2012

HSBC BANK BERMUDA LIMITED

Consolidated Financial Statements

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HSBC BANK BERMUDA LIMITED

Consolidated Financial Statements and Audit Report for the year ended 31 December 2012

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Independent Auditors' Report

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

We have audited the accompanying consolidated financial statements of HSBC Bank Bermuda Limited and its subsidiaries (the 'Group'), which comprise the consolidated balance sheet as at 31 December 2012, and the consolidated income statement, and consolidated statements of comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with relevant ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting principles used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Group as at 31 December 2012, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards.

KPMG Audit Limited
Chartered Accountants
Hamilton, Bermuda
25 February 2013

Consolidated Income Statement
for the year ended 31 December 2012

	Notes	**2012 US$000**	2011 US$000
Interest income		261,735	287,240
Interest expense		(14,022)	(22,776)
Net interest income	*3*	247,713	264,464
Fee income		132,291	146,538
Fee expense		(21,227)	(21,758)
Net fee income	*3*	111,064	124,780
Dealing profits		27,972	32,732
Gains less losses from financial investments	*10*	9,921	5,257
Dividend income		350	297
Other operating income		-	966
Total operating income before loan impairment charges		397,020	428,496
Loan impairment charges	*9*	(162,000)	(37,855)
Net operating income		235,020	390,641
Employee compensation and benefits	*4,5*	(130,717)	(148,274)
General and administrative expenses		(54,886)	(65,702)
Depreciation and impairment of property, plant and equipment	*12,15*	(18,730)	(22,657)
Impairment of goodwill	*13*	(7,467)	-
Total operating expenses		(211,800)	(236,633)
Operating profit		23,220	154,008
Gains less losses on disposal of property, plant and equipment and subsidiary investments	*12,16*	91	807
Share of profit (loss) in associates	*14*	82	(562)
Profit before tax		23,393	154,253
Tax expense	*6*	(3,056)	(2,391)
Profit for the year		20,337	151,862
Less: Profit from discontinued operations (net of income tax)	*17*	(850)	(1,398)
Profit for the year from continuing operations		19,487	150,464

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

Consolidated Statement of Comprehensive Income
for the year ended 31 December 2012

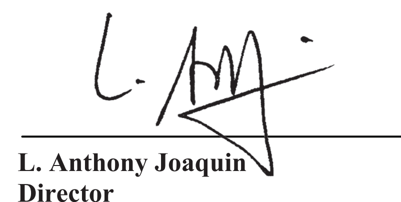
	Notes	**2012** **US$000**	2011 US$000
Profit for the year		20,337	151,862
Other comprehensive income (expense)			
Available-for-sale valuation gains (losses)		40,912	(35,539)
Actuarial losses on defined benefit plans	*4*	(15,995)	(13,472)
Other movements		(3,843)	1,158
Other comprehensive income (expense) for the year		21,074	(47,853)
Total comprehensive income for the year		41,411	104,009

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

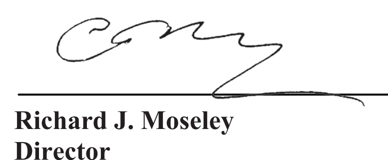
Consolidated Balance Sheet
at 31 December 2012

	Notes	2012 US$000	2011 US$000
ASSETS			
Cash and balances at central banks		31,219	33,753
Items in the course of collection from other banks		136	526
Derivatives	7	6,280	12,981
Loans and advances to banks	8	4,562,064	4,438,287
Loans and advances to customers	9	3,666,811	3,598,052
Financial investments	10	4,638,894	6,444,106
Assets held for sale	17	40,362	42,228
Prepayments and accrued income		65,352	60,710
Deferred tax assets	6	-	53
Other assets		24,935	19,952
Interest in associate	14	1,263	1,181
Property, plant and equipment	12	189,415	198,969
Goodwill	13	22,399	29,866
Total assets		13,249,130	14,880,664
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks		55,803	67,506
Customer accounts		11,361,607	12,929,931
Items in the course of transmission to other banks		7,751	7,335
Derivatives	7	30,779	16,145
Liabilities held for sale	17	893	-
Accruals and deferred income		53,273	61,296
Current tax liabilities		1,279	1,175
Provisions	18	400	-
Other liabilities		34,331	36,383
Retirement benefit liabilities	4	87,051	67,013
Total liabilities		11,633,167	13,186,784
Equity			
Called up share capital	27	30,027	30,027
Share premium	27	388,652	388,652
Other reserves		48,873	5,981
Retained earnings		1,148,411	1,269,220
Total equity		1,615,963	1,693,880
Total liabilities and equity		13,249,130	14,880,664

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



L. Anthony Joaquin
Director



Richard J. Moseley
Director

Consolidated Statement of Cash Flows
for the year ended 31 December 2012

	2012 US$000	2011 US$000
Cash flows from operating activities		
Loss before tax, interest and dividends	(224,670)	(110,508)
Interest received	256,929	273,663
Interest paid	(15,235)	(22,534)
Adjustments for:		
Non-cash items in profit before tax, interest and dividends	140,002	98,184
Change in loans and advances to customers	(230,759)	(398,061)
Change in other operating assets	2,513	22,539
Change in deposits by banks	(11,703)	32,987
Change in customer accounts	(1,568,324)	3,222,916
Change in other operating liabilities	(5,193)	(29,960)
Net gain from investing activities	(9,921)	(246,889)
Tax paid	(2,952)	(18,176)
Net cash flows (used in) from operating activities	(1,669,313)	2,824,161
Cash flows from investing activities		
Dividends received	350	297
Purchase of financial investments	(8,283,429)	(7,586,259)
Proceeds from the sale and maturity of financial investments	10,189,293	4,138,581
Purchase of property, plant and equipment	(6,761)	(2,374)
Proceeds from the sale of property, plant and equipment	3,703	1,072
Net cash inflow from disposal of subsidiaries	-	252,146
Change in assets held for sale	(6,620)	224,688
Net cash flows from (used in) investing activities	1,896,536	(2,971,849)
Cash flows from financing activities		
Dividends paid	(121,308)	(292,040)
Net cash flows used in financing activities	(121,308)	(292,040)
Net increase (decrease) in cash and cash equivalents	105,915	(439,728)
Cash and cash equivalents at the beginning of the year	4,465,231	4,909,077
Effect of exchange rate changes on cash and cash equivalents	14,522	(4,118)
Cash and cash equivalents at the end of the year	4,585,668	4,465,231
Cash and cash equivalents comprise		
Cash and balances at central banks	31,219	33,753
Items in the course of collection from other banks	136	526
Loans and advances to banks	4,562,064	4,438,287
Items in the course of transmission to other banks	(7,751)	(7,335)
Total cash and cash equivalents	4,585,668	4,465,231

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

Consolidated Statement of Changes in Equity
for the year ended 31 December 2012
(In US dollar thousands)

	Called up share capital	Share premium	Other reserves: Available-for-sale fair value reserve	Other reserves: Foreign exchange reserve	Other reserves: Share-based payment reserve	Other reserves: Other reserves	Retained earnings	Total equity
At 1 January 2011	**30,027**	**388,652**	**40,692**	**647**	**1,335**	**1,308**	**1,420,404**	**1,883,065**
Comprehensive income, net of income tax								
Profit for the year	-	-	-	-	-	-	151,862	151,862
Available-for-sale valuation losses	-	-	(35,539)	-	-	-	-	(35,539)
Actuarial losses on defined benefit plans	-	-	-	-	-	-	(13,472)	(13,472)
Other movements	-	-	-	-	-	(1,308)	2,466	1,158
Total comprehensive income, net of income tax	-	-	(35,539)	-	-	(1,308)	140,856	104,009
Transactions with the shareholder recorded directly in equity								
Dividends	-	-	-	-	-	-	(292,040)	(292,040)
Share-based plan movements	-	-	-	-	(1,154)	-	-	(1,154)
Total transactions with the shareholder recorded directly in equity	-	-	-	-	(1,154)	-	(292,040)	(293,194)
At 31 December 2011	**30,027**	**388,652**	**5,153**	**647**	**181**	**-**	**1,269,220**	**1,693,880**
Comprehensive income, net of income tax								
Profit for the year	-	-	-	-	-	-	20,337	20,337
Available-for-sale valuation gains	-	-	40,912	-	-	-	-	40,912
Actuarial losses on defined benefit plans	-	-	-	-	-	-	(15,995)	(15,995)
Other movements	-	-	-	-	-	-	(3,843)	(3,843)
Total comprehensive income, net of income tax	-	-	40,912	-	-	-	499	41,411
Transactions with the shareholder recorded directly in equity								
Dividends	-	-	-	-	-	-	(121,308)	(121,308)
Share-based plan movements	-	-	-	-	1,980	-	-	1,980
Total transactions with the shareholder recorded directly in equity	-	-	-	-	1,980	-	(121,308)	(119,328)
At 31 December 2012	**30,027**	**388,652**	**46,065**	**647**	**2,161**	**-**	**1,148,411**	**1,615,963**

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

1 Basis of preparation

(a) General

HSBC Bank Bermuda Limited (the 'Bank') was established in 1889 and incorporated in 1891. The address of its registered office is 6 Front Street, Hamilton HM11, Bermuda. The consolidated financial statements of the Bank for the year ended 31 December 2012 comprise the Bank and its subsidiaries (together referred to as the 'group') and the group's interests in associates. The Bank is domiciled in Bermuda and provides retail and corporate banking, investment, trust, custody and fund administration services to international and local clients. The immediate parent company of the Bank is HSBC Asia Holdings BV. The ultimate parent company is HSBC Holdings plc ('HSBC'). Copies of the financial statements of HSBC may be obtained from its registered office at 8 Canada Square, London, England, E14 5HQ, or from the HSBC website, www.hsbc.com.

These consolidated financial statements are authorised for issue by the Board of Directors on 17 February 2013.

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

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

Certain reclassifications have been made to the 2011 comparative financial information in order to conform to the current year presentation.

These consolidated financial statements are presented in accordance with IAS 1 'Presentation of Financial Statements'. In the opinion of management, all normal and recurring adjustments considered necessary for a fair presentation of the group's net income, financial position and cash flows for the years ended 31 December 2012 and 31 December 2011 have been made. In accordance with IFRS 8 'Operating Segments', no segment information has been presented as the shares of the group are not publicly traded.

During 2012, the group adopted a number of interpretations and amendments which had an insignificant effect on the consolidated financial statements.

(b) Basis of consolidation

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

All intra-group transactions are eliminated on consolidation. The consolidated financial statements of the group include the attributable share of the results of any interests in associates.

(c) Use of estimates and assumptions

The preparation of financial information requires the use of estimates and assumptions about future conditions. The use of available information and the application of judgement are inherent in the formation of estimates; actual results in the future may differ from estimates upon which financial information is prepared. Management believes that the critical accounting policies where judgement is necessarily applied are those which relate to impairment of loans and advances, goodwill impairment, fair value of assets held for sale, the valuation of financial instruments, the impairment of available-for-sale financial assets and deferred tax assets.

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

(d) Future accounting developments – Amendments issued by the IASB

At 31 December 2012, a number of standards and amendments to standards had been issued by the IASB, which are not effective for these consolidated financial statements. In addition to the projects to complete financial instrument accounting, the IASB is continuing to work on projects on insurance, revenue recognition and lease accounting which, together with the standards described below, will represent significant changes to accounting requirements from 2013.

Standards applicable in 2013

(i) IFRS 10 'Consolidated Financial Statements', IFRS 11 'Joint Arrangements' and IFRS 12 'Disclosure of Interests in Other Entities'

In May 2011, the IASB issued IFRS 10 'Consolidated Financial Statements' ('IFRS 10'), IFRS 11 'Joint Arrangements' ('IFRS 11') and IFRS 12 'Disclosure of Interests in Other Entities' ('IFRS 12'). In June 2012, the IASB issued amendments to IFRS 10, IFRS 11 and IFRS 12 'Transition Guidance'. The standards and amendments are effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. IFRSs 10 and 11 are required to be applied retrospectively.

Under IFRS 10, there will be one approach for determining consolidation for all entities, based on the concept of power, variability of returns and their linkage. This will replace the current approach which emphasises legal control or exposure to risks and rewards, depending on the nature of the entity. IFRS 11 places more focus on rights and obligations than on legal form, and introduces the concept of a joint operation. IFRS 12 includes the disclosure requirements for subsidiaries, joint arrangements and associates and introduces new requirements for unconsolidated structured entities.

Based on our assessment to date, we do not expect the overall impact of these new IFRSs on the consolidated financial statements to be material.

(ii) IFRS 13 'Fair Value Measurement'

In May 2011, the IASB issued IFRS 13 'Fair Value Measurement' ('IFRS 13'). This standard is effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. IFRS 13 is required to be applied prospectively from the beginning of the first annual period in which it is applied. The disclosure requirements of IFRS 13 do not require comparative information to be provided for periods prior to initial application.

IFRS 13 establishes a single source of guidance for all fair value measurements required or permitted by IFRSs. The standard clarifies the definition of fair value as an exit price, which is defined as a price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions, and enhances disclosures about fair value measurement.

The group is currently assessing the impact of this new IFRS however it is not expected to have a significant impact on these consolidated financial statements.

(iii) IAS 19 'Employee Benefits'

In June 2011, the IASB issued amendments to IAS 19 'Employee Benefits' ('IAS 19 revised'). The revised standard is effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. IAS 19 revised must be applied retrospectively.

The most significant amendment to IAS 19 for the group is the replacement of interest cost and expected return on plan assets with a finance cost component comprising the net interest on the net defined benefit liability or asset. This finance cost component is determined by applying the same discount rate used to measure the defined benefit obligation to the net defined benefit liability or asset. The difference between the actual return on plan assets and the return included in the finance cost component in the consolidated income statement will be presented in other comprehensive income. The effect of this change is to increase the pension expense by the difference between the current expected return on plan assets and the return calculated by applying the relevant discount rate.

The group is currently assessing the impact of this new IFRS however it is not expected to have a significant impact on these consolidated financial statements.

(iv) IFRS 7 'Disclosures –Offsetting Financial Assets and Financial Liabilities'

In December 2011, the IASB issued amendments to IFRS 7 'Disclosures – Offsetting Financial Assets and Financial Liabilities' which requires the disclosures about the effect or potential effects of offsetting financial assets and financial liabilities and related arrangements on an entity's financial position. The amendments are effective for annual periods beginning on or after 1 January 2013 and interim periods within those annual periods. The amendments are required to be applied retrospectively.

The group is currently assessing the impact of this new IFRS however it is not expected to have a significant impact on these consolidated financial statements.

Standards applicable in 2014

(i) IAS 32 'Offsetting Financial Assets and Financial Liabilities'

In December 2011, the IASB issued amendments to IAS 32 'Offsetting Financial Assets and Financial Liabilities' which clarified the requirements for offsetting financial instruments and addressed inconsistencies in current practice when applying the offsetting criteria in IAS 32 'Financial Instruments: Presentation'. The amendments are effective for annual periods beginning on or after 1 January 2014 and are required to be applied retrospectively.

(ii) Amendments to IFRS 10 'Consolidated Financial Statements', IFRS 12 'Disclosure of Interests in Other Entities' and IAS 27 'Investment Entities'

In October 2012, the IASB issued amendments to IFRS 10, IFRS 12 and IAS 27 'Investment Entities', which introduced an exception to the principle that all subsidiaries shall be consolidated. The amendments require a parent that is an investment entity to measure its investments in particular subsidiaries at fair value through profit or loss instead of consolidating all subsidiaries in its consolidated and separate financial statements.

The amendments are effective from 1 January 2014 with early adoption permitted. Based on our initial assessment, we do not expect the amendments to have a material impact on the group's consolidated financial statements.

Standards applicable in 2015

(i) IFRS 9 'Financial Instruments'

In November 2009, the IASB issued IFRS 9 'Financial Instruments' ('IFRS 9') which introduced new requirements for the classification and measurement of financial assets. In October 2010, the IASB issued additions to IFRS 9 relating to financial liabilities. Together, these changes represent the first phase in the IASB's planned replacement of IAS 39 'Financial Instruments: Recognition and Measurement' ('IAS 39') with a less complex and improved standard for financial instruments.

Following the IASB's decision in December 2011 to defer the effective date, the standard is effective for annual periods beginning on or after 1 January 2015 with early adoption permitted. IFRS 9 is required to be applied retrospectively but prior periods need not be restated.

The second and third phases in the IASB's project to replace IAS 39 will address the impairment of financial assets measured at amortised cost and hedge accounting. The IASB is in the process of amending the requirements for classification and measurement in IFRS 9 to address practice and other issues.

In December 2012, the IASB added the requirements related to general hedge accounting, to IFRS 9 which align hedge accounting more closely with risk management and established a more principle-based approach to hedge accounting while address inconsistencies and weaknesses in the IAS 39 hedge accounting model. The revised hedge accounting requirements are effective for annual periods beginning on or after 1 January 2015 on a prospective basis. The requirements do not address macro hedge accounting, which is still being considered by the IASB. The group is currently assessing the impact of the hedge accounting draft standard.

As a result of uncertainties with regard to the final IFRS 9 requirements for classification and measurement and impairment, the group remains unable to provide a date by which it will apply IFRS 9 as a whole and it remains impracticable to quantify the effect of IFRS 9 as at the date of the publication of these financial statements.

2 Significant accounting policies

(a) Interest income and expense

Interest income and expense for all interest-bearing financial instruments is recognised in 'Interest income' and 'Interest expense' in the consolidated income statement using the effective interest rates of the financial assets or financial liabilities to which they relate.

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

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

(b) Non-interest income

(i) Fee income

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

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

(ii) Dealing profits

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

(iii) Dividend income

Dividend income is recognised net of withholding taxes when the right to receive payment is established. This is the ex-dividend date for listed equity securities, and usually the date when shareholders have approved the dividend for unlisted equity securities.

(c) Cash and cash equivalents

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

(d) Loans and advances to banks and customers

Loans and advances to banks and customers include loans and advances originated by the group, which are not intended to be sold in the short term and have not been classified either as held for trading or designated at fair value through profit and loss. Loans and advances are recognised when cash is advanced to borrowers. They are initially recorded at fair value plus any net directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method, less impairment losses.

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

(e) Impairment of loans and advances

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

(i) Individually assessed loans and advances

The factors considered in determining that a loan is individually significant for the purposes of assessing impairment include:

- the size of the loan;
- the number of loans in the portfolio;
- the importance of the individual loan relationship, and how this is managed; and
- whether volumes of defaults and losses are sufficient to enable a collective assessment methodology to be applied.

Loans considered as individually significant are typically residential mortgages or loans to corporate and commercial customers and are for larger amounts, which are managed on an individual relationship basis. Retail lending portfolios are generally assessed for impairment on a collective basis as the portfolios generally consist of large pools of homogeneous loans.

For all loans that are considered individually significant, the group assesses, on a case-by-case basis at each balance sheet date, whether there is any objective evidence that a loan is impaired. The criteria used by the group to determine that there is such objective evidence include:

- known cash flow difficulties experienced by the borrower;
- past due contractual payments of either principal or interest;
- breach of loan covenants or conditions;
- the probability that the borrower will enter bankruptcy or other financial realisation; and
- a significant downgrading in credit rating by an external credit rating agency.

For those loans where objective evidence of impairment exists, impairment losses are determined considering the following factors:

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

Impairment losses are calculated by discounting the expected future cash flows of a loan at its original effective interest rate, and comparing the resultant present value with the loan's current carrying amount. The impairment allowances on individually significant accounts are reviewed at least quarterly, and more regularly when circumstances require. This normally encompasses re-assessment of the enforceability of any collateral held and of actual and anticipated receipts. Individually assessed impairment allowances are only released when there is reasonable and objective evidence of a reduction in the established loss estimate.

(ii) Collectively assessed loans and advances

Impairment is assessed on a collective basis in two circumstances:

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

Incurred but not yet identified impairment

Where loans have been individually assessed and no evidence of loss has been identified, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment loss. This loss arises from individual loan impairment at the balance sheet date, which will only be identified in the future.

The collective impairment loss is determined after taking into account:

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

The period between a loss occurring and its identification is estimated by local management for each identified portfolio. The factors that may influence this estimation include economic and market conditions, customer behaviour, portfolio management information, credit management techniques and collection and recovery experiences in the market. As it is assessed empirically on a periodic basis the estimated period between a loss occurring and its identification may vary over time as these factors change.

Homogeneous groups of loans and advances

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

- When appropriate empirical information is available, the group utilises roll rate methodology. This methodology employs statistical analyses of historical data and experience of delinquency and default to estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date which the group is not able to identify on an individual loan basis, and that can be reliably estimated. Under this methodology, loans are grouped into ranges according to the number of days past due and statistical analysis is used to estimate the likelihood that loans in each range will progress through the various stages of delinquency, and ultimately prove irrecoverable. In addition to the delinquency groupings, loans are segmented according to their credit characteristics as described above. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss;
- When the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll rate methodology, the group adopts a basic formulaic approach based on historical loss rate experience.

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

(iii) Write-off of loans and advances

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery. Where loans are secured, this is generally after receipt of any proceeds from the realisation of security. In circumstances where the net realisable value of any collateral has been determined and there is no reasonable expectation of further recovery, write off may be earlier.

(iv) Reversals of impairment

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

(v) Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans in order to achieve an orderly realisation are recorded as assets 'held for sale' and no depreciation is provided in respect of these assets. Assets acquired are recorded at fair value less estimated disposal costs at the date of exchange. Any subsequent decrease in the fair value of the acquired assets is recorded as an impairment loss and included in the

consolidated income statement. Any subsequent increase in the fair value of the acquired assets, to the extent this does not exceed the cumulative impairment loss, is recognised in the consolidated income statement.

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

(vi) Renegotiated loans

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

(f) Financial investments

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

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

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

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

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

Impairment losses for available-for-sale securities are recognised within 'Gains less losses from financial investments' in the consolidated income statement.

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

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

the consolidated income statement, to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost of the equity security.

(g) Valuation of financial instruments

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

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

- *Level 1 - quoted market price:* financial instruments with quoted prices for identical instruments in active markets.
- *Level 2 - valuation technique using observable inputs:* financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.
- *Level 3 - valuation technique with significant unobservable inputs*: financial instruments valued using valuation techniques where one or more significant inputs are unobservable.

(h) Assets held for sale

Non-current assets and disposal groups (including both the assets and liabilities of the disposal groups) are classified as held for sale when their carrying amounts will be recovered principally through sale, they are available for sale in their present condition and their sale is highly probable. Non-current assets held for sale and disposal groups are measured at the lower of their carrying amount and fair value less cost to sell. Immediately before the initial classification as held for sale, the carrying amounts of the asset (or assets and liabilities in the disposal group) are measured in accordance with applicable IFRSs. On subsequent remeasurement of a disposal group, the carrying amounts of the assets and liabilities that are not within the scope of the measurement requirements of IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations' are remeasured in accordance with applicable IFRSs before the fair value less costs to sell of the disposal group is determined.

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

(i) Securities lending and borrowing

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

(j) Derivatives and hedge accounting

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

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative would meet the definition of a stand-alone derivative if they were contained in a separate contract; and the combined contract is not held for trading or designated at fair value. These embedded derivatives are measured at fair value with changes therein recognised in the consolidated income statement.

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

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

Hedge accounting

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

Fair value hedge

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

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

Hedge effectiveness testing

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

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method adopted by an entity to assess hedge effectiveness will depend on its risk management strategy.

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

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

Derivatives that do not qualify for hedge accounting

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

(k) Derecognition of financial assets and financial liabilities

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

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

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

(l) Offsetting financial assets and financial liabilities

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

(m) Subsidiaries and associates

The group classifies investments in entities which it controls as subsidiaries.

Interests in associates, which include entities the group has significant influence over but are not subsidiaries, are recognised using the equity method. Under this method, such investments are initially stated at cost, including attributable goodwill, and adjusted thereafter for the post-acquisition change in the group's share of net assets.

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

(n) Property, plant and equipment

Land and buildings are stated at historical cost except land and buildings held at 1 March 2004, the date of transition to IFRSs. The cost of these land and buildings is the fair value at the transition date. Depreciation is calculated using the straight-line method to write off the cost less residual value of the assets over the estimated useful lives as follows:

Freehold land	not depreciated
Buildings	lesser of 50 years or the remaining useful lives
Leasehold improvements	lesser of life of the lease or the remaining useful lives
Equipment, fixtures and fittings	3 – 7 years

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

(o) Goodwill

Goodwill that arises from business combinations is measured as described in Note 1 (b).

Goodwill is tested annually for impairment, is carried at cost less accumulated impairment losses and is subject to impairment review if there are events or changes in circumstances indicating that the carrying amounts may not be recoverable. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold. Goodwill on the acquisition of associates is included in 'Interests in associates'. At the date of disposal of a business, attributable goodwill is included in the group's share of net assets in the calculation of the gain or loss on disposal.

(p) Impairment of assets other than financial instruments

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

Impairment losses are recognised in the consolidated income statement.

(q) Finance and operating leases

Agreements which transfer to counterparties substantially all the risks and rewards incidental to the ownership of assets, but not necessarily legal title, are classified as finance leases. When the group is a lessee under finance leases, the leased assets are capitalised and included in 'Property, plant and equipment' and the corresponding liability to the lessor is included in 'Other liabilities'. A finance lease and its corresponding liability are recognised initially at the fair value of the asset or, if lower, the present value of the minimum lease payments.

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

(r) Income tax

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

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

Deferred tax is recognised on temporary differences between the carrying amount of assets and liabilities in the consolidated balance sheet and the amount attributed to such assets and liabilities for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that future taxable profits will be available against which deductible temporary differences can be utilised. Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group, relate to income taxes levied by the same taxation authority and a legal right to offset exists in the group.

(s) Pension and other post-employment benefits

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

(i) Defined contribution pension plans

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

(ii) Defined benefit pension plans

The costs recognised for funding defined benefit pension plans are determined using the Projected Unit Credit Method, with annual actuarial valuations performed on each plan. Actuarial differences that arise are recognised directly in retained earnings and presented in the consolidated statement of comprehensive income in the period they arise. Past service costs are recognised immediately to the extent the benefits are vested, and are otherwise recognised on a straight-line basis over the average service period until the benefits vest. The current service costs and any past service costs together with the expected return on plan assets less the unwinding of the discount on the plan liabilities are charged to operating expenses under 'Employee compensation and benefits'. Actuarial gains and losses on defined benefit plans are recognised in other comprehensive income in the period in which they arise.

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

(iii) Post-employment healthcare benefits plan

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

(t) Share-based payments

The cost of share-based payment arrangements with employees is measured by reference to the fair value of equity instruments on the date they are granted, and recognised as an expense on a straight-line basis over the vesting period, with a corresponding credit to the 'Share-based payment reserve' in equity. The vesting period is the period during which all the specified vesting conditions of a share-

based payment arrangement are to be satisfied. The fair value of equity instruments that are made available immediately, with no vesting period attached to the award, are expensed immediately.

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

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

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

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

(u) Foreign currencies

(i) Transactions and balances

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

(ii) Group entities

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

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

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

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate.

(v) Customer accounts

Customer accounts are initially measured at fair value plus transaction costs, and subsequently measured at their amortised cost using the effective interest method.

(w) Provisions

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

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

(x) Fiduciary activities

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

(y) Financial guarantee contracts

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

(z) Trading assets and liabilities

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

3 Net interest income and net fee income

(a) Analysis of net interest income

	2012	2011
Interest income		
Financial investments	69,275	65,646
Loans and advances to banks	2,840	28,894
Loans and advances to customers	189,620	192,700
	261,735	287,240
Interest expense		
Deposits by banks	(81)	(205)
Customer accounts	(13,941)	(22,571)
	(14,022)	(22,776)
Net interest income	247,713	264,464

(b) Analysis of net fee income

	2012	2011
Custody and fund administration fees	19,575	18,842
Trust fees	20,945	26,722
Banking fees	41,609	41,092
Management fees	35,479	37,591
Other fees	14,683	22,291
Fee income	132,291	146,538
Fee expense	(21,227)	(21,758)
Net fee income	111,064	124,780

4 Employee compensation and benefits

Post-employment benefit plans

Income statement charge

	2012	2011	2010
Defined contribution pension plans	5,318	7,347	10,282
Defined benefit pension plans	30	220	549
Post-employment healthcare benefits plan	5,841	3,429	3,973
Total post-employment benefit income statement charge	11,189	10,996	14,804

(a) Defined contribution pension plans

The group provides non-contributory defined contribution pension plans to its employees in Bermuda and in the majority of its locations. Employees are able to make additional voluntary payments to the defined contribution pension plans.

The group's expense for the defined contribution pension plans in 2012 was $5,318 (2011: $7,347), of which $5,023 (2011: $6,981) relates to the Bermuda-based plan.

(b) Defined benefit pension plans

HSBC has a funded defined benefit pension plan for certain of its employees in Europe, known as the 'Sterling area' plan. This plan is divided into four regional subsets, namely Isle of Man, Guernsey, Jersey and a fourth subset covering international managers ('Plan B').

The group continues to assume responsibility for the entire Plan B which consists of fourteen individuals (2011: fourteen) as well as the plan comprising thirty three individuals (2011: thirty four) previously employed by the Bank of Bermuda (Isle of Man) Limited. The

net surplus at 31 December 2012 and 31 December 2011 relates only to the components of the plan over which the group maintains current and future legal responsibility.

The group also has an interest in a funded defined benefit plan relating to eleven individuals (2011: eleven) in Bermuda and the Cayman Islands.

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

Actuarial valuation of the assets and liabilities of the group's defined benefit pension plans are carried out annually to determine their financial position and to ensure that benefit obligations are adequately funded. The group's pension expense for the defined benefit pension plans in 2012 was $30 (2011: expense of $220).

The weighted average principal actuarial financial assumptions used to calculate the defined benefit plans at 31 December are:

Year	Rate of increase for pensions in payment and deferred pensions	Inflation assumption	Discount Rate	Rate of pay increase
	%	%	%	%
2012	3.4	3.3	4.2	3.5
2011	3.2	3.6	4.8	3.6
2010	3.4	4.1	5.4	4.8

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

	2012	2011
Equities	8,507	7,181
Bonds	10,239	8,844
Property and other	1,719	1,776
Fair value of plan assets	20,465	17,801
Present value of defined benefit obligations	(22,246)	(17,550)
Net (deficit) surplus	(1,781)	251

The weighted average expected rate of return on assets for 2012 was 4.8% (2011: 5.3%). The basis used to determine the percentage expected rate of return on assets was market conditions at the date of the actuarial valuation. The changes in the present value of the defined benefit obligation in respect of the group's pension plan are presented below:

	2012	2011
At 1 January	17,550	15,535
Current service cost	125	383
Interest cost	870	905
Actuarial losses (gains)	3,671	(16)
Benefits paid	(673)	(661)
Exchange and other movements	703	1,404
At 31 December	22,246	17,550

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

	2012	2011
At 1 January	17,801	15,913
Expected return	945	1,027
Contributions by the group	398	1,550
Actuarial gains (losses)	1,344	(314)
Benefits paid	(673)	(661)
Exchange and other movements	650	286
At 31 December	20,465	17,801

The actual return on plan assets for the year ended 31 December 2012 was a gain of $2,289 (2011: gain of $712).

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

	2012	2011	2010
Current service cost	(125)	(383)	(165)
Interest cost	(870)	(905)	(815)
Expected return on plan assets	945	1,027	832
Other movements	20	41	(401)
Total net expense	(30)	(220)	(549)

An actuarial loss of $2,360 (2011: loss of $301) was included in the consolidated statement of comprehensive income for the defined benefit pension plans. The cumulative amount of actuarial losses recognised in the consolidated statement of comprehensive income is $5,045 (2011: $2,685).

Summary

	2012	2011	2010	2009	2008
Defined benefit obligations	(22,246)	(17,550)	(15,535)	(15,702)	(12,571)
Fair value of plan assets	20,465	17,801	15,913	14,961	11,392
Net (deficit) surplus	(1,781)	251	378	(741)	(1,179)
Actuarial (losses) gains on plan liabilities	(3,671)	16	(275)	(968)	303
Actuarial gains (losses) on plan assets	1,344	(314)	430	1,669	(3,984)
Exchange and other movements	(33)	(3)	34	(118)	594
Total net actuarial (losses) gains	(2,360)	(301)	189	583	(3,087)

(c) Post-employment healthcare benefits plan

The group provides a non-contributory unfunded post-employment healthcare benefits plan for certain Bermuda-based retired employees. To qualify, employees must have a minimum of 15 years of successive service at the date of retirement. Independent, qualified actuaries carry out an actuarial assessment of the liabilities of the plan on an annual basis using the RP-2000 Fully Generational Mortality Improvement Projection table. The liabilities are evaluated by discounting the expected future claims to a net present value.

The latest actuarial assessment was carried out in October 2012 in accordance with IAS 19 'Employee Benefits'. At 31 December 2012, the estimated present value of the post-employment healthcare benefit obligation was $85,270 (2011: $67,264). The main financial assumptions used to estimate the obligation at 31 December 2012 are current and ultimate healthcare claims trend rate of 8.50% and 4.75% per annum respectively (2011: 9.00% and 4.75%) and a discount rate of 4.10% (2011: 4.75%) per annum.

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

	2012	2011
At 1 January	67,264	51,875
Current service cost	2,674	1,746
Interest cost	3,287	2,832
Contributions by employees	1,530	1,496
Actuarial losses	13,635	13,171
Benefits paid	(3,000)	(2,707)
Plan amendments	(120)	(168)
Curtailments	-	(981)
At 31 December	85,270	67,264

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

	2012	2011
Current service cost	(2,674)	(1,746)
Interest cost	(3,287)	(2,832)
Plan amendments	120	168
Curtailments	-	981
Total net expense	(5,841)	(3,429)

Total net actuarial results recognised in the consolidated statement of comprehensive income in 2012 in respect of the post-employment healthcare benefits plan are a loss of $13,635 (2011: loss of $13,171). The total cumulative net actuarial loss to date, which has been recognised in the consolidated statement of comprehensive income, is $27,309 (2011: $13,674).

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

	2012	2011
Net obligation	85,270	67,264
Experience adjustments on plan liabilities expressed as an amount	(13,635)	(13,171)
Experience adjustments on plan liabilities expressed as a percentage	(16.0%)	(19.6%)

The actuarial assumptions related to the healthcare cost trend rates may have a significant effect on the amounts recognised. A one-percentage point change in assumed healthcare cost trend rates would have the following effects on amounts recognised in 2012:

	1% increase	**1% decrease**
Effect on the aggregate of the current service cost and interest cost	1,677	(1,232)
Effect on present value of the benefit obligation	19,945	(15,092)

5 Share-based payments

During 2012, $2,997 was charged to the consolidated income statement in respect of share-based payment transactions settled in equity (2011: $4,951). This expense, which was computed from the fair values of the share-based payments on transaction dates, arose under employee share awards made in accordance with the group's reward structures. All share plans are based on ordinary $0.50 par value shares in the ultimate parent company HSBC Holdings plc. All exercise prices and fair values of shares and options presented below are exact amounts (not rounded or shown to the nearest thousand).

Calculation of fair values

Fair values of share options/awards, measured at the date of grant of the option/award, are calculated using a Black-Scholes model. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

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

	Savings-related share option plan		
	1-year	**3-year**	**5-year**
2012			
Risk-free interest rate[1] (%)	0.4	0.6	1.2
Expected life (years)	1	3	5
Expected volatility[2] (%)	25	25	25
Share price at grant date ($)	8.74	8.74	8.74
2011			
Risk-free interest rate[1] (%)	0.8	1.7	2.5
Expected life (years)	1	3	5
Expected volatility[2] (%)	25	25	25
Share price at grant date ($)	10.47	10.47	10.47

[1] *The risk-free rate was determined from the UK gilts yield curve. A similar yield curve was used for the HSBC Holdings Savings-Related Share Option Plan: International.*

[2] *Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC Holdings ordinary shares of similar maturity to those of the employee options.*

Expected dividends are incorporated into the valuation model for share options and awards, where applicable. The expected US dollar denominated dividend yield was determined to be 5.0 per cent, in line with consensus analyst forecast (2011: 4.5%).

The HSBC share plan

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

Restricted share awards

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

	2012 Number of awards (000s)	2011 Number of awards (000s)
Outstanding at 1 January	1,269	1,821
Granted in the year[1]	226	319
Transferred out from group companies	(1)	(457)
Exercised in the year	(985)	(371)
Forfeited in the year	(70)	(43)
Outstanding at 31 December	439	1,269

[1] *Additions during the year include reinvested scrip dividends.*

The weighted average fair value of shares awarded by HSBC for restricted share awards in 2012 was $7.45 (2011: $9.01).

Savings-related share option plans

Savings-related share option plans invite eligible employees to enter into savings contracts to save up to three hundred and ninety (2011: three hundred and fifty) dollars per month, with the option to use the savings to acquire shares. The aim of the plans is to align the interests of all employees with the creation of shareholder value. The options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or fifth anniversaries of the commencement of three-year or five-year savings contracts, respectively. The exercise price is set at a 20 per cent discount to the average market value immediately preceding the date of invitation.

	2012		2011	
	Number of options (000s)	**Weighted average exercise price**	Number of options (000s)	Weighted average exercise price
Outstanding at 1 January	459	7.18	984	6.33
Granted in the year[1]	168	5.39	119	6.81
Transferred out from group companies	-	-	(468)	5.15
Exercised in the year	(94)	5.73	(43)	6.16
Forfeited in the year	(142)	8.15	(133)	8.01
Outstanding at 31 December	391	6.41	459	7.18

[1] *Additions during the year include reinvested scrip dividends.*

The weighted average fair value of options granted during the year was $1.63 (2011: $2.04).

The exercise price range and weighted average remaining contractual life for options outstanding at the balance sheet date were as follows:

	2012	2011
Exercise price range from lowest to highest price ($)	4.89 - 8.40	4.58 - 8.76
Weighted average remaining contractual life (years)	1.5	1.4
Number of options exercisable at year end (in thousands)	74	23
Weighted average exercise price of options exercisable at year end ($)	10.97	11.14

6 Tax expense

Under current Bermuda law the group is not required to pay any corporate taxes in Bermuda on either income or capital gains. The group's income tax expense relates to income from operations and is attributable to the income tax expense of certain overseas subsidiaries. Overseas subsidiary undertakings and overseas branches provided for taxation at the appropriate rates in the countries in which they operate.

Tax charged to the consolidated income statement

	2012	2011
Current tax - current overseas tax charge	3,056	2,391
Deferred tax	-	-
Tax expense	3,056	2,391

Tax reconciliation

	2012	**%**	2011	%
Taxation at Bermuda corporation tax rate of 0%	-	-	-	-
Impact of differently taxed overseas profits	2,494	10.66%	2,828	1.83%
Adjustments in respect of prior years	17	0.07%	(430)	(0.28%)
Other items	545	2.33%	(7)	-
Tax expense	3,056	13.06%	2,391	1.55%

Movement of deferred tax assets

	2012	2011
At 1 January	53	67
Exchange differences and other movements	10	(14)
	63	53
Movement arising from subsidiary reclassified as held for sale	(63)	-
Deferred tax assets at 31 December	-	53
Comprising:		
- Other items	-	53
Deferred tax assets at 31 December	-	53

7 Derivatives

Fair values of derivatives by product type

	2012 Fair value		2011 Fair value	
	Assets	**Liabilities**	Assets	Liabilities
Foreign exchange	6,087	5,749	12,795	13,213
Interest rate	193	189	54	48
Trading derivatives	6,280	5,938	12,849	13,261
Fair value hedges	-	24,841	132	2,884
Total derivatives	6,280	30,779	12,981	16,145

Notional contract amounts of derivatives by product type

	2012	2011
Foreign exchange	1,421,260	1,498,664
Interest rate	52,043	69,235
Trading derivatives	1,473,303	1,567,899
Fair value hedges	1,099,690	496,590
Total derivatives	2,572,993	2,064,489

Derivatives are financial instruments that derive their value from the price of an underlying item such as equities, bonds, interest rates, foreign exchange rates, credit spreads, commodities and equity or other indices. Derivatives enable users to increase, reduce or alter exposure to credit or market risks. The group makes markets in derivatives for its customers and uses derivatives to manage its exposure to credit and market risks (Note 24).

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

Derivative assets and liabilities on different transactions are only netted if the transactions are with the same counterparty, a legal right of offset exists and the cash flows are intended to be settled on a net basis. Changes in the values of derivatives are recognised in 'Dealing profits' unless they qualify as hedges for accounting purposes.

Use of derivatives

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

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

With respect to derivative contracts, the notional or contractual amounts of these instruments indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

(a) Trading derivatives

The derivative transactions of the group relate to foreign exchange and interest rate sales trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks.

As mentioned above, other derivatives classified as held for trading may include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge effectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting.

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

A three level fair value hierarchy, which reflects the availability of observable market inputs, is used when estimating fair values. All derivatives are considered Level 2 as they are based upon observable market inputs. There was no netting of derivative assets and liabilities at 31 December 2012 or 31 December 2011. Total exposure to HSBC Group counterparties at 31 December 2012 amounted to $4,026 (2011: $8,266) and cash collateral was $NIL (2011: $NIL). Where the group receives collateral from customers related to outstanding derivative contracts, these comprise cash and cash equivalents, securities and mortgage interests over property. Credit concentrations with large counterparties are controlled though counterparty limits. Credit exposures, incorporating derivative exposures, to single names are capped and monitored by senior management as detailed in Note 24.

(b) Hedging

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

Fair value hedges

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

Gains (losses) arising from the change in fair value of fair value hedges

	2012	2011
- on hedging instruments	(21,160)	(1,719)
- on hedged items attributable to the hedged risk	21,213	1,672
Net gain (loss)	53	(47)

8 Loans and advances to banks

Maturity analysis

	2012		2011	
	Amortised cost	**Fair value**	Amortised cost	Fair value
One year or less	4,447,064	4,447,064	4,358,287	4,358,287
More than one year	115,000	115,000	80,000	80,000
	4,562,064	4,562,064	4,438,287	4,438,287

There are no impairment losses included in loans and advances to banks (2011: $NIL) and there are no netting agreements or collateral held in respect of loans and advances to banks (2011: $NIL).

Loans and advances to banks by country and credit rating

	2012					
Country	**AAA**	**AA+ AA AA-**	**A+ A A-**	**BBB+ BBB BBB-**	**Not rated**	**Total**
Australia	-	18,281	-	-	-	18,281
Belgium	-	3,583	-	-	-	3,583
Bermuda	5,242	-	2,102	219	9,140	16,703
Brazil	-	-	40,000	115,000	-	155,000
Canada	-	253,058	200,000	-	-	453,058
Czech Republic	-	-	-	41	-	41
Denmark	-	-	1,649	-	-	1,649
France	-	-	120,000	-	-	120,000
Germany	-	249,821	145,923	-	-	395,744
Hong Kong	-	31,098	-	-	-	31,098
Israel	-	-	-	90	-	90
Japan	-	-	570,604	-	6,988	577,592
Netherlands	-	-	17	-	-	17
New Zealand	-	-	-	-	97	97
Norway	-	-	109,625	-	-	109,625
Panama	-	-	-	50,000	-	50,000
Poland	-	-	250	-	-	250
Singapore	-	-	-	-	10,485	10,485
South Africa	-	-	-	12	-	12
Sweden	-	-	2,230	-	-	2,230
Switzerland	-	148,536	710	-	-	149,246
United Kingdom	-	831,173	-	-	-	831,173
United States	-	973,762	662,328	-	-	1,636,090
	5,242	2,509,312	1,855,438	165,362	26,710	4,562,064

Loans and advances to banks by country and credit rating

	2011					
Country	AAA	AA+ AA AA-	A+ A A-	BBB+ BBB BBB-	Not rated	Total
Australia	-	34,880	-	-	-	34,880
Belgium	-	1,339	-	-	-	1,339
Bermuda	47,176	-	1,742	1	289	49,208
Brazil	-	-	90,000	215,000	-	305,000
Canada	-	603,223	306,612	-	-	909,835
Chile	-	-	10,000	22,500	-	32,500
Czech Republic	-	-	282	-	-	282
Denmark	-	-	3,436	-	-	3,436
France	-	493,158	100,000	-	-	593,158
Germany	-	-	6,198	-	-	6,198
Hong Kong	-	27,106	-	-	-	27,106
Israel	-	-	-	46	-	46
Japan	-	-	363,773	-	66,334	430,107
Netherlands	-	-	12	-	-	12
New Zealand	-	-	-	-	578	578
Norway	-	-	125,069	-	-	125,069
Panama	-	-	120,438	-	-	120,438
Poland	-	-	314	-	-	314
Singapore	-	-	-	-	8,365	8,365
South Africa	-	-	113	38	-	151
Sweden	-	-	4,772	-	-	4,772
Switzerland	-	91,334	155	-	-	91,489
United Kingdom	-	441,181	-	-	-	441,181
United States	-	791,147	461,676	-	-	1,252,823
	47,176	2,483,368	1,594,592	237,585	75,566	4,438,287

Loans and advances to banks are rated by the banks' Standard & Poor's ('S&P') ratings where available. If a bank is not rated by S&P, the Fitch rating is used. If S&P and Fitch do not provide a rating, the balance is classed as not rated.

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

9 Loans and advances to customers

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

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

	2012	2011
Personal		
Residential mortgages	1,676,426	1,749,057
Other personal	394,607	453,023
Total loans to individuals	2,071,033	2,202,080
Corporate		
Commercial, industrial and international trade	244,918	177,766
Commercial real estate	593,787	557,045
Government	236,410	264,674
Other commercial	505,355	373,149
Total commercial	1,580,470	1,372,634
Non-bank financial institutions	168,013	71,025
Total corporate	1,748,483	1,443,659
Gross loans and advances to customers	3,819,516	3,645,739
Allowance for losses on loans and advances	(152,705)	(47,687)
Loans and advances to customers	3,666,811	3,598,052

Gross loans with variable rates are $3,012,909 (2011: $3,003,052) and fixed rates are $806,607 (2011: $642,687).

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

	2012		2011	
Maturity analysis	**Amortised cost**	**Fair value**	Amortised cost	Fair value
One year or less	709,600	709,260	551,490	551,484
More than one year	2,957,211	2,890,766	3,046,562	2,967,998
	3,666,811	3,600,026	3,598,052	3,519,482

The loan fair values disclosed above are based on weighted average estimated remaining maturities and are determined using a valuation technique supported by observable market rates. Additional information about the interest rate risk exposure pertaining to loans and advances to customers is presented in Note 24.

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

	2012			2011		
Loans and advances to customers	**Gross**	**Allowance**	**Net**	Gross	Allowance	Net
Not past due or impaired	3,047,699	(24,880)	3,022,819	3,268,511	(4,342)	3,264,169
Past due less than 30 days	177,358	(1,218)	176,140	136,589	(181)	136,408
Past due between 30 and 60 days	62,574	(528)	62,046	45,367	(62)	45,305
Past due between 60 and 90 days	16,653	(110)	16,543	18,304	(24)	18,280
Impaired	515,232	(125,969)	389,263	176,968	(43,078)	133,890
Total	3,819,516	(152,705)	3,666,811	3,645,739	(47,687)	3,598,052

Allowances for loans and advances to customers	**2012** Specifically provided	**2012** Collectively provided	**2012** Total allowance	2011 Specifically provided	2011 Collectively provided	2011 Total allowance
Not past due or impaired	-	(24,880)	(24,880)	-	(4,342)	(4,342)
Past due less than 30 days	-	(1,218)	(1,218)	-	(181)	(181)
Past due between 30 and 60 days	-	(528)	(528)	-	(62)	(62)
Past due between 60 and 90 days	-	(110)	(110)	-	(24)	(24)
Impaired	(125,306)	(663)	(125,969)	(41,347)	(1,731)	(43,078)
Total	(125,306)	(27,399)	(152,705)	(41,347)	(6,340)	(47,687)

Gross loans and advances to customers by type of collateral	**2012** Mortgage interest	**2012** Assets other than mortgage interest	**2012** Unsecured	2011 Mortgage interest	2011 Assets other than mortgage interest	2011 Unsecured
Not past due or impaired	1,861,879	208,247	977,573	2,336,610	266,336	665,565
Past due less than 30 days	122,763	42,122	12,473	119,053	3,631	13,905
Past due between 30 and 60 days	59,488	240	2,846	41,736	124	3,507
Past due between 60 and 90 days	7,588	7,395	1,670	16,376	90	1,838
Impaired	502,498	316	12,418	158,027	3,338	15,603
Total	2,554,216	258,320	1,006,980	2,671,802	273,519	700,418

The group holds collateral against loans and advances to customers in the form of mortgage interests over property, other charges over real and financial assets, and guarantees. Estimates of fair value are based on the value of collateral assessed at the time of borrowing, and updated in circumstances where a loan is showing signs of potential impairment or is individually assessed as impaired.

Collateral held is shown in the table below:

	2012				
			Partially collateralised		
	Uncollateralised	**Fully collateralised**	**Loan value**	***Collateral value***	**Total Loans**
Personal					
Residential mortgages	8,550	1,329,877	337,999	*298,800*	1,676,426
Other personal	162,931	210,742	20,934	*17,159*	394,607
Total loans to individuals	171,481	1,540,619	358,933	*315,959*	2,071,033
Corporate					
Commercial, industrial and international trade	42,396	106,147	96,375	*71,567*	244,918
Commercial real estate	105,079	300,897	187,811	*134,683*	593,787
Government	201,410	35,000	-	-	236,410
Other commercial	361,394	16,513	127,448	*123,080*	505,355
Total commercial	710,279	458,557	411,634	*329,330*	1,580,470
Non-bank financial institutions	125,220	42,793	-	-	168,013
Total corporate	835,499	501,350	411,634	*329,330*	1,748,483
Gross loans and advances to customers	1,006,980	2,041,969	770,567	*645,289*	3,819,516

	2011				
			Partially collateralised		
	Uncollateralised	Fully collateralised	Loan value	*Collateral value*	Total Loans
Personal					
Residential mortgages	10,635	1,483,490	254,932	*226,307*	1,749,057
Other personal	160,006	289,196	3,821	*3,114*	453,023
Total loans to individuals	170,641	1,772,686	258,753	*229,421*	2,202,080
Corporate					
Commercial, industrial and international trade	49,449	103,946	24,371	*16,902*	177,766
Commercial real estate	21,123	519,045	16,877	*5,712*	557,045
Government	229,674	35,000	-	-	264,674
Other commercial	187,965	46,812	138,372	*133,296*	373,149
Total commercial	488,211	704,803	179,620	*155,910*	1,372,634
Non-bank financial institutions	41,566	29,459	-	-	71,025
Total corporate	529,777	734,262	179,620	*155,910*	1,443,659
Gross loans and advances to customers	700,418	2,506,948	438,373	*385,331*	3,645,739

The group adheres to HSBC policy direction and monitors credit concentration risk in accordance with local regulatory requirements. A substantial portion of the loans and advances to customers is due from residents of Bermuda and is secured by residential, or commercial property in Bermuda. Additional analysis of credit concentration is provided above.

The group regularly reviews loans and advances to customers and allocates a risk rating against each loan or advance based on performance criteria. The breakdown of loans and advances to customers by risk category at 31 December 2012 is 83.6% (2011: 90.8%) performing, 2.9% (2011: 4.4%) substandard and 13.5% (2011: 4.8%) non-performing.

Included in interest income is interest accrued on non-performing facilities at 31 December 2012 of $8,591 (2011: $13,164).

At 31 December 2012, the group held $12,600 (2011: $12,600) of non-financial assets acquired in exchange for loans which are recorded as ‘assets held for sale’. In addition, at 31 December 2012, the group repossessed collateral relating to impaired loans with carrying value of $6,224 (2011: $NIL).

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

	Individually assessed loans	**Collectively assessed loans**	**Total**
Opening balance at 1 January 2011	11,880	6,192	18,072
Uncollectible amounts written off during the year	(3,403)	(5,859)	(9,262)
Recoveries	138	884	1,022
Impairment charges during the year	32,732	5,123	37,855
Balance at 31 December 2011	41,347	6,340	47,687
Uncollectible amounts written off during the year	(51,935)	(6,110)	(58,045)
Recoveries	1	1,062	1,063
Impairment charges during the year	135,893	26,107	162,000
Balance at 31 December 2012	125,306	27,399	152,705

Renegotiated loans are shown in the table below:

Renegotiated loans and advances to customers	**2012**			
	Neither past due nor impaired	**Past due but not impaired**	**Impaired**	**Total**
Personal				
Residential mortgages	24,148	10,062	37,856	72,066
Other personal	5,707	1,894	4,173	11,774
Total loans to individuals	29,855	11,956	42,029	83,840
Corporate				
Commercial, industrial and international trade	4,940	-	1,463	6,403
Commercial real estate	2,845	-	131,869	134,714
Other commercial	2,991	3,372	1,969	8,332
Total corporate	10,776	3,372	135,301	149,449
Total renegotiated loans and advances to customers	40,631	15,328	177,330	233,289

	2011			
	Neither past due nor impaired	Past due but not impaired	Impaired	Total
Personal				
Residential mortgages	42,251	23,873	6,831	72,955
Other personal	17,481	9,229	18,499	45,209
Total loans to individuals	59,732	33,102	25,330	118,164
Corporate	1,721	491	7,875	10,087
Commercial, industrial and international trade	157,755	802	2,696	161,253
Commercial real estate	2,683	1,234	-	3,917
Total corporate	162,159	2,527	10,571	175,257
Total renegotiated loans and advances to customers	221,891	35,629	35,901	293,421

During 2012 the group developed additional guidelines to identify and classify renegotiated loans by taking into consideration the detailed and specific characteristics of the terms and performance of these loans. Loans in the amount of $111 million that have been subject to changes in their terms on a commercial basis and do not meet these guidelines are no longer included in the renegotiated loans and advances amounts highlighted above.

Of the total renegotiated loans and advances $NIL (2011: $NIL) relates to loans that were derecognised for accounting purposes and a new asset recognised following renegotiation. On derecognition, an impairment charge of the difference between the previous carrying value of the derecognised loan and the new loan recorded at fair value is recognised.

10 Financial investments

The following tables provide an analysis of the group's financial investments, all classified as available-for-sale securities with the exception of $131,277 (2011: $100,079) trading assets related to structured certificates of deposit.

	2012		2011	
	Amortised cost	**Fair value**	Amortised cost	Fair value
Treasury and other eligible bills	710,807	710,723	2,474,233	2,473,597
Debt securities – fixed rate	2,549,637	2,590,094	2,380,045	2,379,938
Debt securities – floating rate	1,308,822	1,303,286	1,580,471	1,558,409
Total debt securities	4,569,266	4,604,103	6,344,749	6,411,944
Equity securities	5,422	34,791	7,421	32,162
Total financial investments	4,574,688	4,638,894	6,442,170	6,444,106

Maturity analysis of debt securities	**2012**	2011
One year or less	1,120,026	3,318,167
More than one year	3,484,077	3,093,777
	4,604,103	6,411,944

Credit rating analysis of debt securities	**2012**	2011
AAA	2,213,134	2,600,957
AA+	912,520	2,496,364
AA-	987,027	1,094,261
A+	438,755	96,721
A	-	34,987
A-	52,667	88,654
	4,604,103	6,411,944

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

Where debt securities are rated by Standard & Poor's ('S&P'), this rating is used. If the debt security is not rated by S&P, the Fitch rating is used. All securities guaranteed by the U.S. Government are assigned the U.S. Government's sovereign rating.

Financial investments by country and sector

	2012					
Country	**Sovereign**	**Bank**	**Corporate**	**Asset backed**	**Equities**	**Total**
Australia	173,234	25,085	-	-	-	198,319
Belgium	-	-	-	-	39	39
Bermuda	126,842	-	-	-	2,157	128,999
Canada	55,435	404,358	-	138,917	-	598,710
Cayman Islands	-	-	-	-	19,992	19,992
France	-	143,578	-	-	-	143,578
Germany	55,279	373,409	-	-	-	428,688
Japan	380,739	72,373	-	-	-	453,112
Netherlands	-	125,696	-	-	-	125,696
New Zealand	156,750	-	-	-	-	156,750
Norway	-	51,550	-	-	-	51,550
Supranational	-	474,632	-	-	-	474,632
Sweden	-	50,110	-	-	-	50,110
United Kingdom	279,858	626,433	-	-	12,319	918,610
United States	454,030	282,292	25,370	128,133	284	890,109
	1,682,167	2,629,516	25,370	267,050	34,791	4,638,894

Financial investments by country and sector

	2011					
Country	Sovereign	Bank	Corporate	Asset backed	Equities	Total
Australia	219,938	45,082	-	-	-	265,020
Belgium	-	-	-	-	38	38
Bermuda	94,894	-	-	-	2,180	97,074
Canada	158,370	122,834	-	139,969	-	421,173
Cayman Islands	-	-	-	-	19,564	19,564
Denmark	-	15,257	-	-	-	15,257
France	118,948	77,096	-	-	-	196,044
Germany	391,881	225,718	-	-	-	617,599
Ireland	-	19,730	-	-	-	19,730
Japan	-	68,208	-	-	-	68,208
Netherlands	-	123,646	-	-	-	123,646
New Zealand	347,009	-	-	-	-	347,009
Norway	-	49,880	-	-	-	49,880
Supranational	-	382,799	-	-	-	382,799
Sweden	-	50,175	-	-	-	50,175
United Kingdom	593,866	679,933	-	-	10,108	1,283,907
United States	1,896,769	299,260	90,519	200,163	272	2,486,983
	3,821,675	2,159,618	90,519	340,132	32,162	6,444,106

Supranational entities are formed by two or more central governments to promote economic development for the member countries.

Debt securities amounting to $50,108 (2011: $50,180) are pledged to third parties as collateral in the normal course of business and debt securities amounting to $165,193 (2011: $498,495) have been transferred to third parties under securities lending agreements.

The group is carrying all financial investments at fair value. During the year the group received proceeds of $10,189,293 (2011: $4,138,581) from the sale or maturity of financial investments and realised a net gain of $9,921 (2011: $5,257). The group monitors interest rate sensitivity under varying interest rate scenarios as summarised in Note 24.

11 Fair values of financial investments carried at fair value

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

	2012			
Fair value hierarchy summary by sector	**Quoted market price Level 1**	**Using observable inputs Level 2**	**With significant unobservable inputs Level 3**	**Total**
Sovereign	454,030	1,228,137	-	1,682,167
Bank	-	2,540,315	89,201	2,629,516
Corporate	-	25,370	-	25,370
Asset backed	-	267,050	-	267,050
Equities	109	-	34,682	34,791
	454,139	4,060,872	123,883	4,638,894

	2011			
Fair value hierarchy summary by sector	Quoted market price Level 1	Using observable inputs Level 2	With significant unobservable inputs Level 3	Total
Sovereign	1,896,769	1,924,906	-	3,821,675
Bank	-	2,159,618	-	2,159,618
Corporate	-	90,519	-	90,519
Asset backed	-	340,132	-	340,132
Equities	356	-	31,806	32,162
	1,897,125	4,515,175	31,806	6,444,106

Sovereign debt securities issued by the United States Government have been presented as Level 1 in the 2011 comparative figures. The fair values of these securities have been measured using quoted market prices for identical instruments in active markets.

The following table shows the reconciliation from the beginning balance to the ending balance for fair value measurements in Level 3 of the fair value hierarchy:

	2012	2011
At 1 January	31,806	32,242
Purchases	12,794	513
Sales	(3,420)	(2,515)
Transfers from Level 2	73,727	-
Total gains or losses:		
in profit or loss	3,799	(1,852)
in other comprehensive income	5,177	3,418
At 31 December	123,883	31,806

Level 3 securities comprise equity and equity-linked securities. The fair values of equity-linked structured certificates of deposit have been transferred from Level 2 to Level 3 in 2012. These securities have been reclassified based upon a review of the observability of significant parameters relating to their valuation.

12 Property, plant and equipment

	Land and buildings	Equipment, fixtures and fittings	Total
Cost			
Cost at 1 January 2012	189,845	88,370	278,215
Additions at cost	15	6,746	6,761
Disposals and write-offs	-	(3,556)	(3,556)
Reclassified as assets held for sale	(3,187)	(2,685)	(5,872)
Other movements	(43)	-	(43)
Cost at 31 December 2012	186,630	88,875	275,505
Accumulated depreciation			
Accumulated depreciation at 1 January 2012	29,205	50,041	79,246
Depreciation charge for the year	4,063	9,266	13,329
Disposals and write-offs	-	(3,054)	(3,054)
Reclassified as assets held for sale	(791)	(2,640)	(3,431)
Other movements	-	-	-
Accumulated depreciation at 31 December 2012	32,477	53,613	86,090
Net book value at 31 December 2012	154,153	35,262	189,415

	Land and buildings	Equipment, fixtures and fittings	Total
Cost			
Cost at 1 January 2011	221,289	90,634	311,923
Additions at cost	52	2,322	2,374
Disposals and write-offs	(171)	(1,828)	(1,999)
Reclassified as assets held for sale	(31,325)	(2,441)	(33,766)
Other movements	-	(317)	(317)
Cost at 31 December 2011	189,845	88,370	278,215
Accumulated depreciation			
Accumulated depreciation at 1 January 2011	31,473	42,831	74,304
Depreciation charge for the year	5,196	10,031	15,227
Disposals and write-offs	(68)	(860)	(928)
Reclassified as assets held for sale	(7,396)	(1,644)	(9,040)
Other movements	-	(317)	(317)
Accumulated depreciation at 31 December 2011	29,205	50,041	79,246
Net book value at 31 December 2011	160,640	38,329	198,969

13 Goodwill

Cost	2012	2011
At 1 January	29,866	51,342
Disposals	-	(21,476)
Impairment	(7,467)	-
At 31 December	22,399	29,866

There were no additions or disposals to goodwill during the year ended 31 December 2012. Note 16 presents information about subsidiary undertakings disposed of during the year ended 31 December 2011.

Goodwill is reviewed for impairment at least annually and was found to be impaired at 31 December 2012 due to an anticipated decline in cash flows based on the most recent strategic review. Goodwill was determined not to be impaired at 31 December 2011.

As part of the annual review of operations management reviews the recoverable amount of the investment in subsidiaries that gives rise to goodwill. The recoverable amount has been calculated based on the value in use and is determined by discounting the future cash flows to be generated from continuing operation of the subsidiaries. Value in use in 2012 was determined in a similar manner as in 2011. Key assumptions used in the calculation of value in use were the following:

- Cash Flows: Cash flows were projected based on past experience, actual operating results and the 5 year business plan. Cash flows were projected to ultimately decline to an ending terminal constant growth rate of 3% based on estimates of country specific GDP growth rates;
- Discount rate: The rate used to discount the cash flows is based on the cost of capital for the operations which is derived using a Capital Asset Pricing Model ('CAPM'). The CAPM depends on inputs reflecting a number of financial and economic variables including the risk-free rate and an equity risk premium based on long term studies and the inherent risk of the business being evaluated.

14 Group entities

(a) Principal subsidiaries

	Country of incorporation or registration	Bank's interest in equity capital (%)
Bermuda International Securities Limited	Bermuda	100
Bermuda Trust Company Limited	Bermuda	100
HSBC Global Asset Management (Bermuda) Limited	Bermuda	100
HSBC Institutional Trust Services (Bermuda) Limited	Bermuda	100
HSBC Securities Services (Bermuda) Limited	Bermuda	100
HSBC Bank (Cayman) Limited	Cayman	100
Bermuda International (Guernsey) Limited	Guernsey	100

All of the above entities prepare their financial statements up to 31 December. Please refer to Note 16 for details of acquisitions and disposals during 2012.

(b) Principal associate

Movement in investment in associate

	2012	2011
At 1 January	1,181	1,743
Share of profit (loss)	82	(562)
At 31 December	1,263	1,181

Summarised aggregate financial information on associate at 31 December

	2012	2011
Assets	3,282	3,533
Liabilities	704	1,214
Operating income	5,662	6,927
Profit (loss) for the year	164	(1,124)

The associate investment is accounted for using the equity method.

15 Impairment of assets other than financial instruments

During 2012, the group obtained an independent market valuation for each major building owned and compared the carrying cost to the appraisal and the assets value in use where appropriate. As a result, an impairment loss on two buildings, classified as 'assets held for sale', was recognised in the amount of $5,401 (2011: $7,430). The impairment has been included in the consolidated income statement as part of 'Depreciation and impairment of property, plant and equipment'.

Note 13 presents detailed information about the impairment of goodwill.

16 Investments

(a) Acquisitions

The group did not purchase any subsidiary undertakings in 2012 or 2011.

(b) Disposals

(i) During the year ended 31 December 2012

The group did not dispose of any subsidiary undertakings in 2012.

(ii) During the year ended 31 December 2011

The group made the following disposal to an HSBC affiliated entity for net cash proceeds of $222,691. The attributable gain has been included in the 'Gains less losses on disposal of property, plant and equipment and subsidiary investments' in the group's consolidated income statement as follows:

Location	**Subsidiary / Business**	**Cash and cash equivalents in subsidiaries**	**Net asset value**	**Attributable gain**
British Virgin Islands	HSBC International Trustee Limited	43,663	219,985	2,706

The group made the following disposal to a third party entity for net cash proceeds of $24,935. The attributable loss has been included in the 'Gains less losses on disposal of property, plant and equipment and subsidiary investments' in the group's consolidated income statement as follows:

Location	**Subsidiary / Business**	**Cash and cash equivalents in subsidiaries**	**Net asset value**	**Attributable loss**
Bermuda	HSBC Insurance Holdings (Bermuda) Limited (and related business)	2,797	27,153	(2,218)

17 Assets held for sale

	Property, plant and equipment	Discontinued operations of subsidiary	Total
Assets			
At 1 January 2011	12,881	254,035	266,916
Disposal of subsidiary	-	(254,035)	(254,035)
Reduction in value through impairment (Note 15)	(7,430)	-	(7,430)
Transfers in	37,326	-	37,326
Disposals	(549)	-	(549)
Assets held for sale 31 December 2011	42,228	-	42,228
Reduction in value through impairment (Note 15)	(5,401)	-	(5,401)
Transfers in	1,753	-	1,753
Disposals	(3,084)	-	(3,084)
Subsidiary assets reclassified as held for sale	-	4,866	4,866
Assets held for sale 31 December 2012	35,496	4,866	40,362
Liabilities			
At 1 January 2011	-	34,119	34,119
Disposal of subsidiary	-	(34,119)	(34,119)
Liabilities held for sale at 31 December 2011	-	-	-
Subsidiary liabilities reclassified as held for sale	-	893	893
Liabilities held for sale at 31 December 2012	-	893	893

(a) Assets held for sale – Property, plant and equipment

At 31 December 2012, assets held for sale is comprised of three office buildings, three condominiums and land, in the process of being sold by the group. The assets were recorded at the lower of net book value and fair value less costs to sell, which amounted to $35,496 (2011: $42,228).

(b) Assets and liabilities held for sale – Discontinued operations of subsidiary

(i) During the year ended 31 December 2012

Subject to regulatory approvals, during 2013 the group will dispose of Bermuda Asia Pacific Holdings Limited and its subsidiaries to an HSBC affiliated entity for total cash proceeds of $12,500 which is the estimated fair value of the business at sale date. The 'Consolidated income statement for the year ended 31 December 2012' has been presented to show the discontinued operations separately from continuing operations and the assets and liabilities of the discontinued operations have been separately included in assets and liabilities held for sale, respectively, in the 'Consolidated balance sheet at 31 December 2012'. The results and impact of the discontinued operations of the subsidiary are summarised below:

	2012	2011
Results from discontinued operations		
Net operating income	2,851	3,106
Total operating expenses	(1,529)	(1,360)
Profit before tax	1,322	1,746
Tax expense	(472)	(348)
Profit from discontinued operations (net of income tax)	850	1,398
Cash flows from (used in) discontinued operations		
Net cash flows from operating activities	1,910	1,025
Net cash flows (used in) from investing operations	(24)	99
Net cash flows used in financing activities	-	(1,300)
Net increase (decrease) in cash and cash equivalents	1,886	(176)

	2012
Net assets of discontinued operations of subsidiary	
Loans and advances to banks	3,518
Prepayments and accrued income	409
Deferred tax assets	63
Other assets	188
Property, plant and equipment	688
Assets held for sale	4,866
Accruals and deferred income	421
Current tax liabilities	147
Other liabilities	325
Liabilities held for sale	893
Net assets	3,973

(ii) During the year ended 31 December 2011

Effective 1 January 2011 the group disposed of HSBC International Trustee Limited to an HSBC affiliated entity for total cash proceeds of $222,691 which is the estimated fair value of the business at sale date. Note 16 presents detailed information about the disposal of this subsidiary which resulted in a gain of $2,706.

18 Provisions

	2012	2011
At 1 January	-	-
Increases in provisions	400	74
Provisions utilised	-	(74)
At 31 December	400	-

'Provisions' for 2012 and 2011 are comprised entirely of legal provisions related to ongoing legal proceedings.

19 Contingent liabilities, contractual commitments and guarantees

The table below discloses the nominal principal amounts of third party off-balance sheet transactions. Contingent liabilities and commitments are credit-related instruments, which include letters of credit, guarantees and commitments to extend credit. The contractual amounts represent the amounts at risk should the contract be fully drawn upon and the client default. Since a significant portion of guarantees and commitments are expected to expire without being drawn upon, the total of the contractual amounts is not representative of future liquidity requirements.

	2012	2011
Guarantees and contingent liabilities in favour of third parties		
Standby letters of credit which are financial guarantees	193,315	165,014
Standby letters of credit related to particular transactions	150	1,531
Guarantees in the form of irrevocable letters of credit	193,465	166,545
Financial and other guarantees	28,500	28,500
Other contingent liabilities	3,032	3,676
	224,997	198,721
Commitments		
Documentary credits and short-term trade-related transactions	1,026	1,804
Undrawn revolving underwriting facilities	186,299	280,472
Undrawn formal standby facilities, credit lines and other commitments to lend		
– remaining contractual maturity one year or less	283,805	263,918
– remaining contractual maturity more than one year	578,735	327,602
	1,049,865	873,796

At 31 December 2012 approximately 74% (2011: 61%) of the above guarantees have an original contractual term of less than one year. Guarantees with a term of more than one year are subject to the group's annual credit review process.

When the group has given a guarantee on behalf of a customer, it will have the right to recover from that customer any amounts paid under the guarantee. At 31 December 2012, the group holds collateral amounting to $123,416 (2011: $79,001), which could be used to recover amounts paid under the above guarantees.

20 Lease commitments

At 31 December 2012, the group was obligated under a number of non-cancellable operating leases for properties, plant and equipment, for which the future minimum lease payments extend over a number of years as follows:

	2012		2011	
Future minimum lease payments under non-cancellable operating leases	**Land and buildings**	**Equipment**	Land and buildings	Equipment
Not later than one year	1,650	137	1,794	107
Later than one year and not later than five years	6,647	113	6,623	112
Later than five years	10,405	-	12,043	-
	18,702	250	20,460	219

During the year $2,433 (2011: $2,957) was recognised within 'General and administrative expenses' in respect of lease agreements.

21 Maturity analysis of financial assets and financial liabilities

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

31 December 2012	**On demand**	**Due within one year**	**Due between one and five years**	**Due after five years**	**Undated**	**Total**	**Fair Value**
Financial assets							
Cash and balances at central banks	31,219	-	-	-	-	31,219	31,219
Items in the course of collection from other banks	136	-	-	-	-	136	136
Derivatives	-	6,034	246	-	-	6,280	6,280
Loans and advances to banks	2,514,483	1,932,581	115,000	-	-	4,562,064	4,562,064
Loans and advances to customers	258,748	450,852	952,198	2,005,013	-	3,666,811	3,600,026
Financial investments	-	1,120,026	2,786,393	697,684	34,791	4,638,894	4,638,894
Total at 31 December 2012	2,804,586	3,509,493	3,853,837	2,702,697	34,791	12,905,404	12,838,619
Financial liabilities							
Deposits by banks	55,803	-	-	-	-	55,803	55,803
Customer accounts	9,690,577	1,649,305	21,509	216	-	11,361,607	11,363,556
Items in course of transmission to other banks	7,751	-	-	-	-	7,751	7,751
Derivatives	1,726	3,973	25,080	-	-	30,779	30,779
Total at 31 December 2012	9,755,857	1,653,278	46,589	216	-	11,455,940	11,457,889

31 December 2011	On demand	Due within one year	Due between one and five years	Due after five years	Undated	Total	Fair Value
Financial assets							
Cash and balances at central banks	33,753	-	-	-	-	33,753	33,753
Items in the course of collection from other banks	526	-	-	-	-	526	526
Derivatives	-	12,789	192	-	-	12,981	12,981
Loans and advances to banks	1,060,879	3,297,408	67,000	13,000	-	4,438,287	4,438,287
Loans and advances to customers	209,579	341,911	923,842	2,122,720	-	3,598,052	3,519,482
Financial investments	-	3,318,167	2,256,874	836,903	32,162	6,444,106	6,444,106
Total at 31 December 2011	1,304,737	6,970,275	3,247,908	2,972,623	32,162	14,527,705	14,449,135
Financial liabilities							
Deposits by banks	67,506	-	-	-	-	67,506	67,506
Customer accounts	10,372,421	2,516,159	41,104	247	-	12,929,931	12,933,595
Items in course of transmission to other banks	7,335	-	-	-	-	7,335	7,335
Derivatives	-	13,210	1,710	1,225	-	16,145	16,145
Total at 31 December 2011	10,447,262	2,529,369	42,814	1,472	-	13,020,917	13,024,581

Financial instruments included within ‘Assets held for sale’, ‘Prepayments and accrued income’, ‘Other assets’, ‘Liabilities held for sale’, ‘Accruals and deferred income’, ‘Provisions’, ‘Other liabilities’ and ‘Retirement benefit liabilities’ have not been included in the analysis above as they do not have contractual maturities. Fair values for ‘Loans and advances to customers’ and ‘Customer accounts’ are based on weighted average estimated remaining maturities determined using a valuation technique supported by observable market rates.

22 Interest rate analysis of financial instruments

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

31 December 2012	Due within three months	Due between three and six months	Due between six months and one year	Due between one and five years	Due after five years	Non-interest bearing	Total	Range of weighted average effective interest rates
Financial assets								
Cash and balances at central banks	-	-	-	-	-	31,219	31,219	
Items in the course of collection from other banks	-	-	-	-	-	136	136	
Derivatives	-	-	-	-	-	6,280	6,280	
Loans and advances to banks	4,562,064	-	-	-	-	-	4,562,064	0.20-0.43%
Loans and advances to customers	3,627,729	39,082	-	-	-	-	3,666,811	4.68-4.94%
Financial investments	3,153,463	25,370	175,752	1,101,072	148,446	34,791	4,638,894	1.75-2.29%
Total at 31 December 2012	11,343,256	64,452	175,752	1,101,072	148,446	72,426	12,905,404	
Financial liabilities								
Deposits by banks	55,803	-	-	-	-	-	55,803	0.24-0.53%
Customer accounts	10,803,629	215,755	189,219	152,998	6	-	11,361,607	0.06-0.18%
Items in course of transmission to other banks	-	-	-	-	-	7,751	7,751	
Derivatives	-	-	-	-	-	30,779	30,779	
Total at 31 December 2012	10,859,432	215,755	189,219	152,998	6	38,530	11,455,940	
Interest rate sensitivity gap	483,824	(151,303)	(13,467)	948,074	148,440	33,896	1,449,464	
Cumulative interest rate sensitivity gap	483,824	332,521	319,054	1,267,128	1,415,568	1,449,464		

31 December 2011	Due within three months	Due between three and six months	Due between six months and one year	Due between one and five years	Due after five years	Non-interest bearing	Total	Range of weighted average effective interest rates
Financial assets								
Cash and balances at central banks	-	-	-	-	-	33,753	33,753	
Items in the course of collection from other banks	-	-	-	-	-	526	526	
Derivatives	-	-	-	-	-	12,981	12,981	
Loans and advances to banks	4,100,787	337,500	-	-	-	-	4,438,287	0.37-0.86%
Loans and advances to customers	2,716,126	852,487	29,439	-	-	-	3,598,052	4.82-5.56%
Financial investments	4,394,193	577,372	237,368	1,086,504	116,507	32,162	6,444,106	1.30-2.18%
Total at 31 December 2011	11,211,106	1,767,359	266,807	1,086,504	116,507	79,422	14,527,705	
Financial liabilities								
Deposits by banks	67,506	-	-	-	-	-	67,506	0.52-0.77%
Customer accounts	11,980,403	592,009	309,728	47,626	165	-	12,929,931	0.69-0.94%
Items in course of transmission to other banks	-	-	-	-	-	7,335	7,335	
Derivatives	-	-	-	-	-	16,145	16,145	
Total at 31 December 2011	12,047,909	592,009	309,728	47,626	165	23,480	13,020,917	
Interest rate sensitivity gap	(836,803)	1,175,350	(42,921)	1,038,878	116,342	55,942	1,506,788	
Cumulative interest rate sensitivity gap	(836,803)	338,547	295,626	1,334,504	1,450,846	1,506,788		

Financial instruments included within ‘Assets held for sale’, ‘Prepayments and accrued income’, ‘Other assets’, ‘Liabilities held for sale’, ‘Accruals and deferred income’, ‘Provisions’, ‘Other liabilities’ and ‘Retirement benefit liabilities’ have not been included in the analysis above and are all considered non-interest bearing.

23 Foreign currency exposures

(a) Balance sheet denominated in foreign currency

The group recognises that changes in foreign exchange rates can result in changes to profit and loss and other comprehensive income. In order to effectively mitigate this risk, the group matches assets and liabilities by currency to the greatest extent possible.

	2012	2011
Assets		
US and Bermuda dollars	10,391,213	11,396,739
Euro	707,631	989,226
Pound sterling	973,267	967,352
Japanese yen	397,792	392,341
Canadian dollars	235,673	383,697
Australian dollars	189,916	241,944
New Zealand dollars	167,072	358,603
Swiss Franc	117,961	96,680
Other currencies	68,605	54,082
Total assets	13,249,130	14,880,664
Liabilities and equity		
US and Bermuda dollars	10,352,437	11,342,072
Euro	715,705	1,002,784
Pound sterling	989,800	997,392
Japanese yen	397,593	383,560
Canadian dollars	242,895	389,430
Australian dollars	187,923	249,450
New Zealand dollars	173,336	361,316
Swiss Franc	119,075	97,903
Other currencies	70,366	56,757
Total liabilities and equity	13,249,130	14,880,664

At 31 December 2012, assets and liabilities in all currencies other than US and Bermuda dollars are matched to within 3.6% (2011: 3.0%) of each currency total and to within 0.3% (2011: 0.4%) of total assets. The group therefore considers that the overall risk of changes in foreign exchange rates to profit and loss and equity is not significant.

(b) Structural currency exposures

The group's structural foreign currency exposure is represented by the net asset value of its foreign currency equity and subordinated debt investments in subsidiary undertakings and associates. Gains or losses on structural foreign currency exposures are recognised in other comprehensive income. The group's management of structural foreign currency exposures is discussed in the 'Market risk management' section in Note 24.

24 Risk management

All of the group's activities – whether lending, payment transmission, trading business to support clients and markets, or maintenance of infrastructure for delivering financial services - involve to varying degrees the measurement, evaluation, acceptance and management of risks.

The objective of risk management is to support the group strategies to build sustainably profitable business in the best long-term interests of shareholder and stakeholders. Risk management objectives are integrated into the balanced scorecards of heads of businesses and key functions and cascaded through the group. The objectives of the Risk function as such are also fully aligned in this process with strategic business objectives.

The group's approach to risk appetite, explained in further detail below, reinforces the integration of risk considerations into key business goals and planning processes. Preserving the strong capital position remains a key priority for the group, and the level of integration of risk and capital management helps to optimise response to business demand for regulatory and economic capital.

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

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

(i) Risk governance

The risk management framework established by the group seeks to foster the continuous monitoring of the risk environment and an integrated evaluation of risks and their interdependencies.

Primary responsibility for managing risk at the group's operating entity levels lies with the relevant Chief Executive Officer, as custodian of the relevant balance sheets. In turn, the Chief Risk Officer and the group's internal controls division ('IC') have functional responsibility for the primary financial risk types, namely: credit, market, operational and security / fraud risks. The IC co-ordinates the development of the risk appetite, economic capital and stress-testing frameworks, in consultation with the finance and the asset and liability management divisions.

(ii) Risk management framework and risk appetite

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

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

The group's risk appetite framework describes the quantum and types of risk the group is prepared to take in executing its strategy. It is central to an integrated approach to risk, capital and business management and supports the group in achieving its return on equity objectives, as well as being a key element of meeting the group's obligations under the supervisory review process of Basel II.

The formulation of risk appetite considers the group's risk capacity, its financial position, the strength of its core earnings and the resilience of its reputation and brand. It is expressed both qualitatively, describing which risks are taken and why, and quantitatively.

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

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

(a) Market risk management

Market risk is the risk that movements in market factors, including foreign exchange rates, commodity prices, interest rates, credit spreads, and equity prices, will reduce the group's income or value of portfolios. Market risk arises on financial instruments which are valued at current market prices (mark-to-market basis) and those valued at cost plus accrued interest (accruals basis). The main valuation sources are securities prices, foreign exchange rates, interest rate yield curves and volatilities.

Trading risks arise from customer-related business and positions are valued on a mark-to-market basis.

Equity price risk is subject to regular monitoring by the group but is not currently significant in relation to the overall results and financial position.

The group manages market risk through risk limits assigned by HSBC. Wholesale and Market Risk ('WMR'), a division within HSBC, develops risk management policies and measurement techniques and reviews limit utilisation. HSBC global risk limits are recommended for approval by WMR, with final approval by local entity Boards. Limits are set by product and risk type, using a combination of risk measurement techniques, including position limits, sensitivity limits, as well as value at risk limits at a portfolio level.

Interest rate risk in the banking book ('IRRBB') is defined as the exposure of our non-trading products to interest rates. This risk arises in such portfolios principally from mismatches between the future yield on assets and their funding costs, as a result of interest rate changes. Analysis of this risk is complicated by behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts.

The group assesses the structural interest rate risks which arise in the businesses and transfers these risks to the group's balance sheet management team. When the behavioural characteristics of a product differ from its contractual characteristics, the behavioural characteristics are assessed to determine the appropriate underlying interest rate risk. The Asset and Liability Committee ('ALCO') regularly monitors all such behavioural assumptions and interest rate risk positions to ensure they comply with established interest rate risk limits.

In the course of managing interest rate risk, quantitative techniques and simulation models are used where appropriate to identify the potential net interest income and market value effects of these interest rate positions under different scenarios. The primary objective of such interest rate risk management is to limit potential adverse effects of interest rate movements on net interest income whilst balancing the effect on the current net operating income stream and unrealised mark-to-market positions.

The table in Note 22 discloses the mismatching of the dates on which interest rates on assets and interest rates on liabilities are next reset to market rate on a contractual basis, or, if earlier, the dates on which the instruments mature. Contractual terms may not be representative of the behaviour of assets and liabilities and the group therefore manages its interest rate risk on the behavioural characteristics of its assets and liabilities.

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

The models measure the effect on net interest income due to parallel and ramp movements of plus or minus 100 basis points in all yield curves. The results represent the effect of the pro-forma movements in net interest income based on the projected yield curve scenarios and the group's current interest rate risk profile.

Change in 2013 projected net interest income arising from 100 basis points movement in yield curves *(unaudited)*	**At 31 December 2012 increase (decrease)**	At 31 December 2011 increase (decrease)
+100 basis points parallel	35,980	43,559
+100 basis points ramp	22,803	17,103
-100 basis points parallel	(24,057)	(28,209)
-100 basis points ramp	(19,910)	(14,420)

The scenarios are calculated by first establishing a base case projection for the following financial year using the current consolidated balance sheet. The base case assumes no change in volumes or margins across all currencies. The parallel scenario is calculated by impacting all interest margins by 100 basis points immediately while the ramp scenario simulates a margin impact of 25 basis points every 3 months. The prospective annual differences in net interest income, between the base case and the parallel and ramp cases respectively, are set out in the table above. The model is further simplified in the assumption that all currency yield curves rise and fall at the same time and does not incorporate any management response to changes in prospective interest rates. In particular, the model does not incorporate the proactive management of the interest rate risk profile undertaken by the group's ALCO and global markets division in order to minimise losses and optimise net income.

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

(b) Liquidity risk management

The group manages its liquidity risk by:

- Modelling scenarios based on behavioural characteristics of individual classes of financial instruments;
- Monitoring balance sheet liquidity ratios against internal and regulatory requirements;
- Monitoring of depositor concentration both in terms of the overall funding mix and to avoid undue reliance on large individual depositors; and
- Maintaining liquidity and funding contingency plans.

These actions ensure the group adheres to HSBC liquidity policies and maintains sufficient liquidity to meet day-to-day needs and local regulatory requirements.

Core deposits form a significant part of the group's overall funding. Considerable importance is attached to this core deposit base which, over the years, has been stable and predictable. Additional information regarding liquidity risk is found in Note 21.

(c) Operational risk management

Operational risk is defined as 'the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk'. Operational risk is relevant to every aspect of the group's business and covers a wide spectrum of issues. Losses arising through fraud, unauthorised activities, errors, omission, inefficiency, systems failure or from external events all fall within the definition of operational risk. The objective of the group's operational risk management is to manage and control operational risk in a cost-effective manner within targeted levels of operational risk consistent with the group's risk appetite. Operational risk management is primarily the responsibility of employees and business management. Local management within the group is responsible for implementing HSBC standards on operational risk throughout their operations. Where deficiencies are evident, these are required to be rectified within a reasonable timeframe.

The group manages this risk through a controls-based environment in which processes are documented, authorisation is independent and transactions are reconciled and monitored. This is supported by Internal Control as well as an independent programme of periodic reviews undertaken by Internal Audit, and by monitoring external operational risk events, which ensures that the group adheres to best practice and actively learns from the publicised operational failures within the financial services industry.

The group has adopted the HSBC operational risk management process with annual compliance certification. The HSBC standards explain how the group manages operational risk by identifying, assessing, monitoring, controlling and mitigating the risk, rectifying operational risk events, and implementing any additional procedures required for compliance with local regulatory requirements. The process undertaken to manage operational risk is determined by reference to the scale and nature of each business operation. The HSBC standard covers the following:

- operational risk management responsibility is assigned at a senior management level within the business operation;
- information systems are used to record the identification and assessment of operational risks and to generate appropriate, regular management reporting;
- operational risks are identified by risk assessments covering operational risks facing each business and risks inherent in processes, activities and products. Risk assessment incorporates a regular review of risks identified to monitor significant changes;
- operational risk loss data is collected and reported to senior management. This report covers aggregate operational risk losses and details of incidents above a materiality threshold; and
- risk mitigation, including insurance, is considered where this is cost-effective.

HSBC has adopted the standardized approach to determine its operational risk capital requirement. It continues to enhance its Operational Risk Management Framework including the use of the risk and control assessment process that provides business areas and functions with a forward-looking view of operational risks and an assessment of the effectiveness of controls, and a tracking mechanism for action plans so that they can proactively manage operational risks within acceptable levels.

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

(d) Credit risk management

Credit risk is the risk that a customer or counterparty of the group will be unable or unwilling to meet a commitment into which it has entered with a member of the group. It arises from lending, trade finance, treasury and other activities. The group has in place standards, policies and procedures for the control and monitoring of all such risks. Additional credit-related information is presented in Note 7 ‘Derivatives’, Note 8 ‘Loans and advances to banks’, Note 9 ‘Loans and advances to customers’ and Note 10 ‘Financial investments’.

The group is responsible for the formulation of high-level credit policies based on HSBC policies. The group also reviews the application of HSBC’s universal credit risk rating system. The group’s credit risk limits to counterparties in the financial and government sectors are managed centrally to optimise the use of credit availability and to avoid excessive risk concentration. Cross-border risk is controlled through the imposition of country limits, which are determined by taking into account economic and political factors, and local business knowledge, with sub-limits by maturity and type of business. Transactions with counterparties in higher risk countries are considered on a case-by-case basis.

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

(e) Capital management

(i) Regulatory capital

The group’s lead regulator, Bermuda Monetary Authority (the ‘BMA’ or the ‘Authority’), sets and monitors capital requirements for the group as a whole under the Banks and Deposit Companies Act 1999. Individual banking operations of the group are directly supervised by their local regulators.

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

The group’s total banking regulatory capital is analysed into two tiers:

- Tier 1: Called up share capital, share premium, retained earnings, less goodwill; and
- Tier 2: Collective impairment allowances.

Various limits are applied to elements of the capital base. Total Tier 2 capital is limited to 100% of the Tier 1 capital. There are also restrictions on the level of collective impairment allowances that may be included in Tier 2 capital. Other deductions from capital include the investments in the capital of banks and investment in associate.

The group's policy is to maintain a strong capital base so as to maintain creditor and market confidence and to sustain future development of the business. The group and its individual regulated operations have complied with all external imposed capital requirements throughout the period. There have been no material changes in the group's management of capital during the year.

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

Composition of regulatory capital

	Notes	**2012**	2011
Tier 1 capital			
Called up share capital	*27*	30,027	30,027
Share premium		388,652	388,652
Retained earnings		1,152,171	1,273,135
Less goodwill	*13*	(22,399)	(29,866)
Total Tier 1 capital		1,548,451	1,661,948
Tier 2 capital			
Collective impairment allowances	*9*	27,399	6,340
Capital deductions			
Investments in capital of other banks		(450,057)	(450,275)
Investment in associate	*14*	(1,263)	(1,181)
Total regulatory capital		1,124,530	1,216,832

Pillar 1

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

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

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

Pillar 2

The second pillar of Basel II, supervisory assessment process, involves both the group and the Authority to assess and agree the appropriate capital necessary to mitigate the impact of risks not fully captured by the credit risk measures ('Pillar 1'). The annual Supervisory Assessment Process ('SAP'), undertaken by the Authority, aims to assess the group's risk profile and self assessment as documented in the Capital Assessment and Risk Profile ('CARP'). The completion of the SAP formed the basis for the final agreements on new statutory minimum capital requirements for the group going forward. The group has complied with all minimum capital requirements prescribed by the Authority in 2012 and 2011.

Pillar 3

The third pillar of Basel II, market discipline, complements the minimum capital requirements and the supervisory review process. Its aim is to develop disclosures by banks which allow market participants to assess the scope of application of Basel II, capital, particular risk exposures and risk assessment processes, and hence the capital adequacy of the institution. Under the Pillar 3 framework all material risks must be disclosed, enabling a comprehensive view of the institution's risk profile. Disclosures consist of both quantitative and qualitative information and are provided at the consolidated level. The most recent disclosure of the group, 'Capital and Risk Management Interim Pillar 3 Disclosures at 30 June 2012', is published in the group's internet website in the 'About us' section.

(ii) Capital allocation

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

25 Litigation

In the ordinary course of business, the group is routinely defendant in, or party to, a number of pending and threatened legal actions and proceedings. Apart from the matter described below, the group considers that none of these matters is material, either individually or in the aggregate. The group recognises a provision for a liability in relation to these matters when it is probable that an outflow of economic benefits will be required to settle an obligation which has arisen as a result of past events, and for which a reliable estimate can be made of the amount of the obligation. While the outcome of these matters is inherently uncertain, management believes that, based on the information available to it, appropriate provisions have been made in respect of legal proceedings as at 31 December 2012 (see Note 18).

Bernard L. Madoff Investment Securities LLC

In December 2008, Bernard L. Madoff ('Madoff') was arrested for running a Ponzi scheme and a trustee was appointed for the liquidation of his firm, Bernard L. Madoff Investment Securities LLC ('Madoff Securities'), an SEC-registered broker-dealer and investment adviser. Since his appointment, the trustee has been recovering assets and processing claims of Madoff Securities customers. Madoff subsequently pleaded guilty to various charges and is serving a 150 year prison sentence. He has acknowledged, in essence, that while purporting to invest his customers' money in securities and, upon request, return their profits and principal, he in fact never invested in securities and used other customers' money to fulfil requests for the return of profits and principal. The relevant US authorities are continuing their investigations into his fraud, and have brought charges against others, including certain former employees and the former auditor of Madoff Securities.

Various non-US HSBC companies provided custodial, administration and similar services to a number of funds incorporated outside the US whose assets were invested with Madoff Securities. Based on information provided by Madoff Securities, as at 30 November 2008, the purported aggregate value of these funds was US$8.4 billion, an amount that includes fictitious profits reported by Madoff. Based on information available to HSBC to date, we estimate that the funds' actual transfers to Madoff Securities minus their actual withdrawals from Madoff Securities during the time that HSBC serviced the funds totalled approximately US$4.0 billion.

Plaintiffs (including funds, fund investors, and the Madoff Securities trustee) have commenced Madoff-related proceedings against numerous defendants in a multitude of jurisdictions. Various HSBC companies have been named as defendants in suits in the US, Ireland, Luxembourg, and other jurisdictions. Certain suits (which include US putative class actions) allege that the HSBC defendants knew or should have known of Madoff's fraud and breached various duties to the funds and fund investors.

In November 2011, the US District Court Judge overseeing three related putative class actions in the Southern District of New York dismissed all claims against the HSBC defendants on forum non conveniens grounds, but temporarily stayed this ruling as to one of the actions against the affected HSBC defendants – the claims of investors in Thema International Fund plc – in light of a proposed amended settlement agreement, pursuant to which, subject to various conditions, the affected HSBC defendants had agreed to pay from US$52.5 million up to a maximum of US$62.5 million. In December 2011, the court lifted this temporary stay and dismissed all remaining claims against the HSBC defendants, and declined to consider preliminary approval of the settlement. In light of the court's decisions, HSBC terminated the settlement agreement. The Thema plaintiff contests HSBC's right to terminate. Plaintiffs in all three actions have filed notices of appeal to the US Court of Appeals for the Second Circuit. Briefing in that appeal was completed in September 2012; oral argument is expected in early 2013.

In December 2010, the Madoff Securities trustee commenced suits against various HSBC companies in the US Bankruptcy Court and in the English High Court. The US action (which also names certain funds, investment managers, and other entities and individuals) sought US$9 billion in damages and additional recoveries from HSBC and the various co-defendants. It sought damages against HSBC for allegedly aiding and abetting Madoff's fraud and breach of fiduciary duty. In July 2011, after withdrawing the case from the Bankruptcy Court in order to decide certain threshold issues, the US District Court Judge dismissed the trustee's various common law claims on the grounds that the trustee lacks standing to assert them. In December 2011, the trustee filed a notice of appeal to the US Court of Appeals for the Second Circuit. Briefing in that appeal was completed in April 2012, and oral argument was held in November 2012. A decision is expected in 2013.

The District Court returned the remaining claims to the US Bankruptcy Court for further proceedings. Those claims seek, pursuant to US bankruptcy law, recovery of unspecified amounts received by HSBC from funds invested with Madoff, including amounts that HSBC received when it redeemed units HSBC held in the various funds. HSBC acquired those fund units in connection with financing transactions HSBC had entered into with various clients. The trustee's US bankruptcy law claims also seek recovery of fees earned by HSBC for providing custodial, administration and similar services to the funds. Between September 2011 and April 2012, the HSBC defendants and certain other defendants moved again to withdraw the case from the Bankruptcy Court. The District Court granted those withdrawal motions as to certain issues, and briefing and oral arguments on the merits of the withdrawn issues are now complete. The District Court has issued rulings on two of the withdrawn issues, but decisions with respect to all other issues are still pending and are expected in early 2013.

The trustee's English action seeks recovery of unspecified transfers of money from Madoff Securities to or through HSBC, on the grounds that the HSBC defendants actually or constructively knew of Madoff's fraud. HSBC has not been served with the trustee's English action.

Between October 2009 and April 2012, Fairfield Sentry Limited, Fairfield Sigma Limited, and Fairfield Lambda Limited ('Fairfield'), funds whose assets were directly or indirectly invested with Madoff Securities, commenced multiple suits in the British Virgin Islands ('BVI') and the US against numerous fund shareholders, including various HSBC companies that acted as nominees for clients of HSBC's private banking business and other clients who invested in the Fairfield funds. The Fairfield actions seek restitution of amounts paid to the defendants in connection with share redemptions, on the ground that such payments were made by mistake, based on inflated values resulting from Madoff's fraud, and some actions also seek recovery of the share redemptions under BVI insolvency law. The actions in the US are currently stayed in the Bankruptcy Court pending developments in related appellate litigation in the BVI.

There are many factors which may affect the range of possible outcomes, and the resulting financial impact, of the various Madoff-related proceedings, including but not limited to the circumstances of the fraud, the multiple jurisdictions in which the proceedings have been brought and the number of different plaintiffs and defendants in such proceedings. For these reasons, among others, it is not practicable at this time for HSBC to estimate reliably the aggregate liabilities, or ranges of liabilities, that might arise as a result of all such claims but they could be significant. In any event, HSBC considers that it has good defences to these claims and will continue to defend them vigorously.

26 Related party transactions

Related parties of the group include subsidiaries, associates, post-employment benefit plans for group employees, key management personnel, close family members of key management personnel and entities which are controlled, jointly controlled or significantly influenced, or for which significant voting power is held, by Key Management Personnel or their close family members.

The group classifies the Directors of the Bank, members of the Executive Management Committee and senior executives as the key management personnel of the group.

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

	Loans and mortgages	Deposits
Balance at 1 January 2011	12,168	17,147
Advances and transfer in during the year	40,021	-
Repayments and transfers out during the year	(4,667)	(7,054)
Balance at 31 December 2011	47,522	10,093
Advances and transfers in during the year	640	19,156
Repayments and transfers out during the year	(41,414)	(4,224)
Balance at 31 December 2012	6,748	25,025

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

Compensation to key management personnel

	2012	2011	2010
Short-term employee benefits	7,758	7,268	9,478
Post-employment benefits	305	285	836
Other long-term employee benefits	110	132	136
Share-based payments	1,616	2,666	2,739
	9,789	10,351	13,189

Amounts included in balance sheet due from HSBC and affiliated companies

	2012	2011
Loans and advances to banks	2,316,800	2,021,031
Financial investments	579,849	697,372
Derivatives	4,215	8,134
Assets held for sale	2,768	-
Other assets	8,385	5,875

Amounts included in balance sheet due to HSBC and affiliated companies

	2012	2011
Deposits by banks	30,583	17,822
Derivatives	2,556	4,248
Liabilities held for sale	227	-
Other liabilities	7,237	624

Amounts in income statement received from HSBC and affiliated companies

	2012	2011
Interest income	15,325	11,442
Fee income	7,999	8,273
Other operating income	-	509

Amounts in income statement paid to HSBC and affiliated companies

	2012	2011
Interest expense	78	28
Fee expense	1,743	1,752
General and administration expenses	14,490	19,326

There are no individually assessed loan impairment allowances in respect of outstanding balances in 2012 (2011: $NIL). No impairment charges were recognised during the year in respect of loans to related parties (2011: $NIL).

27 Equity

(a) Called up share capital and share premium

The total number of authorised ordinary shares at 31 December 2012 was 140,000,000 (2011: 140,000,000) with a par value of $1 per share (2011: $1 per share). The total number of shares issued and fully paid at 31 December 2012 was 30,026,671 (2011: 30,026,671). These figures and amounts are exact (not rounded or shown to the nearest thousand). Share premium comprises additional paid in capital in excess of the par value. Share premium is not ordinarily available for distribution. The holders of ordinary shares are entitled to receive dividends as declared from time to time, and are entitled to one vote per share at meetings of the Bank.

(b) Dividends

A final dividend of $108,640,000 ($3.62 per ordinary share), was declared by the Board of Directors on 9 February 2012 in respect of the 2011 financial year. An interim dividend of $12,668,000 ($0.42 per ordinary share), was declared by the Board of Directors on 26 July 2012 in respect of the 2012 financial year. These figures and amounts are exact (not rounded or shown to the nearest thousand).

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