credit markets, the continuing illiquidity in asset-backed securities markets, which led to further write-downs, and a £585 million charge within the equities business following the fraud at Madoff Securities. Underlying results also include a gain of £265 million arising from the cancellation of an agreement to sell the London headquarters building during 2008. With the exception of Personal Financial Services in France, underlying revenue growth was delivered in the group's Private Banking, Commercial Banking and Personal Financial Services businesses across Europe.

*Net interest income* increased by 53 per cent. There was significant growth in Balance Sheet Management revenues, which reflected favourable interest rate risk positioning in expectation of interest rate cuts by central banks. Net interest income also

benefited from necessarily selective incremental lending as credit availability generally contracted, and from improved spreads in Global Banking in the UK, France and Germany.

The group experienced a strong increase in customer numbers, with a corresponding growth in liability balances across all businesses as the market turmoil intensified. The volume benefit was partially offset by narrowing deposit spreads, as base rates were cut in the UK, and increased funding costs, principally for trading activities, in France. Higher net interest income from the expansion of credit card lending and commercial loan portfolio growth in the small and mid+market customer segments in Turkey was partially offset by narrower spreads following credit card interest rate cap reductions by the central bank.

*Net fee income* fell by 2 per cent, with lower fees from mergers and acquisitions and equity capital markets due to origination and execution difficulties, coupled with a rise in brokerage expenses in line with increased trading activity in France. Lower performance fees in the UK and France, as the value of the funds under management reduced, reflected the decline in global equity markets. Increased customer acquisition partly offset this with higher packaged account and transaction fees in France and credit card fees in Turkey.

*Trading income* was 15 per cent lower than in 2007, falling significantly in Global Banking and Markets due to further write-downs on legacy exposures in credit, structured credit derivatives and leveraged and acquisition finance caused by the ongoing turmoil in the credit markets. In addition, a £585 million charge was taken in the equities business following the fraud at Madoff Securities. £6.0 billion and £1.6 billion of held-for-trading financial assets were reclassified under revised IFRS rules as loans and receivables and available-for-sale assets, respectively, preventing any further mark-to-market trading losses on these assets.

Excluding the write-downs on legacy exposures and the charge relating to Madoff Securities in Global Banking and Markets in UK, trading income increased by 21 per cent, driven by a significant increase in foreign exchange revenues against the backdrop of greater market volatility, and robust revenues in the Rates business, which was positioned to take advantage of falling interest rates. The widening of credit spreads, particularly in the second half of 2008, contributed to fair value gains on structured liabilities and on credit protection bought in the form of credit default swaps.

*Net income from financial instruments designated at fair value* decreased by £992 million, to a net expense of £797 million, primarily from a reduction in the value of instruments held to meet liabilities under unit-linked insurance business. The reduction in fair value of assets held to meet liabilities under unit-linked insurance contracts was offset by a corresponding reduction in “Net insurance claims and liabilities to policyholders”.

*Gains less losses from financial investments* of £84 million were £452 million lower than in 2007 as there were fewer disposal opportunities in 2008 and the significant realisations from equity investments in the UK and France in 2007 did not recur. Gains in 2008 largely reflected the sale of MasterCard shares and certain mutual funds in France. Net unrealised losses on financial investments of £11.6 billion were recorded directly in equity. £10.8 billion of this amount related to debt securities, largely reflecting the fall in value of asset-backed securities during 2008. Net unrealised losses on debt securities are excluded from capital resources under FSA rules.

*Net earned insurance premiums* increased by 30 per cent, largely due to growth in the Guaranteed Income Bond launched in June 2007 and the introduction of enhanced death benefits to certain pension products in the UK. In France, HSBC Assurances performed well in a declining market from the launch of a range of guaranteed rate products. However, net



earned insurance premiums fell following a significant reinsurance transaction undertaken in the first half of 2008.

*Other operating income* increased by £446 million. This was primarily due to recognition of the gain in respect of the purchase of the subsidiary of Metrovacesa that owned the property and long leasehold land comprising 8 Canada Square, London. The growth in revenue also reflected the non-recurrence of a decrease in the value of the present value of in-force long-term (“PVIF”) insurance business in 2007 following regulatory changes to the rules governing the calculation of insurance liabilities. In addition, there was a favourable embedded value adjustment following the group’s introduction of enhanced benefits to existing commercial pension products in the first half of 2008. These benefits were partially offset by costs associated with the support of money market funds in the global asset management business.

*Net insurance claims incurred and movement in liabilities to policyholders* increased by 5 per cent driven by an increase in liabilities following the rise in sales of the Guaranteed Income Bond. This was augmented by the implementation of FSA rule changes in 2007 which led to a lower reserving requirement. This was partially offset by a reduction in insurance liabilities due to the fall in the value of market-linked funds.

*Loan impairment charges and other credit risk provisions* rose by 81 per cent to £1,858 million, primarily in Global Banking and Markets and Commercial Banking. The deteriorating credit environment resulted in a rise in loan impairment charges, largely reflecting an exposure to a single European property company, and additional credit risk provisions on debt securities held within the Group’s available-for-sale portfolio, mainly in Solitaire Funding Limited (‘Solitaire’), a special purpose entity managed by HSBC. Credit conditions worsened in Commercial Banking and specific loan impairment charges increased in the UK, France and internationally due to the deteriorating credit environment in the second half of 2008. In Turkey, credit card and personal loan delinquency rates were significantly higher resulting in the implementation of tighter underwriting criteria, reduced credit limits and revised account management policies throughout 2008.

*Operating costs* increased by 7 per cent to £8,072 million. Costs in the UK were broadly in line with 2007, which included ex-gratia payments expensed in respect of overdraft fees applied in previous years and a provision for reimbursement of certain charges on historic will trusts and other related services. Excluding these items, costs rose as a result of an increase in the Financial Services Compensation Scheme levy, restructuring costs and increased rental charges following the sale and leaseback of branch properties. These were partially offset by lower performance related pay and a reduction in the defined benefit pension scheme costs due to a change in actuarial assumptions.

Operating costs in France were broadly in line with 2007 with lower incentive compensation and a reduction in pension and retirement healthcare costs following the transfer of certain obligations to a third-party offsetting the higher costs of a voluntary retirement programme.

There was investment in premises and new staff to support business expansion in Turkey, Russia and Central and Eastern Europe. In 2008, 112 new branches opened and staff numbers increased by 30 per cent in these markets.

*Share of profit in associates and joint ventures* declined to £9 million with 2007 benefiting from an adjustment to the embedded value of HSBC Assurances, which is now a wholly-owned subsidiary. The absence of this gain was partially offset by increased joint venture profits following the sale of the card acquiring business in the UK.

## Business Segment Discussion

### 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
	<b>4,014</b>	<b>4,366</b>	<b>4,273</b>	<b>2,950</b>

### 2009 compared with 2008

HSBC Bank plc and its subsidiary undertakings reported a pre-tax profit of £4,014 million in 2009, compared with £4,366 million in 2008, a decrease of 8 per cent.

The commentary that follows is on an underlying basis for each of the principal business segments, except for Other business segment which is on a reported basis.

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.

### 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.....	<b>988</b>	<b>2,139</b>

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 are adjusted for the £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 group 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 group has however built on its strong deposit base in 2009, despite fierce competition for liability balances. Mortgage balances also increased as the group 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 reduced the 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 group 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 group 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 significant 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 group'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	2008
	£m	£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 does not include the £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. Despite sharp falls in international trade volumes across the region, the group's trade business continued to grow with revenues up 4 per cent on 2008 with particularly strong growth in key markets such as Poland and Turkey, and record results in Spain, Armenia, Israel and Ireland. Despite steady net interest income growth, Personal Banking losses increased in 2009 due to a large re-insurance loss of £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 significant 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 group'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 <sup>1</sup> .....	2,849	1,963
Net fee income.....	1,060	845
Trading income <sup>1</sup> .....	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 .....	<b>2,511</b>	122

<sup>1</sup> 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 on the 2009 HSBC Bank plc Financial Statements).

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 group 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 .....	<b>1,679</b>	1,634
Loan impairment charges and credit risk provisions .....	<b>(19)</b>	(31)
Net operating income .....	<b>1,660</b>	1,603
Total operating expenses.....	<b>(932)</b>	(877)
Operating profit .....	<b>728</b>	726
Share of profit in associates and joint ventures .....	-	-
Profit on ordinary activities before tax .....	<b>728</b>	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, on a reported basis, 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 2009. In 2008 the group reported a gain of £265 million from the cancellation of an agreement to sell this building.

## Profit on ordinary activities before tax

	2008 £m Reported	2007 £m Reported	2008 £m Underlying	2007 £m Underlying
UK Retail Banking.....	2,139	1,744	1,924	1,744
Continental Europe Retail Banking.....	236	407	134	272
Global Banking and Markets.....	122	1,120	122	1,120
Private Banking.....	726	663	726	663
Other.....	1,143	129	499	129
	<b>4,366</b>	<b>4,063</b>	<b>3,405</b>	<b>3,928</b>

## 2008 compared with 2007

HSBC Bank plc and its subsidiary undertakings reported a pre-tax profit of £4,366 million, compared with £4,063 million in 2007, an increase of 7 per cent.

On an underlying basis pre-tax profits decreased by 21 per cent. This primarily reflected a sharp decline in Global Banking and Markets' revenues in the UK, which was mainly attributable to the deterioration in credit markets, the continuing illiquidity in asset-backed securities markets, which led to further write-downs, and a £585 million charge within the equities business following the fraud at Madoff Securities. With the exception of Personal Financial Services in France, underlying revenue growth was delivered in the group's Private Banking, Commercial Banking and Personal Financial Services businesses across Europe.

The commentary that follows is on an underlying basis for each of the principal business segments except for Other business segment which is on a reported basis.

### UK Retail Banking

	2008	2007
	£m	£m
Net interest income.....	3,692	3,553
Net fee income.....	1,917	2,042
Trading income.....	61	17
Other income.....	770	364
Net operating income before impairments and provisions.....	6,440	5,976
Loan impairment charges and credit risk provisions.....	(1,095)	(967)
Net operating income.....	5,345	5,009
Total operating expenses.....	(3,214)	(3,265)
Operating profit.....	2,131	1,744
Share of profit in associates and joint ventures.....	8	0
Profit on ordinary activities before tax.....	2,139	1,744

The above table is on a reported basis. UK Retail banking reported a profit of £2,139 million for 2008, against £1,744 million in 2007.

Underlying basis is adjusted for a £215 million gain on the sale of a 51 per cent interest in the point-of-sale card payment business in the UK to a joint venture with Global Payments Inc. in June 2008. There is no difference between reported and underlying basis in 2007. On an underlying basis, UK Retail Banking pre-tax profits increased by 10 per cent over the year in 2008.

*Net interest income* increased by 4 per cent. Net interest income benefited from selective incremental lending as credit availability generally contracted, and from improved asset spreads. Mortgage balances increased following the launch of the Rate Matcher campaign in April 2008. Falling confidence in the UK banking sector necessitated government intervention in a number of competitor banks. The group experienced a strong increase in customer numbers with corresponding growth in liability balances. The volume benefit was partially offset by narrowing deposit spreads as base rates were cut.

*Net fee income* decreased by 6 per cent. UK GDP declined in the second half of the year, with weakness widespread across the economy. House prices continued to fall while unemployment hit a nine year high. A fall in consumer confidence and demand led to lower



transaction and new business volumes across lending, protection, and investment products, thereby resulting in lower fee income.

*Other operating income* increased by 52 per cent. The growth in revenue reflected the non-recurrence of a decrease in the value of PVIF business in 2007 following regulatory changes to the rules governing the calculation of insurance liabilities. In addition, there was a favourable embedded value adjustment following HSBC's introduction of enhanced benefits to existing commercial pension products in the first half of 2008.

*Loan impairment charges and other credit risk provisions* increased by 13 per cent. The credit risk environment deteriorated significantly against 2007, and this led to increased impairments. This was particularly evident in commercial banking, where specific loan impairment charges increased and a large number of customers were impacted by difficult trading conditions. Delinquency rates in cards were marginally higher, partly offset by action taken to mitigate risk through the continued application of strict lending criteria and the sale of non-core credit card portfolios.

*Operating expenses* were broadly in line with 2007, which included ex-gratia payments expensed in respect of overdraft fees applied in previous years and a provision for reimbursement of certain charges on historic will trusts and other related services. Excluding these items, costs rose as a result of an increase in the FSCS levy, restructuring costs, and increased rental charges following the sale and leaseback of branch properties. This was offset by constrained investment and a reduction in the defined benefit pension scheme costs due to a change in actuarial assumptions.

*Share of profit in associates and joint ventures* in 2008 reflects the joint venture profits following the sale of the UK card acquiring business.

## Continental Europe Retail Banking

	2008 £m	2007 £m
Net interest income.....	1,505	1,266
Net fee income.....	532	577
Trading income .....	11	48
Other income .....	(14)	(26)
Net operating income before impairments and provisions .....	2,034	1,866
Loan impairment charges and credit risk provisions .....	(279)	(87)
Net operating income .....	1,755	1,779
Total operating expenses.....	(1,519)	(1,379)
Operating profit.....	236	399
Share of profit in associates and joint ventures .....	-	8
Profit on ordinary activities before tax .....	236	407

The above table is on a reported basis.

Continental Europe Retail Banking reported a profit of £236 million for 2008, against £407 million in 2007.

Underlying basis is adjusted for £80 million and £128 million operating profit in 2008 and 2007 respectively, relating to the seven regional banks in France which were sold in July 2008. In addition the group's acquisition of the remaining 50 per cent in HSBC Assurances in France completed in March 2007 is excluded from underlying basis, and operating profit is consequently adjusted by £22 million in 2008 and by £7 million in 2007.

On an underlying basis, profit before tax decreased by £138 million or 51 per cent. Adjusting for the impact of foreign exchange movements, profit before tax decreased by 59 per cent. With the exception of Personal Financial Services in France, underlying revenue growth was delivered in the Commercial Banking and Personal Financial Services businesses across Continental Europe Retail Banking. However, this was more than offset by an increase in impairments and operating expenses.

*Net interest income* increased by 31 per cent to £1,386 million. Adjusting for the impact of foreign exchange movements net interest income increased by 12 per cent. Income growth in Turkey, Central and Eastern Europe and Russia was due to increased volumes from new business activity following investment spend throughout 2008. Net interest income in France, Germany and Malta was also favourable as a result of higher liability volumes. The group experienced a strong increase in customer numbers, with corresponding growth in liability balances across Continental Europe as the market turmoil intensified. Higher net interest income from the expansion of credit card lending and commercial loan portfolio growth in the small and mid-market customer segments in Turkey was partially offset by narrower spreads following credit card interest rate cap reductions by the central bank.

Interest rates were cut aggressively in many countries during 2008, as central banks reduced their reference rates as part of stimulus programmes introduced in response to deteriorating economic conditions. This contributed to a decline in asset yields. The cost of funding also fell, but this was less significant than the decline in yields as spreads narrowed overall. Net interest income also benefited from selective incremental lending as credit availability generally contracted. Average interest-earning assets increased led by growth in average loans and advances to customers. This was mainly due to an increase in average term lending balances in Europe.

*Net fee income* increased by 20 per cent to £524 million. Adjusting for foreign exchange movements, net fee income increased by 2 per cent driven by an increase in customer levels with higher packaged account and transaction fees in France and credit card fees in Turkey.

*Loan impairment charges and other credit risk provisions* increased 232 per cent to £276 million, or 195 per cent after adjusting for foreign exchange movements, due to a deteriorating credit environment as economies across Continental Europe slowed. Credit conditions worsened in Commercial Banking and specific loan impairment charges increased particularly in France, Turkey, Russia and the Czech Republic due to the deteriorating credit environment in the second half of 2008. The largest increase in impairments in Personal Banking was seen in Turkey where credit card and personal loan delinquency rates were significantly higher, resulting in the implementation of tighter underwriting criteria, reduced credit limits and revised account management policies throughout 2008.

*Operating expenses* increased by 27 per cent to £1,471 million, or 9 per cent after adjusting for the impact of foreign exchange movements. The increase in operating expenses was mainly due to the cost of growth in Turkey, Central and Eastern Europe and Russia, with investment in premises and new staff to support business expansion. In 2008, 112 new branches opened and staff numbers increased by 30 per cent in these markets. Operating costs in France were broadly in line with 2007 with lower incentive compensation and a reduction in pension and retirement healthcare costs following the transfer of certain obligations to a third-party offsetting the higher costs of a voluntary retirement programme.

## Global Banking and Markets

	2008	2007
	£m	£m
Net interest income.....	1,963	693
Net fee income.....	845	1,040
Trading income .....	318	926
Other income .....	(110)	870
Net operating income before impairments and provisions .....	3,016	3,530
Loan impairment charges and credit risk provisions .....	(453)	15
Net operating income .....	2,563	3,545
Total operating expenses.....	(2,442)	(2,426)
Operating profit.....	121	1,119
Share of profit in associates and joint ventures .....	1	1
Profit on ordinary activities before tax .....	122	1,120

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

Global Banking and Markets reported a profit of £122 million for 2008, against £1,120 million in 2007. Adjusting for the impact of foreign exchange movements, profit before tax declined by £1,109 million. The sharp decline in revenues was mainly attributable to the deterioration in credit markets, the continuing illiquidity in asset-backed securities markets which led to further write-downs, and a significant charge within the equities business following the fraud at Madoff Securities.

*Net interest income* increased by £1,270 million. There was significant growth in Balance Sheet Management revenues, which reflected favourable interest rate risk positioning in expectation of interest rate cuts by central banks. In Global Banking, net interest income was boosted by improved spreads against the backdrop of a weakening credit environment.

*Net fee income* fell by 19 per cent. Excluding the impact of foreign exchange movements, net fee income decreased by 23 per cent, with lower fees from mergers and acquisitions and equity capital markets due to origination and execution difficulties, coupled with a rise in brokerage expenses in line with increased trading activity in France. Lower performance and management fees in the UK and France, as the value of funds under management reduced, reflected the decline in global equity markets.

*Trading income* decreased by 66 per cent due to further write-downs on legacy exposures in credit, structured credit derivatives and leveraged and acquisition finance caused by the ongoing turmoil in the credit markets. In addition, a £585 million charge was recorded in equities following the fraud at Madoff Securities in December 2008. £6.0 billion and £1.6 billion of held-for-trading financial assets were reclassified under revised IFRS rules as loans and receivables and available-for-sale assets. This was partly offset by a significant increase in foreign exchange revenues against the backdrop of greater market volatility. Robust revenues were recorded in the Rates business, which was positioned to take advantage of falling interest rates. The widening of credit spreads, particularly in the second half of 2008, contributed to fair value gains on structured liabilities and on credit protection bought in the form of credit default swaps.

*Other income* fell by £980 million as there were fewer disposal opportunities in 2008 and the significant realisations from equity investments in the UK and France in 2007 did not

recur. In addition, costs associated with the provision of support to certain money market funds in the global asset management business resulted in lower revenues.

*Loan impairment charges and other credit risk provisions* increased by £468 million. The deteriorating credit environment resulted in a rise in loan impairment charges, largely reflecting an exposure to a single European property company, and additional credit risk provisions on debt securities held within the Group's available-for-sale portfolio, mainly in Solitaire Funding Limited ('Solitaire'), a special purpose entity managed by HSBC.

*Operating expenses* were broadly in line with 2007. Excluding the impact of foreign exchange movements, operating expenses decreased by £89 million in 2008. Higher costs in line with volume increases in selective businesses were offset by lower performance costs.

## Private Banking

	2008	2007
	£m	£m
Net interest income.....	746	477
Net fee income.....	627	599
Trading income .....	212	256
Other income .....	49	62
Net operating income before impairments and provisions .....	<u>1,634</u>	1,394
Loan impairment charges and credit risk provisions .....	<u>(31)</u>	(2)
Net operating income .....	<u>1,603</u>	1,392
Total operating expenses.....	<u>(877)</u>	(729)
Operating profit.....	<u>726</u>	663
Share of profit in associates and joint ventures .....	-	1
Profit on ordinary activities before tax .....	<u>726</u>	663

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

Private Banking reported a profit of £726 million for 2008, against £663 million in 2007. Excluding foreign exchange movements, profit before tax increased by £23 million. Client-related income increased as a result of flight-to-quality customer acquisition and balance sheet expansion. However, this was offset in part by narrowing of margins on deposits following the sharp reductions in base rates, and by increased competition from the nationalised or state guaranteed banks over client liabilities towards the end of the year.

*Net interest income* increased by 56 per cent to £746 million, mainly driven by balance sheet growth. Deposit balances increased as customers reduced risk in response to market turbulence, choosing HSBC for its strength and switching investment securities to cash deposits. Moreover, asset spreads improved as interest rates declined sharply

*Net fee income* increased by 5 per cent to £627 million. Adjusting for the impact of foreign exchange movements, net fee income declined by 4 per cent due to lower client activity.

*Trading income* decreased by 17 per cent to £212 million. Adjusting for the impact of foreign exchange movements, trading income decreased by 23 per cent, mainly as a result of difficult and volatile market conditions particularly in relation to income from forward accumulators and bond trading.

*Loan impairment charges and credit risk provisions* increased by £29 million to £31 million, due to losses on Washington Mutual bonds and higher impairment provisions associated with the deterioration in the credit environment.

*Operating expenses* increased by 20 per cent to £877 million. Excluding foreign exchange movements, operating expenses increased by 10 per cent, mainly driven by an increase in headcount and compensation to support business growth and performance, and the non-recurrence of a pension fund gain realised in the prior year. Staff numbers increased in Asia and Europe in late 2007 and the first half of 2008, leading to higher costs, although these reduced in the second half of the year.

## Other

	2008	2007
	£m	£m
Net interest income.....	(108)	(65)
Net fee income.....	36	(74)
Trading income .....	264	11
Other income .....	1,082	211
Net operating income before impairments and provisions .....	1,274	83
Loan impairment charges and credit risk provisions .....	(3)	(2)
Net operating income .....	1,271	81
Total operating expenses.....	(128)	10
Operating profit .....	1,143	91
Share of profit in associates and joint ventures .....	–	37
Profit on ordinary activities before tax .....	1,143	129

Reported profit before tax in Other was £1,143 million, compared with a profit of £129 million in 2007.

Other, on a reported basis, includes:

- the £644 million gain on the disposal of seven regional banks in France in July 2008;
- the gain of £265 million from the cancellation of an agreement to sell group's London headquarters building in 2008;
- the change in own credit spread on long-term debt which resulted in a £477 million gain in 2008 compared with a gain of £205 million for 2007.

## Capital and performance ratios

	2009	2008	2007
	%	%	%
<b>Capital ratios</b>			
Tier 1 ratio <sup>1</sup> .....	11.2	6.8	7.5
Total capital ratio <sup>1</sup> .....	15.7	10.5	10.8
<b>Performance ratios</b>			
Return on average invested capital (on underlying basis) <sup>2</sup> .....	9.2	7.8	12.9
Return on average total shareholders' funds (equity) of the parent company <sup>3</sup> .....	13.2	14.5	14.5
Post-tax return on average total assets .....	0.4	0.5	0.6
Post-tax return on average risk-weighted assets .....	1.4	1.5	1.6
<b>Credit coverage ratios</b>			
Loan impairment charges as a percentage of total operating income .....	13.7	10.6	7.2
Loan impairment charges as a percentage of average gross customer advances .....	1.1	0.7	0.6
Total impairment allowances outstanding as a percentage of impaired loans at the year-end .....	55.1	68.0	60.7
<b>Efficiency and revenue mix ratios</b>			
Cost efficiency ratio <sup>4</sup>			
As a percentage of total operating income:			
– net interest income .....	52.7	56.6	60.5
– net fee income .....	42.4	35.2	26.6
– trading income .....	21.3	24.5	28.9
– trading income .....	13.7	18.3	24.1
<b>Financial ratios</b>			
Loans and advances to customers as a percentage of customer accounts .....	82.5	80.6	84.9
Average total shareholders' equity to average total assets .....	2.7	3.0	4.3

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: total capital ratio: 10.6 per cent; Tier 1 capital ratio: 7.6 per cent.

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

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

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

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

## Balance sheet data

	At 31 December		
	2009	2008	2007
	£m	£m	£m
Loans and advances to customers (net) .....	274,659	298,304	227,687
Loans and advances to banks (net) .....	46,994	50,719	60,764
Trading assets, financial assets designated at fair value and financial investments .....	268,138	289,432	237,703
Total assets .....	751,928	924,231	622,280
Deposits by banks .....	57,729	61,431	48,786
Customer accounts .....	332,896	369,880	268,269

## Average balance sheet and net interest income

Average balances are based on daily averages of the group's banking activities with monthly or less frequent averages used elsewhere.

Net interest margin numbers are calculated by dividing net interest income as reported in the income statement by the average interest-earning assets from which interest income is reported within the "Net interest income" line of the income statement. Interest income and

interest expense arising from trading assets and liabilities and the funding thereof is included within “Net trading income” in the income statement.

### Assets

	2009			2008			2007		
	Average Balance £m	Interest Income £m	Yield %	Average Balance £m	Interest Income £m	Yield %	Average Balance £m	Interest Income £m	Yield %
Total interest-earning assets (itemised below)...	<b>396,784</b>	<b>12,643</b>	<b>3.19</b>	374,203	18,998	5.08	264,424	16,439	6.22
Trading assets .....	<b>150,491</b>	<b>3,548</b>	<b>2.36</b>	163,239	6,376	3.91	110,546	4,899	4.43
Financial assets									
designated at fair value...	<b>8,763</b>	<b>285</b>	<b>3.25</b>	8,219	192	2.34	4,820	110	2.28
Impairment provisions .....	<b>(3,302)</b>	-	-	(1,965)	-	-	(1,735)	-	-
Non-interest-earning assets .....	<b>311,518</b>	-	-	237,028	-	-	143,223	-	-
Total assets and interest income .....	<b>864,254</b>	<b>16,476</b>	<b>1.91</b>	780,723	25,566	3.27	521,278	21,448	4.11
Short-term funds and loans and advances to banks .....	<b>61,378</b>	<b>1,307</b>	<b>2.13</b>	70,342	2,508	3.57	54,301	2,247	4.51
Loans and advances to customers .....	<b>242,776</b>	<b>8,720</b>	<b>3.59</b>	226,366	13,089	5.78	164,484	11,609	7.06
Financial investments .....	<b>91,624</b>	<b>2,604</b>	<b>2.84</b>	75,168	3,375	4.49	43,872	2,301	5.24
Other interest-earning assets .....	<b>1,006</b>	<b>12</b>	<b>1.19</b>	2,327	26	1.12	1,767	82	4.64
Total interest-earning assets .....	<b>396,784</b>	<b>12,643</b>	<b>3.19</b>	374,203	18,998	5.08	264,424	16,439	6.22

### Total equity and liabilities

	2009			2008			2007		
	Average Balance £m	Interest Income £m	Cost %	Average Balance £m	Interest Income £m	Cost %	Average Balance £m	Interest Income £m	Cost %
Total interest-bearing liabilities (itemised below) ...	<b>417,613</b>	<b>4,552</b>	<b>1.09</b>	393,091	13,301	3.38	290,747	12,585	4.33
Trading liabilities .....	<b>91,033</b>	<b>1,892</b>	<b>2.08</b>	112,233	4,574	4.08	71,815	3,110	4.33
Financial liabilities									
designated at fair value (excluding own debt issued) .....	<b>9,002</b>	<b>185</b>	<b>2.06</b>	10,251	181	1.77	7,937	101	1.27
Non-interest bearing current accounts .....	<b>32,520</b>	-	-	21,296	-	-	16,329	-	-
Total equity and other non-interest-bearing liabilities .....	<b>314,086</b>	-	-	243,852	-	-	134,450	-	-
Total equity and liabilities .....	<b>864,254</b>	<b>6,629</b>	<b>0.77</b>	780,723	18,056	2.31	521,278	15,796	3.03
Deposits by banks .....	<b>62,187</b>	<b>928</b>	<b>1.49</b>	65,264	2,263	3.47	44,298	2,105	4.75
Financial liabilities									
designated at fair value									
own debt issued .....	<b>8,233</b>	<b>211</b>	<b>2.56</b>	5,840	331	5.67	4,962	277	5.58
Customer Accounts .....	<b>283,204</b>	<b>2,412</b>	<b>0.85</b>	247,462	7,944	3.21	192,402	7,774	4.04
Debt securities in issue .....	<b>62,744</b>	<b>947</b>	<b>1.51</b>	69,713	2,690	3.86	46,825	2,356	5.03
Other interest-bearing liabilities .....	<b>1,245</b>	<b>54</b>	<b>4.34</b>	4,812	73	1.52	2,260	73	3.23
Total interest-bearing liabilities .....	<b>417,613</b>	<b>4,552</b>	<b>1.09</b>	393,091	13,301	3.38	290,747	12,585	4.33

### Net interest margin

	2009	2008	2007
	%	%	%
Net interest margin .....	<b>2.04</b>	1.52	1.46

## Analysis of changes in net interest income

The following table allocates changes in net interest income between volume and rate for 2009 compared to 2008, and for 2008 compared to 2007.

	Increase/(decrease) in 2009 compared with 2008			2008 £m	Increase/(decrease) in 2008 compared with 2007		2007 £m
	2009 £m	Volume £m	Rate £m		Volume £m	Rate £m	
<b>Interest income</b>							
Short-term funds and loans and advances to banks.....	1,307	(320)	(881)	2,508	723	(662)	2,447
Loans and advances to customers.....	8,720	949	(5,318)	13,089	4,368	(2,888)	11,609
Financial investments.....	2,604	739	(1,510)	3,375	1,641	(567)	2,301
<b>Interest expense</b>							
Deposits by banks.....	928	(107)	(1,228)	2,263	996	(838)	2,105
Customer accounts.....	2,412	1,147	(6,679)	7,944	2,225	(2,055)	7,774
Financial liabilities designated at fair value – own debt issued	211	136	(256)	331	49	5	277
Debt securities in issue.....	947	(269)	(1,474)	2,690	1,152	(818)	2,356

## Contractual obligations

The table below provides details of the group's known contractual obligations as at 31 December 2009.

	Total £m	Payments due by period		
		Less than 1 year £m	1-5 years £m	More than 5 years £m
Long-term debt obligations.....	55,689	22,364	20,793	12,532
Term deposits and certificates of deposit.....	105,955	101,538	4,417	–
Capital (finance) lease obligations.....	497	22	103	372
Operating lease obligations.....	1,963	173	608	1,182
Purchase obligations.....	232	174	58	–
Short positions in debt securities and equity shares.....	40,876	31,255	2,709	6,912
Current tax liability.....	197	197	–	–
Pension/healthcare obligation.....	6,545	502	2,273	3,770
	211,954	156,225	30,961	24,768

## Deposits

The following table summarises the average amount of bank deposits, customer deposits and certificates of deposit (“CDs”) and other money market instruments (which are included within “Debt securities in issue” in the balance sheet), together with the average interest rates paid thereon for each of the past three years. The “Other” category includes securities sold under agreements to repurchase.

	2009		2008		2007	
	Average balance £m	Average rate %	Average balance £m	Average rate %	Average balance £m	Average rate %
<b>Deposits by banks</b> .....	66,330		70,471		47,909	
Demand and other – non-interest bearing.....	4,143	–	5,207	–	3,611	–
Demand – interest bearing.....	9,019	1.0	11,361	2.9	5,521	3.8
Time.....	19,169	1.7	26,149	3.5	19,355	4.6
Other.....	33,999	1.5	27,754	3.7	19,422	5.1
<b>Customer accounts</b> .....	320,010		271,804		209,997	
Demand and other – non-interest bearing.....	36,806	–	24,342	–	17,595	–
Demand – interest bearing.....	141,965	0.4	125,634	2.7	106,451	3.5
Savings.....	36,642	2.2	41,377	4.2	31,211	4.6
Time.....	56,013	1.3	58,621	3.5	43,535	4.9
Other.....	48,584	0.6	21,830	3.1	11,205	4.8
<b>CDs and other money market instruments</b> .....	41,564	1.0	43,237	4.2	33,173	5.0



## Certificates of deposit and other time deposits

At 31 December 2009, the maturity analysis of CDs and other wholesale time deposits, by remaining maturity, was as follows:

	3 months or less £m	After 3 months but within 6 months £m	After 6 months but within 12 months £m	After 12 months £m	Total £m
Certificates of deposit .....	11,099	2,348	2,314	–	15,761
Time deposits					
- banks .....	18,358	1,269	5,893	2,467	27,987
- customers .....	51,990	4,044	4,223	1,950	62,207

## Critical accounting policies

### *Introduction*

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 Note 2 on the HSBC Bank plc 2009 Financial Statements.

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, and 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) on the HSBC Bank plc 2009 Financial Statements. Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at the balance sheet date.

Management is required to exercise judgement in making assumptions and estimates 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. Of the group's total loans and advances to customers before impairment allowances of £278,251 million (2008 £300,806 million), £ 5,438 million or 2 per cent (2008 £2,902 million; 1 per cent) were individually assessed for impairment, and £272,813 million or 98 per cent (2008 £297,904 million; 99 per cent) were collectively assessed for impairment.

The group's most significant areas of exposure to collectively assessed loans and advances are the personal industry sector and the corporate and commercial sector which comprised 37 per cent (2008:33 per cent) and 44 per cent (2008:50 per cent) respectively of the group's collectively assessed loans.

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 utilises 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 basic formulaic approach which allocates progressively higher percentage loss rates the longer the 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 which result in the most recent trends in the portfolio risk factors being 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, geographical 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 countries to reflect the variation in economic conditions, 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 homogenous 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.

### *Valuation of financial instruments*

The group's accounting policy for valuation of financial instruments is described in Note 2(d) on the HSBC Bank plc 2009 Financial Statements. 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 is 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 is 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.

The value of financial assets and liabilities measured at fair value that use a valuation technique was £229,092 million (2008: £381,090 million) and £187,591 million (2008: £312,172 million) or 60 per cent (2008: 72 per cent) and 73 per cent (2008: 82 per cent) of total financial assets and total financial liabilities measured at fair value, respectively.

Disclosures 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 on the HSBC Bank plc 2009 Financial Statements. In addition a sensitivity analysis of fair value for financial instruments with significant observable inputs to reasonably possibly alternative assumptions and a range of assumptions can be found in Note 31 on the HSBC Bank plc 2009 Financial Statements. Given the uncertainty and subjective nature of valuing financial instruments at fair value, it is possible that the outcomes in the next financial year could differ from the assumptions used, and this could 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 HSBC Bank plc 2009 Financial Statements.

At 31 December 2009, the group's total available for sale assets amounted to £81,844 million (2008: £103,486 million), of which £ 77,179 million (2008: £90,256 million) were debt securities. The available-for-sale reserve relating to debt securities amounted to a deficit of £6,388 million (2008: deficit £11,965 million).

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 loss is measured with reference 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. When cash flows are readily determinable, less judgement is required. When determination of estimated future cash flows requires consideration of a number of variables, some of which may be unobservable in current market conditions, more judgement is required.

The most significant judgements concern more complex instruments, such as asset-backed securities ('ABS's), 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 uncertainties when the assessment is based on historical information on pools of assets, and judgement is required to determine whether historical performance is likely to be representative of current economic and credit conditions. Further details of the nature and extent of the group's exposures to ABSs classified as available-for-sale are provided on page 65.

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.

## Risk

### UK regulation and supervision

UK banking and financial services institutions are subject to multiple regulations. The primary UK statute is the Financial Services and Markets Act 2000 (“FSMA”). Additionally, data privacy is regulated by the Data Protection Act 1998. Other UK financial services legislation is derived from EU directives relating to banking, securities, insurance, investments and sales of personal financial services.

The bank is HSBC Holdings’ principal authorised institution in the UK. In addition to its role as the bank’s lead regulator, the FSA is responsible for authorising and supervising all of the bank’s businesses in the UK that require authorisation under FSMA. These include deposit-taking, retail banking, life and general insurance, pensions, investments, mortgages, custody and share dealing businesses, and treasury and capital markets activity.

FSA rules establish the minimum criteria for authorisation for banks and financial services businesses in the UK. They also set out reporting (and, as applicable, consent) requirements with regard to large individual exposures and large exposures to related borrowers. In its capacity as supervisor of HSBC Holdings on a consolidated basis, the FSA receives information on the capital adequacy of, and sets requirements for, HSBC Holdings as a whole. The FSA’s approach to capital requirements for UK insurers is to require minimum capital to be calculated on two bases. First, firms must calculate their liabilities on a prudent basis and add a statutory solvency margin (“pillar 1”). Secondly, firms must calculate their liabilities on a realistic basis then add to this their own calculation of risk-based capital. The sum of realistic reserves and risk-based capital (“pillar 2”) is agreed with the FSA. Insurers are required to maintain capital equal to the higher of pillars 1 and 2. The FSA has the right to object, on prudential grounds, to persons who hold, or intend to hold, 10 per cent or more of the voting power of a financial institution.

The regulatory framework of the UK financial services system has traditionally been based on co-operation between the FSA and authorised institutions. The FSA monitors authorised institutions through ongoing supervision and the review of routine and *ad hoc* reports relating to financial and prudential matters. The FSA may periodically obtain independent reports, usually from the auditors of the authorised institution, as to the adequacy of internal control procedures and systems as well as procedures and systems governing records and accounting. The FSA meets regularly with the bank’s senior executives to discuss its adherence to the FSA’s prudential guidelines. They also regularly discuss fundamental matters relating to the bank’s business in the UK, including areas such as strategic and operating plans, risk control, loan portfolio composition and organisational changes, including succession planning. In light of current conditions, the bank has experienced an increased level of ongoing interaction with the FSA.

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

- Formulating 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 group's credit risk portfolio. These executives, as well as the Risk Management Meeting, 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 Group'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 Chief Risk Officer, 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 of the group's 2009 annual report and accounts.

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 conditions.

## **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.

	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
	<u>839,512</u>	<u>(137,838)</u>	<u>701,674</u>	<u>1,058,610</u>	<u>(235,357)</u>	<u>823,253</u>

## 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.

## **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.

	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
	<u>14</u>	<u>16</u>
	<u>100</u>	<u>100</u>

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 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).

### Loans and advances to customers by industry sector

	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Personal					
Residential mortgages .....	68,028	60,240	47,997	46,661	43,145
Other personal .....	33,588	38,412	36,496	33,458	31,361
	<u>101,616</u>	<u>98,652</u>	<u>84,493</u>	<u>80,119</u>	<u>74,506</u>
Corporate and commercial					
Commercial, industrial and international trade .....	69,211	83,163	60,036	50,339	44,355
Commercial real estate .....	20,987	22,563	18,372	14,773	12,878
Other property-related .....	3,840	5,301	5,656	4,927	4,437
Government .....	1,357	1,275	1,137	1,198	1,082
Other commercial .....	29,858	38,915	27,310	29,041	24,469
	<u>125,253</u>	<u>151,217</u>	<u>112,511</u>	<u>100,278</u>	<u>87,221</u>
Financial					
Non-bank financial institutions .....	47,008	45,891	31,663	21,008	22,055
Settlement accounts .....	502	754	813	773	727
	<u>47,510</u>	<u>46,645</u>	<u>32,476</u>	<u>21,781</u>	<u>22,782</u>
Asset-backed securities reclassified .....	3872	4292	-	-	-
Total gross loans and advances .....	<u>278,251</u>	<u>300,806</u>	<u>229,480</u>	<u>202,178</u>	<u>184,509</u>

### Loans and advances to banks

At 31 December	47,051	50,762	60,767	44,432	31,583
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### Mortgage lending products

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 an underlying property.

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

	UK £m	Rest of the world £m
<b>At 31 December 2009</b> .....		
Residential mortgages .....	62,037	5,991
<b>Total mortgage lending</b> .....	<b>62,037</b>	<b>5,991</b>
Interest-only (including endowment) mortgages .....	28,024	47
Affordability mortgages, including adjustable rate mortgages .....	1,566	668
Other .....	71	-
<b>Total interest-only and affordability mortgages</b> .....	<b>29,661</b>	<b>715</b>
As a percentage of total mortgage lending .....	47.8%	11.9%
Negative equity mortgages <sup>1</sup> .....	74	3
Other loan to value ratios greater than 90 per cent <sup>2</sup> .....	3,062	-
	<b>3,136</b>	<b>3</b>
<b>-as a percentage of total mortgage lending</b> .....	<b>5.1%</b>	<b>0.1%</b>
<b>At 31 December 2008</b> .....		
Residential mortgages .....	53,706	6,534
<b>Total mortgage lending</b> .....	<b>53,706</b>	<b>6,534</b>
Second lien as a percentage of total mortgage lending .....	0.0%	0.0%
Interest-only (including endowment) mortgages .....	23,161	437
Affordability mortgages, including ARMs .....	3,127	565
Other .....	76	-
<b>Total interest-only and affordability mortgages</b> .....	<b>26,364</b>	<b>1,002</b>
As a percentage of total mortgage lending .....	49.1%	15.3%
Negative equity mortgages <sup>1</sup> .....	116	-
Other loan to value ratios greater than 90 per cent <sup>2</sup> .....	4,027	73
	<b>4,143</b>	<b>73</b>
<b>- as a percentage of total mortgage lending</b> .....	<b>7.7%</b>	<b>1.1%</b>

*1 Negative equity arises when the value of the loan exceeds the value of available equity, generally based on values at origination date.*

*2 Loan to value ratios are generally based on values at origination date.*

## 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

	At 31 December	
	2009	2008
	£m	£m
Customers .....	1,545	1,298

### 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

#### 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 <sup>1</sup>	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

<sup>1</sup> 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.

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

31 December 2009

	Neither past due nor impaired			Sub-Standard	Past due not impaired		Impairment allowances	Total
	Strong	Medium			Impaired	Total		
		Good	Satisfactory					
	£m	£m	£m	£m	£m	£m	£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



31 December 2008

	Neither past due nor impaired			Sub-Standard	Past		Impairment allowances	Total
	Strong	Medium			Due not Impaired	Impaired		
		Good	Satisfactory					
	£m	£m	£m	£m	£m	£m	£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

## 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.

	Up to 29 days £m	30-59 days £m	60-89 days £m	90-179 days £m	Over 180 days £m	Total £m
<b>At 31 December 2009</b>						
Loans and advances held at amortised cost .....	1,518	366	235	19	16	2,154
Other assets.....	4	-	8	3	1	16
	<u>1,522</u>	<u>366</u>	<u>243</u>	<u>22</u>	<u>17</u>	<u>2,170</u>
	Up to 29 days £m	30-59 days £m	60-89 days £m	90-179 days £m	Over 180 days £m	Total £m
<b>At 31 December 2008</b>						
Loans and advances held at amortised cost .....	1,220	437	257	198	227	2,339
	<u>1,220</u>	<u>437</u>	<u>257</u>	<u>198</u>	<u>227</u>	<u>2,339</u>

## 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:

	2009 £m	2008 £m
<b>Nature of assets</b>		
Residential property .....	<u>75</u>	<u>67</u>

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.

## Impaired loans and advances

### *Impaired loans and advances to customers and banks by industry sector*

	Impaired loans and advances at 31 December 2009			Impaired loans and advances at 31 December 2008		
	Individually assessed £m	Collectively assessed £m	Total £m	Individually assessed £m	Collectively assessed £m	Total £m
Banks .....	97	–	97	42	–	42
Customers .....	5,438	1,088	6,526	2,902	800	3,702
Personal .....	801	1,035	1,836	451	744	1,195
Corporate and commercial .....	4,280	53	4,333	2,383	56	2,439
Financial .....	357	–	357	68	–	68
	<u>5,535</u>	<u>1,088</u>	<u>6,623</u>	<u>2,944</u>	<u>800</u>	<u>3,744</u>

### *Impairment allowances and charges on loans and advances to customers*

The table below analyses the impairment allowances recognised for impaired loans and advances that are either individually assessed or collectively assessed, and collective impairment allowances on loans and advances classified as not impaired.

	At 31 December 2009 £m	At 31 December 2008 £m
<b>Gross loans and advances</b>		
Individually assessed impaired loans <sup>1</sup> .....	5,438	2,902
Collectively assessed <sup>2</sup> .....	272,813	297,904
Impaired loans <sup>1</sup> .....	1,088	800
Non-Impaired loans <sup>3</sup> .....	271,725	297,104
Total gross loans and advances .....	<u>278,251</u>	<u>300,806</u>
<b>Impairment allowances</b>		
Individually assessed .....	2,312	1,380
Collectively assessed .....	1,280	1,122
Total impairment allowances .....	<u>3,592</u>	<u>2,502</u>
Individually assessed allowances as a percentage of individually assessed loans and advances .....	42.5%	47.6%
Collectively assessed allowances as a percentage of collectively assessed loans and advances .....	0.5%	0.4%

<sup>1</sup> Impaired loans and advances are those classified as CRR 9, CRR 10, EL 9 or EL 10 and all retail loans 90 days or more past due.

<sup>2</sup> Collectively assessed loans and advances comprise homogeneous groups of loans that are not considered individually significant, and loans subject to individual assessment where no impairment has been identified on an individual basis, but on which a collective impairment allowances has been calculated to reflect losses which have been incurred but not yet identified.

<sup>3</sup> Collectively assessed loans and advances not impaired are those classified as CRR1 to CRR8 and EL1 to EL8 but excluding retail loans 90 days past due.

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

	At 31 December 2009			At 31 December 2008		
	Individually assessed allowances £m	Collectively assessed allowances £m	Total allowances £m	Individually assessed allowances £m	Collectively assessed allowances £m	Total allowances £m
Banks	57	–	57	43	–	43
Customers .....	2,312	1,280	3,592	1,380	1,122	2,502
Personal .....	246	969	1,215	148	847	995
Corporate and commercial ..	1,926	306	2,232	1,182	264	1,446
Financial .....	140	5	145	50	11	61
	<b>2,369</b>	<b>1,280</b>	<b>3,649</b>	<b>1,423</b>	<b>1,122</b>	<b>2,545</b>

**Impairment allowances as a percentage of gross loans and advances to banks and customers<sup>1</sup>**

	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
	<b>1.73</b>	<b>1.08</b>

<sup>1</sup> Net of reverse repo transactions, settlement accounts and stock borrowings

## Movement in impairment allowances

The tables below describe details of the movements in HSBC's loan impairment allowances (i) for loans and advances and (ii) by industry segment for each of the past 5 years.

### Movement in impairment allowances on loans and advances

	Banks	Customers		Total £m
	Individually assessed £m	Individually assessed £m	Collectively Assessed £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)
<b>At 31 December 2009 .....</b>	<b>57</b>	<b>2,312</b>	<b>1,280</b>	<b>3,649</b>
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 <sup>1</sup> .....	–	22	135	157
Charge to income statement <sup>1</sup> .....	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

### Movement in impairment allowances by industry sector

	2009 £m	2008 £m	2007 £m	2006 £m	2005 £m
Impairment allowances at 1 January .....	2,545	1,796	1,766	1,885	2,373
Amounts written off .....	(1,580)	(1,150)	(1,297)	(1,238)	(1,351)
Personal .....	(1,012)	(859)	(1,031)	(880)	(1,059)
– residential mortgages .....	(25)	(2)	(1)	(1)	(7)
– other personal .....	(987)	(857)	(1,030)	(879)	(1,052)
Corporate and commercial .....	(508)	(280)	(264)	(348)	(290)
– commercial, industrial and international trade.....	(275)	(200)	(183)	(245)	(193)
– commercial real estate and other property-related.....	(93)	(42)	(36)	(37)	(36)
– other commercial .....	(140)	(38)	(45)	(66)	(61)
Financial .....	(60)	(11)	(2)	(10)	(2)
Recoveries of amounts written off in previous years .....	170	157	268	227	45
Personal .....	133	150	231	194	33
– residential mortgages .....	17	–	–	–	–
– other personal .....	116	150	231	194	33
Corporate and commercial .....	32	7	34	33	12
– commercial, industrial and international trade.....	30	4	8	13	6
– commercial real estate and other property-related.....	2	3	9	8	1
– other commercial .....	–	–	17	12	5
Financial .....	5	–	3	–	–
Charge to income statement .....	2,619	1,716	1,043	935	807
Personal .....	1,130	876	789	776	613
– residential mortgages .....	100	11	4	13	5
– other personal .....	1,030	865	785	763	608
Corporate and commercial .....	1,329	749	248	169	202
– commercial, industrial and international trade.....	543	304	176	133	192
– commercial real estate and other property-related.....	626	304	60	20	31
– other commercial .....	160	141	12	16	(21)
Financial .....	160	91	7	(3)	(11)

Governments .....	–	–	(1)	(7)	3
Exchange and other movements .....	<b>(105)</b>	26	16	(43)	11
<b>Impairment allowances at 31 December .....</b>	<b><u>3,649</u></b>	<b><u>2,545</u></b>	<b><u>1,796</u></b>	<b><u>1,766</u></b>	<b><u>1,885</u></b>
Impaired allowances against banks:					
– individually assessed .....	57	43	3	4	5
Impaired allowances against customers <sup>2</sup>					
– individually assessed .....	2,312	1,380	920	878	905
– collectively assessed .....	1,280	1,122	873	884	975
Impairment allowances at 31 December .....	<b><u>3,649</u></b>	<b><u>2,545</u></b>	<b><u>1,796</u></b>	<b><u>1,766</u></b>	<b><u>1,885</u></b>
<b>Impairment allowances as a percentage of loans and advances</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>
– individually assessed .....	<b>0.84</b>	0.46	0.40	0.44	0.50
– collectively assessed .....	<b>0.47</b>	0.38	0.38	0.44	0.53
<b>At 31 December .....</b>	<b><u>1.31</u></b>	<b><u>0.84</u></b>	<b><u>0.78</u></b>	<b><u>0.88</u></b>	<b><u>1.03</u></b>

***Individually and collectively assessed charge to impairment allowances by industry segment***

	Individually assessed	2009 Collectively assessed	Total
	£m	£m	£m
Banks .....	35	–	35
Personal .....	125	1,005	1,130
– Residential mortgages .....	89	11	100
– Other personal .....	36	994	1,030
Corporate and commercial .....	1,153	176	1,329
– Commercial, industrial and international trade .....	434	109	543
– Commercial real estate and other property-related .....	559	67	626
– Other commercial .....	160	–	160
Financial .....	130	(5)	125
Total charge to income statement .....	<b><u>1,443</u></b>	<b><u>1,176</u></b>	<b><u>2,619</u></b>
		2008	
	Individually assessed	Collectively assessed	Total
	£m	£m	£m
Banks .....	35	–	35
Personal .....	25	851	876
– Residential mortgages .....	10	1	11
– Other personal .....	15	850	865
Corporate and commercial .....	586	163	749
– Commercial, industrial and international trade .....	198	106	304
– Commercial real estate and other property-related .....	282	22	304
– Other commercial .....	106	35	141
Financial .....	45	11	56
Total charge to income statement .....	<b><u>691</u></b>	<b><u>1,025</u></b>	<b><u>1,716</u></b>

### *Net loan impairment charge to the income statement*

	2009	2008	2007	2006	2005
	£m	£m	£m	£m	£m
Individually assessed impairment allowances					
New allowances .....	1,654	893	390	388	564
Release of allowances no longer required.....	(167)	(180)	(194)	(240)	(354)
Recoveries of amounts previously written off .....	(44)	(22)	(21)	(19)	(12)
	<b>1,443</b>	691	175	129	198
Collectively assessed impairment allowances .....					
New allowances net of allowance required .....	1,445	1,266	1,228	1,123	824
Release of allowances no longer required .....	(143)	(106)	(113)	(109)	(182)
Recoveries of amounts previously written off .....	(126)	(135)	(247)	(208)	(33)
	<b>1,176</b>	1,025	868	806	609
Total charge for impairment losses .....	<b>2,619</b>	1,716	1,043	935	807
Banks .....	35	35	-	-	(3)
Customers .....	<b>2,584</b>	1,681	1,043	935	810
Charge for impairment losses as a percentage of closing gross loans and advances.....	0.81	0.49	0.36	0.38	0.37
At 31 December.....	£m	£m	£m	£m	£m
Impaired loans .....	6,623	3,744	2,959	2,773	2,722
Impairment allowances .....	3,649	2,545	1,796	1,766	1,885

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

	2009	2008	2007	2006	2005
	%	%	%	%	%
Net allowances net of allowances releases .....	1.11	0.78	0.72	0.71	0.54
Recoveries.....	(0.07)	(0.07)	(0.15)	(0.14)	(0.03)
Total charge for impairment losses .....	<b>1.04</b>	0.71	0.57	0.57	0.51
Amount written off net of recoveries .....	<b>0.63</b>	0.48	0.71	0.75	0.85

### **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 coordinated 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 on the HSBC Bank plc 2009 Financial Statements.

#### *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 on the HSBC Bank plc 2009 Financial Statements.

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)

#### *Advances to deposits ratios*

	<b>2009</b>	2008
	%	%
Year-end .....	<b>89.3</b>	88.9
Maximum .....	<b>91.7</b>	93.4
Minimum .....	<b>88.8</b>	86.4
Average .....	<b>90.1</b>	90.6

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*

	<b>2009</b>	2008
	%	%
Year-end .....	<b>16.0</b>	15.4
Maximum .....	<b>19.4</b>	17.9
Minimum .....	<b>14.8</b>	12.9
Average .....	<b>17.3</b>	15.1

*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.

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

	2009 £bn	2008 £bn
<b>Conduits</b>		
Client-originated assets <sup>1</sup>		
– total lines .....	4.6	3.8
– largest individual lines .....	0.6	0.7
Assets managed by the group <sup>2</sup> .....	17.9	23.9
<b>Single-issuer liquidity facilities</b>		
– five largest <sup>3</sup> .....	2.8	4.1
– largest market sector <sup>4</sup> .....	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.

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 interrelationships 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;
- 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 group. 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:

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

<sup>1</sup> The reporting of commodity risk is consolidated with foreign exchange risk and is not applicable to non-trading portfolios.

<sup>2</sup> 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:

	<u>£m</u>
Total	
At 31 December 2009 .....	53.5
At 31 December 2008 .....	144.5

	<u>Average</u>	<u>Minimum</u>	<u>Maximum</u>
	<u>£m</u>	<u>£m</u>	<u>£m</u>
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:

### *Total trading VAR by risk type*

	<u>Foreign exchange and commodity</u>	<u>Interest rate</u>	<u>Equity</u>	<u>Credit</u>	<u>Total<sup>1</sup></u>
	<u>£m</u>	<u>£m</u>	<u>£m</u>	<u>£m</u>	<u>£m</u>
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

<sup>1</sup>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 59.

#### **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) on the HSBC Bank plc 2009 Financial Statements.

### **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 comprehensive income. 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).

## Asset Backed Securities

	31 December 2009				31 December 2008			
	Gross principal <sup>2</sup>		Net CDS gross protection <sup>3</sup>		Principal exposure <sup>4,10</sup>		Carrying Amount <sup>5,10</sup>	
	£m	£m	£m	£m	£m	£m	£m	£m
– High grade <sup>1</sup> .....	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 .....	<b>42,978</b>	<b>(5,931)</b>	<b>37,047</b>	<b>25,360</b>	<b>52,118</b>	<b>(6,824)</b>	<b>45,294</b>	<b>29,062</b>

	Gross fair value Movements	Gross fair value movements Other comprehensive Income <sup>9</sup>	Realised gains/(losses) in the Income statement <sup>7</sup>	Reclassified from equity on impairment, disposal or payment <sup>8</sup>
	Income statement <sup>6</sup>	Income <sup>9</sup>	Income statement <sup>7</sup>	Income statement <sup>7</sup>
	£m	£m	£m	£m
– High grade <sup>1</sup> .....	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 .....	<b>168</b>	<b>2,109</b>	<b>(172)</b>	<b>2,432</b>

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 other comprehensive income 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: 1 GBP: USD 1.623; 2008: 1 GBP: 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).

### Operational risk

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

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

A formal governance structure provides oversight over the management of operational risk. A Global Operational Risk and Control Committee, which reports to the Group Risk

Management Meeting, meets at least quarterly to discuss key risk issues and review the effective implementation of the Group's operational risk management framework.

In each of HSBC's subsidiaries, business managers are responsible for maintaining an acceptable level of internal control, commensurate with the scale and nature of operations. They are responsible for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The operational risk management framework helps managers to fulfil these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational loss data.

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

Further details of the HSBC approach to Operational Risk Management can be found in the Group pillar 3 disclosures.

## **Legal risk**

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

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

HSBC has a global legal function to assist management in controlling legal risk. The function provides legal advice and support in managing claims against HSBC companies, as well as in respect of non-routine debt recoveries or other litigation against third parties.

The Group Management Office Legal department oversees the global legal function and is headed by a Group General Manager. There are legal departments in each of the countries in which HSBC operates.

Operating companies must notify the appropriate legal department immediately any litigation is either threatened or commenced against HSBC or an employee. The appropriate regional legal department must be immediately advised (and must in turn immediately advise the Group Management Office Legal department) of any action by a regulatory authority, where the proceedings are criminal, or where the claim might materially affect the Group's reputation. Further, any claims which exceed US\$1.5 million or equivalent must also be advised to the appropriate regional legal department and the regional legal department must immediately advise the Group Management Office Legal department if any such claim

exceeds US\$5 million. All such matters are then reported to the Risk Management Meeting of the Group Management Board in a monthly paper.

An exception report must be made to the local compliance function and escalated to the Head of Group Compliance in respect of any breach which has given rise to a fine and/or costs levied by a court of law or regulatory body where the amount is US\$1,500 or more, and material or significant issues are reported to the Risk Management Meeting of Group Management Board and/or the Group Audit Committee.

In addition, operating companies are required to submit quarterly returns detailing outstanding claims where the claim (or group of similar claims) exceeds US\$10 million, where the action is by a regulatory authority, where the proceedings are criminal, where the claim might materially affect the Group's reputation, or, where the Group Management Office Legal department has requested returns be completed for a particular claim. These returns are used for reporting to the Group Audit Committee and the Board of HSBC Holdings, and disclosure in the HSBC Holdings plc *Interim Report* and HSBC Holdings plc *Annual Report and Accounts*, if appropriate.

### **Group security and fraud risk**

Security and fraud risk issues are managed at Group level by Group Security and Fraud Risk. This unit, which has responsibility for physical risk, fraud, information and contingency risk, and security and business intelligence, is fully integrated within the central Group Management Office Risk function. This enables the Group to identify and mitigate the permutations of these and other non-financial risks to its business lines across the jurisdictions in which it operates.

### **Pension risk**

The group operates a number of pension plans, as described in Note 7 on the HSBC Bank plc 2009 Financial Statements. Some of them are defined benefit plans, of which the largest is the HSBC Bank (UK) Pension Scheme.

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

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

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

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

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

The plan's investment strategy is determined after taking into consideration the market risk inherent in the investments and its consequential impact on potential future contributions.

Ultimate responsibility for investment strategy rests with either the trustees or, in certain circumstances, a Management Committee. The degree of independence of the trustees from HSBC varies in different jurisdictions. For example, the HSBC Bank (UK) Pension Scheme, which accounts for approximately 88 per cent of the obligations of the group's defined benefit pension plans, is overseen by a corporate trustee who regularly monitors the market risks inherent in the scheme.

### **Reputation risk**

Reputation risk is managed at the Group level. The safeguarding of HSBC's reputation is of paramount importance to its continued prosperity and is the responsibility of every member of staff.

HSBC regularly reviews its policies and procedures for safeguarding against reputational and operational risks. This is an evolutionary process which takes account of relevant developments and industry guidance such as The Association of British Insurers' guidance on best practice when responding to environmental, social and governance ('ESG') risks.

HSBC 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 can arise from a wide variety of causes, including ESG issues and 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 whom it provides financial services, conduct themselves. The training of Directors on appointment includes reputational matters.

A Group Reputational Risk Committee ('GRRC') was established in 2008 at which Group functions with responsibility for activities that attract reputational risk are represented. The primary role of the GRRC is to consider areas and activities presenting significant reputational risk and, where appropriate, to make recommendations to the Risk Management Meeting and Group Management Board for policy or procedural changes to mitigate such risk.

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

detail and co-operation between Group Management Office departments and businesses is required to ensure a strong adherence to HSBC's risk management system and its sustainability practices.

### **Sustainability Risk**

Assessing the environmental and social impacts of providing finance to the Group's customers has been firmly embedded into HSBC's 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. Within the Group Management Office, a separate function, Group Corporate Sustainability, is mandated to manage these risks globally working through local offices as appropriate. Sustainability Risk Managers have regional or national responsibilities for advising on and managing environmental and social risks.

Group Corporate Sustainability's risk management responsibilities include:

- formulating sustainability risk policies. This includes oversight of HSBC's sustainability risk standards, management of 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); undertaking an independent review of transactions where sustainability risks are assessed to be high, and supporting HSBC's operating companies to assess similar risks of a lower magnitude;
- building and implementing systems-based processes to ensure consistent application of policies, reduce the costs of sustainability risk reviews and capture management information to measure and report on the effect of HSBC's lending and investment activities on sustainable development; and
- providing training and capacity building within HSBC's operating companies to ensure sustainability risks are identified and mitigated consistently to either HSBC's own standards, international standards or local regulations, whichever is the higher.

### **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 £m	2008 £m
Life (non-linked)		
Insurance contracts with DPF1 .....	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 .....	<b>15,746</b>	<b>15,249</b>

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.

*Analysis of non-life insurance risk – net written insurance premiums<sup>1</sup>*

	2009	2008
	£m	£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 .....	<u>232</u>	<u>355</u>
Net insurance claims incurred and movement in liabilities to policyholders.....	<u>(473)</u>	<u>(306)</u>

<sup>1</sup> 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:

*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
<b>Financial assets designated at fair value</b>	28	5	–	2	35
Treasury bills .....	1,145	808	–	156	2,109
Debt securities .....	3,645	2,769	–	531	6,945
Equity securities .....	4,818	3,582	–	689	9,089
<b>Financial investments available-for-sale:</b>					
– 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
	<u>5,296</u>	<u>13,721</u>	<u>608</u>	<u>1,834</u>	<u>21,459</u>
At 31 December 2008					
	Life linked contracts £m	Life non- linked contracts £m	Non-life insurance £m	Other assets £m	Total £m
<b>Financial assets designated at fair value</b>					
Treasury bills .....	21	17	–	5	43
Debt securities .....	1,578	502	–	709	2,789
Equity securities .....	2,681	2,895	–	231	5,807
	<u>4,280</u>	<u>3,414</u>	<u>–</u>	<u>945</u>	<u>8,639</u>
<b>Financial investments available-for-sale:</b>					
– 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
	<u>4,757</u>	<u>13,502</u>	<u>671</u>	<u>1,979</u>	<u>20,909</u>

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 present value of the in-force long-term insurance business asset ("PVIF") is included in the results of the stress tests. The relationship between the values of certain assets and liabilities and the risk factors may be non-linear and, therefore, the results disclosed cannot be extrapolated to measure sensitivities to different levels of stress. The sensitivities are stated before allowance for the effect of management

actions which may mitigate changes in market rates, and for any factors such as policyholder behaviour that may change in response to changes in market risk.

*Sensitivity of the group's insurance subsidiaries to risk factors*

	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 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 five credit quality classifications are provided on pages 45 and 46. 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			Past due not impaired	Impaired <sup>1</sup>	Impairment allowances	Total
	Strong	Medium	Sub- standard				
	£m	£m	£m	£m	£m	£m	£m
<b>At 31 December 2009</b>							
<b>Supporting liabilities under non-linked insurance and investment contracts</b>							
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
<b>Supporting shareholders' funds<sup>2</sup></b>							
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
<b>Total</b>							
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

	Neither past due nor impaired			Past due not impaired	Impaired <sup>1</sup>	Impairment allowances	Total
	Strong £m	Medium £m	Sub- standard £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
	<u>9,501</u>	<u>346</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>9,847</u>
Supporting shareholders' funds <sup>2</sup> .....							
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
	<u>875</u>	<u>12</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>887</u>
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
	<u>10,376</u>	<u>338</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>–</u>	<u>10,734</u>

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
<b>At 31 December 2009</b>				
Governments .....	106	4	3,198	3,308
Local authorities .....	–	–	173	173
Corporates and other .....	82	168	7,526	7,776
	<u>188</u>	<u>172</u>	<u>10,897</u>	<u>11,257</u>
	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
	<u>187</u>	<u>273</u>	<u>10,274</u>	<u>10,734</u>

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 45 and 46. 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			Past due not Impaired	Impaired	Impairment allowances		Total
	Strong	Medium	Sub- standard			£m	£m	
	£m	£m	£m	£m	£m	£m	£m	£m
<b>At 31 December 2009</b>								
Linked insurance contracts .....	17	-	-	-	-	-	-	17
Non-linked insurance contracts ....	380	8	2	-	-	-	-	390
<b>Total .....</b>	<b>397</b>	<b>8</b>	<b>2</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>407</b>
Reinsurance debtors .....	9	-	-	1	-	-	-	10
<b>At 31 December 2008 .....</b>								
Linked insurance contracts .....	7	-	-	-	-	-	-	7
Non-linked insurance contracts .....	602	9	-	-	-	-	-	611
<b>Total .....</b>	<b>609</b>	<b>9</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>618</b>
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.

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)				Total £m
	Within 1 year	1-5 years	5-15 years	Over 15 years	
	£m	£m	£m	£m	
<b>At 31 December 2009</b>					
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
<b>Total .....</b>	<b>850</b>	<b>1,184</b>	<b>1,034</b>	<b>896</b>	<b>3,964</b>
<b>At 31 December 2008</b> .....					
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
<b>Total .....</b>	<b>1,268</b>	<b>1,258</b>	<b>1,064</b>	<b>754</b>	<b>4,344</b>

*Remaining contractual maturity of investment contract liabilities*

	Liabilities under investment contracts by insurance underwriting subsidiaries			
	Linked investment contracts	Non-linked investment contracts	Investment contracts with DPF	Total
	£m	£m	£m	£m
<b>At 31 December 2009</b>				
<b>Remaining contractual maturity:</b>				
– 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 <sup>1</sup> .....	1,445	26	12,930	14,401
<b>Total .....</b>	<b>3,980</b>	<b>26</b>	<b>12,930</b>	<b>16,936</b>
<b>At 31 December 2008</b>				
<b>Remaining contractual maturity:</b>				
– 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 <sup>1</sup> .....	1,627	24	12,157	13,808
<b>Total .....</b>	<b>3,616</b>	<b>24</b>	<b>12,157</b>	<b>15,797</b>

<sup>1</sup> 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 insurance business 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.

### *Sensitivity of PVIF to changes in economic assumptions*

	PVIF at 31 December	
	2009 £m	2008 £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 31December 2009 £m	Total equity at 31December 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

#### **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 SPEs 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 on the HSBC Bank plc 2009 Financial Statements 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.