HSBC Bank Canada
Annual Report and Accounts 2014

HSBC

Annual Report and Accounts 2014

Headlines

- Profit before income tax expense was $912m for the year ended 31 December 2014, a decrease of 2.4% compared with 2013.
- Profit attributable to the common shareholder was $613m for the year ended 31 December 2014, a decrease of 0.5% compared with 2013.
- Return on average common equity was 13.9% for the year ended 31 December 2014 compared with 14.5% for 2013.
- The cost efficiency ratio was 52.2% for the year ended 31 December 2014 compared with 49.5% for 2013.
- Total assets were $88.2bn at 31 December 2014 compared with $84.3bn at 31 December 2013.
- Common equity tier 1 capital ratio was 10.6%, the tier 1 ratio was 12.0% and the total capital ratio was 13.5% at 31 December 2014.

Basis of preparation of financial information

HSBC Bank Canada ('the bank', 'we', 'our') is an indirectly wholly-owned subsidiary of HSBC Holdings plc ('HSBC Holdings'). Throughout Management's Discussion and Analysis ('MD&A'), the HSBC Holdings Group is defined as the 'HSBC Group' or the 'Group'. The MD&A is dated 20 February 2015, the date that our consolidated financial statements and MD&A for the year ended 31 December 2014 were approved by our Board of Directors ('the Board').

The bank has prepared its consolidated financial statements in accordance with International Financial Reporting Standards ('IFRS') and accounting guidelines as issued by the Office of the Superintendent of Financial Institutions Canada ('OSFI'), as required under Section 308(4) of the *Bank Act*. The information in this MD&A is derived from our consolidated financial statements or from the information used to prepare them. The abbreviations '$m' and '$bn' represent millions and billions of Canadian dollars, respectively. All tabular amounts are in millions of dollars except where otherwise stated.

The references to 'notes' throughout this MD&A refer to notes on the consolidated financial statements for the year ended 31 December 2014.

Table of contents

Message from the President and Chief Executive Officer

As HSBC celebrates 150 years of connecting customers to opportunities, I feel very fortunate to have led HSBC Bank Canada and our incredible team over the past two years. Canada remains one of the HSBC Group's priority growth markets and has been a top five contributor to Group profits for the last several years. Over the past year, we have grown the business in line with our strategy under streamlined structures and a more sustainable cost base.

In 2014, our team in Canada worked extremely hard to build the business – investing to more effectively serve our clients with the tools they need to do business internationally, and help internationally minded individuals to manage their finances. Our strategy delivered strong results consistent with our annual plan despite the challenges of the continued low interest rate environment and our previous repositioning efforts.

In Commercial Banking, we improved our acquisition of new to bank clients, leveraging our global network to serve businesses with international aspirations. In fact, our International Growth Fund for small and medium-sized businesses announced in July 2013 was oversubscribed, and in early 2014, we increased the fund to $2 billion. Authorizations to businesses grew over the course of the year although the amount actually borrowed has not grown at the same pace. We also expanded our import solutions and pre-shipment financing options. We were therefore pleased to have been named Best Trade Finance Provider in Canada by Euromoney Magazine for 2015 – a testament to the value of being part of an integrated global network.

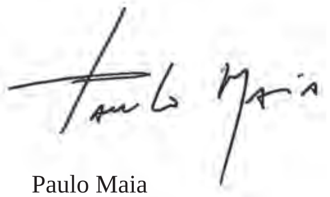
In Global Banking and Markets, we focused our collaboration efforts with Commercial Banking, providing improved trade execution and increased volumes through our FX e-platform. There were also particularly strong results with Commercial Banking clients in equity capital markets and debt capital markets. Overall, we saw a significant increase in FX volumes, where HSBC ranked third in Canada on Euromoney's league tables up from sixth two years ago. The Capital Financing business was expanded to include Project and Export Financing, leveraging 50 years of HSBC Group expertise in infrastructure funding. Our China and renminbi leadership globally was solidified in Canada as we acted as joint book runner on a Dim Sum bond issuance for the Province of British Columbia in October 2014 for the second year in a row.

In Retail Banking and Wealth Management, we grew our Premier and Advance customer base, strengthened our wealth management capabilities, and focused on improving the customer experience through a series of initiatives targeted at the areas that customers told us mattered most, including improving the overall onboarding experience with the bank. We saw our customer recommendation index improve by 8 points in 2014, with 70% of our customers now telling us they would recommend us to their family and friends.

We have accomplished a great deal in 2014, but our challenges once again include a sluggish economy in the midst of a difficult adjustment. The decline in commodity prices, particularly oil prices, since mid-2014 presents an unexpected challenge for the Canadian economy that will weigh heavily on corporate profits, business investment and energy exports in the first half of 2015. These developments also present further hurdles to rebalancing the economy away from consumer spending and housing. Further rate cuts are required to offset the impact of rising job losses in the oil patch and elsewhere, though lower rates could also increase risks to financial stability by encouraging already overly indebted households to increase borrowing. With the Canadian dollar expected to fall further, and given that lower oil prices are on the whole positive for the US economy, non-energy and currency-sensitive exports are expected to provide critical support to the economy in 2015.

Our research clearly shows that companies that export beyond Canada's borders grow at a more rapid pace than their strictly domestic competitors. With the Canadian economy continuing to face headwinds, it is more important than ever for Canadian companies to take advantage of opportunities for expansion in faster growing markets. With HSBC's global footprint, we are well placed to take them there with services that will help businesses that are importing, exporting, or with operations outside of Canada and for those investing globally.

Throughout our history we have been where the growth is, connecting customers to opportunities. We enable businesses to thrive and economies and communities to prosper, helping people fulfil their hopes and dreams and realize their ambitions. We are grateful for the partnerships we've enjoyed with our customers in 2014 and look forward to supporting them in 2015 and for many decades to come.



Paulo Maia
President and Chief Executive Officer
HSBC Bank Canada

Vancouver, Canada
20 February 2015

Management's Discussion and Analysis

Financial summary

($ millions, except where otherwise stated)	**2014**	2013	2012
Financial performance for the year ended 31 December ($m)			
Total operating income	**2,110**	2,161	2,393
Profit before income tax expense	**912**	934	1,029
Profit attributable to the common shareholder	**613**	616	683
Basic earnings per common share ($)	**1.23**	1.24	1.37
Financial position at 31 December ($m)			
Loans and advances to customers[1]	**41,219**	40,524	42,456
Customer accounts	**50,843**	50,926	46,292
Ratio of customer advances to customer accounts (%)[2]	**81.1**	79.6	91.7
Shareholders' equity	**4,800**	4,885	5,146
Average total shareholders' equity to average total assets (%)[2]	**5.7**	6.1	6.1
Capital measures[3]			
Common equity tier 1 capital ratio (%)	**10.6**	11.0	n/a
Tier 1 ratio (%)	**12.0**	13.2	13.8
Total capital ratio (%)	**13.5**	15.0	16.0
Assets-to-capital multiple	**17.1**	15.1	13.1
Risk-weighted assets ($m)[3]	**40,269**	36,862	36,668
Performance ratios (%)[2]			
Return ratios (%)			
Return on average common shareholder's equity	**13.9**	14.5	16.6
Post-tax return on average total assets	**0.72**	0.72	0.83
Pre-tax return on average risk-weighted assets[3]	**2.3**	2.6	2.8
Credit coverage ratios (%)			
Loan impairment charges to total operating income	**5.1**	8.7	8.8
Loan impairment charges to average gross customer advances and acceptances	**0.3**	0.5	0.5
Total impairment allowances to impaired loans and acceptances at year end	**69.9**	66.4	49.2
Efficiency and revenue mix ratios (%)			
Cost efficiency ratio	**52.2**	49.5	48.4
Adjusted cost efficiency ratio	**52.1**	49.4	47.9
As a percentage of total operating income:			
– net interest income	**57.4**	60.7	61.6
– net fee income	**30.6**	27.9	25.1
– net trading income	**6.9**	8.2	7.5

1 *From 1 January 2014, non-trading reverse repurchase and repurchase agreements are presented as separate lines in the balance sheet. Previously, non-trading reverse repurchase agreements were included within 'Loans and advances to banks' and 'Loans and advances to customers' and non-trading repurchase agreements were included within 'Deposits by banks' and 'Customer accounts'. Comparative data have been restated accordingly. Refer to the 'Accounting matters' section of this document for further information on this change in presentation.*

2 *Refer to the 'Use of non-IFRS financial measures' section of this document for a discussion of non-IFRS financial measures.*

3 *Effective 1 January 2013, the bank assesses capital adequacy against standards established in guidelines issued by OSFI in accordance with the Basel III capital adequacy frameworks. Comparative 2012 information is presented using guidelines issued by OSFI in accordance with the Basel II capital adequacy framework and therefore is not comparable.*

Management's Discussion and Analysis (continued)

Use of non-IFRS financial measures

In measuring our performance, the financial measures that we use include those which have been derived from our reported results. However these are not presented within the Financial Statements and are not defined under IFRS. These are considered non-IFRS financial measures and are unlikely to be comparable to similar measures presented by other companies. The following non-IFRS financial measures are used throughout this document and their purposes and definitions are discussed below.

Financial position ratios

These measures are indicators of the stability of the bank's balance sheet and the degree to which funds are deployed to fund assets.

Ratio of customer advances to customer accounts is calculated by dividing loans and advances to customers by customer accounts using year-end balances.

Average total shareholders' equity to average total assets is calculated by dividing average total shareholders' equity for the year (determined using month-end balances) with average total assets (determined using month-end balances) for the year.

Return ratios

Return ratios are useful for management to evaluate profitability on equity, assets and risk-weighted assets.

Return on average common shareholder's equity is calculated as annual profit attributable to the common shareholder divided by average common equity (determined using month-end balances).

Post-tax return on average total assets is calculated as annual profit attributable to common shareholders divided by average assets (determined using average month-end balances).

Pre-tax return on average risk-weighted assets is calculated as the profit before income tax expense divided by the average monthly balances of risk-weighted assets for the year. Risk-weighted assets are calculated using guidelines issued by OSFI in accordance with the Basel III capital adequacy framework (2012: Risk-weighted assets are calculated using the guidelines issued by OSFI in accordance with the Basel II capital adequacy framework).

Credit coverage ratios

Credit coverage ratios are useful to management as a measure of the extent of incurred loan impairment charges relative to the bank's performance and size of its customer loan portfolio during the period.

Loan impairment charges to total operating income is calculated as loan impairment charges and other credit provisions, as a percentage of total operating income for the year.

Loan impairment charges to average gross customer advances is calculated as annualized loan impairment charges and other credit provisions for the period as a percentage of average gross customer advances (determined using month-end balances).

Total impairment allowances to impaired loans at period-end are useful to management to evaluate the coverage of impairment allowances relative to impaired loans using year-end balances.

Efficiency and revenue mix ratios

Efficiency and revenue mix ratios are measures of the bank's efficiency in managing its operating expense to generate revenue and demonstrate the contribution of each of the primary revenue streams to total income.

Cost efficiency ratio is calculated as annual total operating expenses as a percentage of annual total operating income.

Adjusted cost efficiency ratio is calculated similar to the cost efficiency ratio; however, annual total operating income excludes annual gains and losses from financial instruments designated at fair value, as the movement in value of the bank's own subordinated debt issues are primarily driven by changes in market rates and are not under the control of management.

Net interest income, net fee income and net trading income as a percentage of total operating income is calculated as annual net interest income, annual net fee income and annual net trading income divided by annual total operating income.

Who we are

HSBC is one of the world's largest banking and financial services organizations with around 6,100 offices in 73 countries and territories and assets of US$2,634bn at 31 December 2014.

Throughout our history HSBC has been where the growth is, connecting customers to opportunities, enabling businesses to thrive and economies to prosper, helping people fulfil their hopes and dreams and realize their ambitions.

HSBC Bank Canada is the leading international bank in Canada with total assets of $88.2bn at 31 December 2014. Established in 1981 and headquartered in Vancouver, British Columbia, we have grown organically and through strategic acquisitions to become an integrated financial services organization with more than 150 offices across the country.

No international bank has our Canadian presence and no domestic bank has our international reach. Our business model is structured and focused on helping companies and individuals do business internationally with a comprehensive range of financial service, trade and investment products.

We are a priority market for the HSBC Group, whose parent company, HSBC Holdings plc, is headquartered in London, UK. HSBC's international network spans Europe, the Asia-Pacific region, the Americas, the Middle East and Africa. Shares in HSBC Holdings are listed on the London, Hong Kong, New York, Paris and Bermuda stock exchanges. The shares are traded in New York in the form of American Depositary Receipts.

Through an international network linked by advanced technology, the HSBC Group provides a comprehensive range of financial services through four business lines: Retail Banking and Wealth Management, Commercial Banking, Global Banking and Markets, and Global Private Banking.

The bank's continuous disclosure materials, including interim and annual filings, are available on the bank's website and on the Canadian Securities Administrators' website at www.sedar.com.

Complete financial and operational information for HSBC Holdings and the HSBC Group, including copies of HSBC Holdings 2014 Annual Review and its 2014 Annual Report and Accounts, can be obtained from its website: www.hsbc.com.

Our strategic priorities

Our strategic priorities

Our strategic goal is to support the HSBC Group to be regarded as the world's leading and most respected international bank, through an international network connecting faster-growing and developed markets, and investment in the Wealth and Retail markets where there is scale.

We have set three interconnected priorities to help us deliver our strategy. They are:

- grow the business and dividends;
- implement Global Standards; and
- streamline processes and procedures.

Grow the business and dividends

Profit underpins long-term business sustainability and growing our profit is an integral part of our strategy. The conditions for creating value and generating profits are reflected in our global lines of business.

Our business model is based on an international network connecting and serving the Canadian market.

The three HSBC global lines of business that operate in Canada are Commercial Banking, Global Banking and Markets, and Retail Banking and Wealth Management. They are responsible for developing, implementing and managing their business propositions consistently across the HSBC Group, focusing on profitability and efficiency. They set their strategies within the parameters of the HSBC Group strategy, are responsible for issuing planning guidance regarding their businesses, are accountable for their profit and loss performance, and headcount.

We launched a strategic plan focused on growing HSBC's business in Canada, with investments committed in all of our global lines of business, and in the Risk and Compliance functions.

Management's Discussion and Analysis (continued)

Implement Global Standards

The HSBC Group has committed to develop Global Standards shaped by the highest or most effective standards available in any location where HSBC operates and to deploy them globally on a consistent basis. They affect all aspects of our business, including governance, and are embedded in the HSBC Values to which employees are required to adhere. They inform our response to employee and remuneration issues, and set the tone for our interactions with customers.

We see the implementation of Global Standards as a source of competitive advantage as they allow us to:

– strengthen our response to the ongoing threat of financial crime;

– make consistent – and therefore simplify – the ways by which we monitor and enforce high standards;

– strengthen policies and processes which govern how we do business and with whom; and

– ensure that we consistently apply HSBC Values to how we conduct our business.

Embedding HSBC Values in every decision and every interaction with customers and with each other is a top priority for the HSBC Group. It is shaping the way we do business and is integral to the selection, assessment, recognition and training of staff.

The role of HSBC Values in daily operating practice is fundamental to our culture, and is particularly important in the light of developments in regulatory policy, investor confidence and society's expectations of banks. We expect our executives and employees to act with courageous integrity in the execution of their duties by being:

– dependable and doing the right thing;

– open to different ideas and cultures; and

– connected with our customers, communities, regulators and each other.

We are committed to the highest standards of corporate governance. We believe that a strong and transparent corporate governance framework is directly linked to the long-term success of the HSBC Group globally.

Streamline processes and procedures

This initiative is critical to the long-term sustainability of our business. Society's expectations of the financial services industry are evolving and becoming more demanding and markets are becoming increasingly competitive. In this environment, it is essential that we focus relentlessly on improving efficiency, streamlining the bank's processes and procedures and reducing costs while remaining aware of our wider obligations to the community.

During 2013, the bank initiated a comprehensive program to reposition our portfolios in line with our risk appetite which has continued in 2014. We made progress with programs to improve organizational efficiency, making the bank easier to manage and control. Our risk profile is underpinned by our core philosophy of maintaining a strong balance sheet, liquidity position, and capital strength.

We have simplified management structures and will continue to remove unnecessary complexity from our activities and make processes and systems consistent in all businesses. We will continue to refine our operational processes, develop our support functions and streamline our information technology.

Financial performance 2014

Summary consolidated income statement

	2014 $m	2013 $m
Net interest income	**1,212**	1,311
Net fee income	**645**	603
Net trading income	**146**	178
Net expense from financial instruments designated at fair value	**(5)**	(5)
Gains less losses from financial investments	**56**	58
Other operating income	**56**	16
Net operating income before loan impairment charges and other credit risk provisions	**2,110**	2,161
Loan impairment charges and other credit risk provisions	**(107)**	(188)
Net operating income	**2,003**	1,973
Total operating expenses	**(1,102)**	(1,070)
Operating profit	**901**	903
Share of profit in associates	**11**	31
Profit before income tax expense	**912**	934
Income tax expense	**(263)**	(247)
Profit for the year	**649**	687

Overview

HSBC Bank Canada reported a profit before income tax expense for 2014 of $912m, a decrease of $22m or 2%, compared with 2013. While there was positive growth in line with our strategy, the effect of repositioning the business and the low interest rate environment continued to negatively impact our bottom line.

The decrease in profit before income tax expense compared with the prior year was primarily due to the impact of declining loan balances from the run-off consumer finance portfolio, lower foreign exchange trading income, a lower share of profit in associates, and higher operating expenses from implementing HSBC's Global Standards program and other risk and compliance activities. This was partially offset by increased fee income from credit and wealth management products, lower loan impairment charges primarily from lower specific commercial loan provisions and the lower collective provisions as a result of the run-off consumer finance portfolio. In addition, an increase in other operating income reflected the non-recurrence of a reduction in the fair value of an investment property recorded in 2013.

Management's Discussion and Analysis (continued)

Performance by income and expense item

Net interest income

	2014			2013		
	Average balance **$m**	*Interest income/ (expense)* **$m**	*Yield* **%**	*Average balance* $m	*Interest income/ (expense)* $m	*Yield* %
Interest-earning assets						
Loans and advances with customers	**41,384**	**1,514**	**3.66**	41,617	1,671	4.02
Other interest-earning assets	**28,756**	**372**	**1.29**	31,777	394	1.24
Total interest-earning assets	**70,140**	**1,886**	**2.69**	73,394	2,065	2.81
Total interest costing liabilities	**(60,123)**	**(674)**	**1.12**	(63,749)	(754)	1.18
Net interest and net interest spread		**1,212**	**1.57**		1,311	1.63

Net interest income in 2014 was $1,212m, a decrease of $99m, or 8%, compared with 2013. The decrease was primarily due to declining loan balances from the impact of the continued run-off of the consumer finance portfolio, lower higher-yielding personal loans volumes and the competitive pressures in a low interest rate environment.

Net fee income

	2014 **$m**	2013 $m
Credit facilities	**278**	254
Funds under management	**163**	135
Account services	**77**	83
Credit cards	**62**	62
Corporate finance	**37**	34
Remittances	**32**	32
Immigrant Investor Program	**17**	35
Brokerage commissions	**13**	14
Insurance	**12**	14
Trade finance import/export	**9**	10
Trustee fees	**5**	6
Other	**18**	15
Fee income	**723**	694
Less: fee expense	**(78)**	(91)
Net fee income	**645**	603

Net fee income for 2014 was $645m, an increase of $42m or 7%, compared with 2013. The increase in net fee income was primarily due to higher fees from credit products such as standby lines of credit and banker's acceptances, as well as increased fees from wealth related products and from higher funds under management. This was partially offset by lower fees earned following the cancellation of the Canadian federal government's Immigrant Investor Program.

Net trading income

	2014 $m	2013 $m
Trading activities	**127**	129
Net interest from trading activities	**18**	43
Hedge ineffectiveness	**1**	6
Net trading income	**146**	178

Net trading income for 2014 was $146m, a decrease of $32m, or 18%, compared with 2013. This decrease is mainly due to lower spreads on foreign exchange products and the impact of valuation adjustments on derivative contracts as a result of the narrowing of our own credit spreads and the impact on net interest from trading activities of funding customer facilitation trading transactions.

Other items of income

	2014 $m	2013 $m
Net expense from financial instruments designated at fair value	**(5)**	(5)
Gains less losses from financial investments	**56**	58
Other operating income	**56**	16
Other items of income	**107**	69

Net expense from financial instruments designated at fair value for 2014 was in line with 2013. Gains less losses from financial investments for 2014 were $56m, a decrease of $2m, or 3%, compared with 2013. Balance Sheet Management recognized lower gains on sale of available-for-sale debt securities arising from the continued rebalancing of the Balance Sheet Management portfolio.

Other operating income for 2014 was $56m, an increase of $40m, or 250%, compared with 2013. The increase primarily reflects the impact of the non-recurrence of a reduction in the fair value of an investment property recorded in 2013.

Loan impairment charges and other credit risk provisions

	2014 $m	2013 $m
Individually assessed allowances	**90**	138
Collectively assessed allowances	**2**	69
Loan impairment charges	**92**	207
Other credit risk provisions/(reversal of provisions)	**15**	(19)
Loan impairment charges and other credit risk provisions	**107**	188

Loan impairment charges and other credit risk provisions for 2014 were $107m, a decrease of $81m, or 43%, compared with 2013. The decrease in loan impairment charges and other credit risk provisions is primarily as a result of a reduction in specifically assessed allowances and collectively assessed allowances due to the run-off consumer finance portfolio, and lower levels of other personal lending. In addition, the volume of undrawn commitments driven by increased credit activity as well as changes in other credit metrics resulted in an increase in other credit risk provisions.

Management's Discussion and Analysis (continued)

Operating expenses

	2014 **$m**	2013 $m
Employee compensation and benefits	**619**	614
General and administrative expenses	**434**	408
Depreciation of property, plant and equipment	**33**	34
Amortization and impairment of intangible assets	**16**	14
Total operating expenses	**1,102**	1,070

Total operating expenses for 2014 were $1,102m, an increase of $32m, or 3%, compared with 2013. The increase was primarily due to continued investments in the implementation of HSBC's Global Standards and other risk and compliance activities.

Share of profit in associates

Share of profit in associates for 2014 was $11m, a decrease of $20m, or 65%, compared with 2013. The share of profit was lower compared with 2013 when two underlying investments performed particularly strongly and were realized.

Income tax expense

The effective tax rate was 29.2% for 2014, compared with 26.7% for 2013. The higher income tax expense resulted from the resolution and closure of multiple tax issues covering a number of years with the Canadian tax authorities.

Movement in financial position

Summary consolidated balance sheet

	2014 **$m**	2013 $m	2012 $m
ASSETS			
Trading assets	**8,914**	6,728	5,272
Derivatives	**4,082**	2,112	1,810
Loans and advances to banks	**1,264**	1,149	673
Loans and advances to customers	**41,219**	40,524	42,456
Reverse repurchase agreements – non-trading	**6,714**	6,161	3,923
Financial investments	**20,122**	21,814	20,411
Customers' liability under acceptances	**5,023**	4,757	4,737
Other assets	**866**	1,015	1,432
Total assets	**88,204**	84,260	80,714
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	**681**	635	1,156
Customer accounts	**50,843**	50,926	46,292
Repurchase agreements – non-trading	**4,054**	1,487	3,029
Trading liabilities	**4,227**	4,396	2,672
Derivatives	**3,885**	1,746	1,415
Debt securities in issue	**10,610**	11,348	11,980
Acceptances	**5,023**	4,757	4,737
Other liabilities	**3,881**	3,880	4,057
Total liabilities	**83,204**	79,175	75,338
Equity			
Share capital and other reserves	**1,692**	1,959	2,452
Retained earnings	**3,108**	2,926	2,694
Non-controlling interests	**200**	200	230
Total equity	**5,000**	5,085	5,376
Total equity and liabilities	**88,204**	84,260	80,714

Assets

Total assets at 31 December 2014 were $88.2bn, an increase of $3.9bn from 31 December 2013. Trading assets increased by $2.2bn due to timing of client trading settlements as well as increased holdings in trading assets. Derivatives increased by $2.0bn due to considerably increased positions held on behalf of clients as well as the impact of recent changes in the value of the US dollar on values of forward foreign exchange contracts. This was matched by similar increases in the mark to market liabilities of derivatives. Loans and advances to customers increased by $0.7bn, mainly as a result of increased term lending by Commercial Banking and Global Banking and Markets clients. Residential mortgages increased by almost $0.6bn although this was largely offset by the planned run-off of the consumer finance portfolio and reductions in other personal lending. Customer acceptances increased by $0.3bn due to increased utilization of customer credit facilities. Loans and advances to banks and non-trading reverse repurchase agreements increased by $0.7bn while financial investments were reduced by $1.7bn due to balance sheet management activities.

Liabilities

Total liabilities at 31 December 2014 were $83.2bn, an increase of $4.0bn from 31 December 2013. Repurchase agreements increased by $2.6bn due to funding of increased asset trading noted above. Derivatives increased $2.1bn due to client activities and the impact of foreign exchange movements on forward foreign exchange positions noted above. Liabilities under customer acceptances increased by $0.3bn. Although we issued $2.0bn in new medium term notes during the year, this was more than offset by secured funding maturities leading to a net reduction of $0.7bn in debt securities in issue.

Equity

Total equity at 31 December 2014 was $5.0bn, a decrease of $0.1bn from 31 December 2013, primarily due to the redemption of $250m preferred share capital in accordance with the bank's capital plan. The decrease in equity was partially offset by profits generated in the year.

Global lines of business

We manage and report our operations around the following global lines of business: Commercial Banking, Global Banking and Markets, and Retail Banking and Wealth Management. The latter segment also includes the run-off consumer finance portfolio following a previous decision to wind down the consumer finance business in Canada.

Commercial Banking

Commercial Banking offers a full range of commercial financial services and tailored solutions to a range of customers, from small and medium-sized enterprises ('SMEs') to global multi-national companies, with a clear focus on internationally active and aspirant customers.

We place particular emphasis on international connectivity and aim to be recognized as the leading international trade and business bank by focusing on segments directed towards international business and enhancing collaboration across the Group.

Products and services

In Canada our Commercial Banking business is segmented by three customer groups, enabling differentiated coverage of our target customers. Segments include: Large Corporate Banking, serving large, multi-national companies with more sophisticated financial needs; Mid-Market, providing tailored solutions both domestically and internationally; and, Business Banking, serving small and medium-sized enterprises. This allows us to provide continuous support to companies as they grow both domestically and internationally.

– *Credit and Lending:* we offer a broad range of domestic and cross-border financing, including overdrafts, term loans, leasing, and syndicated, leveraged, acquisition and project finance.

– *Global Trade and Receivables Finance:* we provide the services and finance our clients' needs throughout the trade cycle including: letters of credit, collections, guarantees; receivables finance; supply chain solutions; and risk distribution including renminbi denominated services for exporters, importers, and companies looking to invest in China.

– *Payments and Cash Management:* we are a leading provider of domestic and cross-border payments, collections, liquidity management and account services offering local, regional and global solutions delivered via electronic platforms designed to address the current and future needs of our clients.

Management's Discussion and Analysis (continued)

- *Global Banking and Markets:* our Commercial Banking franchise represents a key client base for Global Banking and Markets products and services, including foreign exchange and interest rate products, together with capital raising on debt and equity markets.

Strategic direction

Commercial Banking aims to be the banking partner of choice for international businesses – building on our rich heritage, international capabilities and relationships to enable connectivity and support trade and capital flows around the world. Thereby, strengthening our leading position in international business and trade.

We have three growth priorities:

- grow coverage in all target segments;
- drive revenue growth through our international network; and
- grow collaboration revenues.

Implementing Global Standards, enhancing risk management controls models and simplifying processes by adopting a global operating model also remains a top priority for Commercial Banking.

Review of financial performance

	2014 $m	2013 $m
Net interest income	**658**	675
Net fee income	**324**	317
Net trading income	**26**	28
Gains less losses from financial investments	**16**	–
Other operating income/(expense)	**19**	(31)
Net operating income before loan impairment charges and other credit risk provisions	**1,043**	989
Loan impairment charges and other credit risk provisions	**(79)**	(124)
Net operating income	**964**	865
Total operating expenses	**(408)**	(373)
Operating profit	**556**	492
Share of profit in associates	**11**	31
Profit before income tax expense	**567**	523

Overview

In 2014 we improved our acquisition of new to bank customers across three target business segments with an increase in lending to these customers. However, the impacts of repositioning our Business Banking and Commercial Real Estate businesses in the early part of the year, together with lower levels of credit lines by existing customers partially offset some of that growth.

Profit before income tax expense for 2014 was $567m, an increase of $44m, or 8%, compared with 2013. The increase was primarily due to the non-recurrence in other income of a reduction in the fair value of an investment property held for sale recorded in 2013, lower specific loan impairment charges and gains from financial investments. These increases were partially offset by higher operating expenses primarily from increased investments in HSBC's Global Standards, risk and compliance activities and the impact of adoption of a revised methodology for allocating functional support costs to lines of business by the HSBC Group.

Financial performance by income and expense item

Net interest income for 2014 was $658m, a decrease of $17m, or 3%, compared with 2013 primarily due to repositioning of the portfolio and recovery of interest income on impaired loans recorded in 2013.

Net fee income for 2014 was $324m, an increase of $7m or 2% compared with 2013 mainly arises from higher banker's acceptances and other credit products.

Net trading income for 2014 was $26m, a decrease of $2m, or 7%, compared with 2013, primarily from lower foreign exchange revenues.

Gains less losses from financial investments for 2014 compared with 2013 included gains of $16m which were recorded on the disposal of certain available-for-sale securities.

Other operating income for 2014 was $19m, an increase of $50m compared with 2013, reflecting the reduction in the fair value of an investment property held for sale that was recorded in 2013.

Loan impairment charges and other credit risk provisions for 2014 were $79m, a decrease of $45m or 36% compared with 2013, mainly as a result of lower specific loan impairment charges in 2014.

Total operating expenses for 2014 were $408m, an increase of $35m or 9% compared with 2013, primarily from increased investments in HSBC's Global Standards, risk and compliance, growth in underlying businesses and the adoption of a revised methodology by HSBC Group for allocation of functional support costs to the global lines of business.

Share of profit in associates for 2014 was $11m, a decrease of $20m, compared with 2013 when two underlying investments performed particularly strongly and were realized.

Global Banking and Markets

Global Banking and Markets provides tailored financial solutions to major government, corporate and institutional clients worldwide.

Products and services

Managed as a global business, Global Banking and Markets operates with a long-term relationship management approach to build a full understanding of clients' financial requirements. Sector-focused client service teams comprised of relationship managers and product specialists develop financial solutions to meet individual client needs. With a presence in over 60 countries and territories and access to the HSBC Group's worldwide presence and capabilities, this business serves subsidiaries and offices of our clients on a global basis.

Global Banking and Markets is managed as three principal business lines: Markets, Capital Financing, and Banking. This structure allows us to focus on relationships and sectors that best fit the HSBC Group's geographic reach and facilitate seamless delivery of our products and services.

– *Markets* consists of sales and trading functions specializing in products including foreign exchange; currency, interest rate, bond, credit, equity and other derivatives; government and non-government fixed income and money market instruments; and precious metals and exchange-traded futures. Markets also includes Balance Sheet Management, which is responsible for the management of liquidity, funding and the structural interest rate risk positions of the bank.

– *Capital Financing* brings together our capital raising and risk management services into a single platform. This group provides clients with a single integrated financing business, focused across a client's capital structure and financing needs. Its expertise includes: primary equity and debt capital markets; specialized structured financing solutions such as asset-backed finance, leveraged and acquisition finance and project finance; transformative merger and acquisition advisory and execution; and credit and lending activities.

– *Banking* is responsible for the overall management of relationships with major corporate, government and institutional clients across a broad range of geographies. This involves working closely with a variety of product specialists to deliver a comprehensive range of Markets, Capital Finance, Trade and Receivables Finance, and Payments and Cash Management services.

Strategic direction

Global Banking and Markets continues to pursue its well-established 'tailored financial solutions' strategy, with the objective of being a leading international wholesale bank. This strategy has evolved to include a greater emphasis on connectivity between the global businesses, across the regions and within Global Banking and Markets, leveraging the HSBC Group's extensive distribution network.

We focus on four strategic initiatives:

– leveraging our distinctive geographical network which connects developed and faster-growing regions;

– connecting clients to global growth opportunities;

– continuing to be well positioned in products that will benefit from global trends; and

– enhancing collaboration with other global businesses to appropriately serve the needs of our international clients.

Implementing Global Standards, enhancing risk management controls and simplifying processes also remain top priorities for Global Banking and Markets.

Management's Discussion and Analysis (continued)

Review of financial performance

	2014 $m	2013 $m
Net interest income	**179**	159
Net fee income	**98**	83
Net trading income	**68**	103
Gains less losses from financial investments	**40**	54
Other operating income	**1**	1
Net operating income before loan impairment charges and other credit risk	**386**	400
Loan impairment charges and other credit risk provisions	**(5)**	–
Net operating income	**381**	400
Total operating expenses	**(117)**	(113)
Profit before income tax expense	**264**	287

Overview

Global Banking and Markets continued to increase lending and credit activities with Global Banking clients including growing the Multinational client base. In addition, the Capital Financing business expanded its product offering to include Project and Export Financing capabilities taking advantage of 50 years of HSBC Group expertise in this area. The persisting low volatility and low interest rate environment negatively impacted the Global Markets performance.

Profit before income tax expense was $264m for 2014, a decrease of $23m, or 8%, compared with 2013. There was an increase in net interest income and higher standby and debt capital market fees. However this was more than offset by lower trading income arising from lower spreads on foreign exchange products and lower gains on disposal from re-balancing of the financial investments portfolio.

Financial performance by income and expense item

Net interest income for 2014 was $179m, an increase of $20m or 13% compared with in 2013, primarily due to higher investments in reverse repurchase agreements from a higher level of short positions to facilitate customer transactions.

Net fee income for 2014 was $98m, an increase of $15m, or 18%, compared with 2013 primarily due to higher standby and capital market fees.

Net trading income for 2014 was $68m, a decrease of $35m, or 34%, compared with 2013. The decrease in net trading income was mainly due to lower spreads on foreign exchange products, valuation adjustments on derivative contracts due to the narrowing of our own credit spread, and funding of short inventory positions to facilitate customer trading transactions.

Gains less losses from financial investments for 2014 was $40m, a decrease of $14m, or 26%, compared with 2013, primarily as a result of the bank's continuous balance sheet management activities. The bank realizes gains and losses from financial investments from disposals of available-for-sale financial investments driven by balance sheet management activities.

Total operating expenses for 2014 was $117m, an increase of $4m or 4%, compared with 2013 primarily due to increased investments in HSBC's Global Standards, risk and compliance activities.

Retail Banking and Wealth Management

Retail Banking and Wealth Management provides banking and wealth management services to more than 800,000 personal banking customers, helping them to manage their finances and protect and build their financial future.

Products and services

We take deposits and provide transactional banking services to enable customers to manage their day-to-day finances and save. We selectively offer credit facilities to assist customers in their short or longer-term borrowing requirements, and we provide wealth advisory and investment services to help them to manage their finances.

We develop products designed to meet the needs of specific customer segments, which may include a range of different services and delivery channels.

Typically, customer offerings include:

– *liability-driven services:* deposits and account services;

– *asset-driven services:* secured and unsecured credit and lending; and

– *fee-driven and other services:* wealth advisory and asset management.

Strategic direction

Retail Banking and Wealth Management provides a full range of banking and wealth products and services through our branches and direct channels to individuals.

We focus on three strategic initiatives:

– building a consistent, high standard, customer needs-driven wealth management service for retail customers drawing on our financial advisory and asset management businesses;

– leveraging global expertise to efficiently provide a high standard of banking solutions and service to our customers; and

– simplifying the Retail Banking and Wealth Management portfolio of products and services, directing resources towards the development and delivery of lending products through a relationship led approach.

To support these initiatives, we have targeted growth through deepening customer relationships and enhancing distribution capabilities.

Implementing Global Standards, enhancing risk management control models and simplifying processes also remain top priorities for Retail Banking and Wealth Management.

Review of financial performance

	2014 **$m**	2013 $m
Net interest income	**413**	505
Net fee income	**223**	203
Net trading income	**18**	19
Gains less losses from financial investments	**–**	4
Other operating income	**8**	13
Net operating income before loan impairment charges and other credit risk provisions	**662**	744
Loan impairment charges and other credit risk provisions	**(23)**	(64)
Net operating income	**639**	680
Total operating expenses	**(533)**	(549)
Profit before income tax expense	**106**	131

Profit before income tax expense

	2014 **$m**	2013 $m
Ongoing Retail Banking and Wealth Management business	**76**	52
Run-off consumer finance portfolio[1]	**30**	79
Profit before income tax expense	**106**	131

1 *In 2013 the former Consumer Finance division was merged with Retail Banking and Wealth Management.*

Overview

Retail Banking and Wealth Management has grown its Premier and Advance customer base in 2014, strengthened its wealth management capabilities through the increase in dedicated Relationship Managers, and enhanced its digital offering to customers through the introduction of Interac eTransfer capability. Although overall personal lending has decreased, residential mortgages have grown strongly during the year.

Profit before income tax expense was $106m for 2014, a decrease of $25m, or 19%, compared with 2013. Profit before income tax expense relating to ongoing business (excluding the run-off consumer finance portfolio) was $76m for 2014, an increase of $24m, or 46%, compared with 2013. Profit before income tax expense relating to ongoing business increased from the same period last year primarily due to lower loan impairment charges and other credit risk provisions

Management's Discussion and Analysis (continued)

together with higher fee revenues from sales of wealth management products. This was partially offset by increased costs, lower net interest income driven by lower personal lending balances and lower net interest spreads in a competitive, low interest rate environment.

Profit before income tax expense relating to the consumer finance portfolio was $30m, compared with $79m for the same period in 2013 reflecting the planned run-off of this portfolio.

Financial performance by income and expense item

Net interest income of the ongoing business for 2014 was $346m, a decrease of $14m, or 4%, compared with 2013 primarily due to lower personal lending balances and lower net interest spread in a competitive low interest rate environment.

Net fee income of the ongoing business for 2014 was $220m, an increase of $23m, or 12%, compared with 2013 mainly due to increases wealth management product sales.

Net trading income relating to ongoing business for 2014 was $18m, little changed compared with 2013.

Loan impairment charges and other credit risk provisions relating to ongoing business for 2014 was $12m, a decrease of $21m, or 64%, compared with 2013 due to lower collectively assessed provisions on lower loan balances.

Total operating expenses of the ongoing business for 2014 was $504m, an increase of $3m, or 1%, compared with 2013. The variances were primarily from higher staff, marketing and customer printing expenses as well as the bank's continued investment in HSBC's Global Standards, risk and compliance, partially offset by a reduction of allocated support costs.

Other

'Other' contains the results of movements in fair value of own debt, income related to information technology services provided to HSBC Group companies on an arm's length basis with associated recoveries and other transactions which do not directly relate to our global lines of business.

Loss before income tax expense was $25m for the year ended 31 December 2014, compared with a loss of $7m for 2013. The increased loss was mainly due to foreign exchange losses on settlements of US dollar denominated services provided by HSBC Group companies, the timing of recoveries from other Group companies as well as changes in how we allocate costs of certain corporate services to the global lines of business.

Review of financial performance

	2014 $m	2013 $m
Net interest expense	**(38)**	(28)
Net trading income	**34**	28
Net expense from financial instruments designated at fair value	**(5)**	(5)
Other operating income	**28**	33
Net operating income	**19**	28
Total operating expenses	**(44)**	(35)
Loss before income tax expense	**(25)**	(7)

Fourth quarter 2014 financial performance

Summary consolidated income statement

	Quarter ended		
	31 December 2014 $m	31 December 2013 $m	30 September 2014 $m
Net interest income	**295**	316	303
Net fee income	**169**	151	161
Net trading income	**39**	34	35
Net expense from financial instruments designated at fair value	**(1)**	(2)	(1)
Gains less losses from financial investments	**3**	6	7
Other operating income	**14**	19	15
Net operating income before loan impairment charges and other credit risk provisions	**519**	524	520
Loan impairment charges and other credit risk provisions	**(37)**	(39)	(17)
Net operating income	**482**	485	503
Total operating expenses	**(278)**	(270)	(272)
Operating profit	**204**	215	231
Share of profit in associates	**2**	17	–
Profit before income tax expense	**206**	232	231
Income tax expense	**(81)**	(50)	(61)
Profit for the quarter	**125**	182	170

Overview

HSBC Bank Canada reported a profit before income tax expense of $206m for the fourth quarter of 2014, a decrease of $26m, or 11%, compared with the fourth quarter of 2013, and a decrease of $25m, or 11%, compared with the third quarter of 2014.

Profit before income tax expense decreased, compared with the same quarter last year primarily due to lower net interest income from the planned run-off of the consumer finance portfolio, and a lower share of profit from associates. This was offset by increased fee incomes from credit and wealth management. The decrease in profit before income tax expense compared with the prior quarter is primarily due to specific loan impairment charges raised against a small number of specific exposures in the Commercial Banking business.

Performance by income and expense item

Net interest income

Net interest income for the fourth quarter of 2014 was $295m, a decrease of $21m, or 7%, compared with the fourth quarter of 2013 and a decrease of $8m, or 3% compared with the third quarter of 2014. Net interest income decreased compared to previous periods primarily due to declining loan balances from the planned run-off of the consumer finance portfolio, lower personal loan volumes and the low interest rate environment.

Management's Discussion and Analysis (continued)

Net fee income

	Quarter ended		
	31 December 2014 $m	31 December 2013 $m	30 September 2014 $m
Credit facilities	**72**	64	68
Funds under management	**42**	32	43
Account services	**19**	20	18
Credit cards	**16**	16	16
Corporate finance	**9**	10	10
Remittances	**8**	8	8
Immigrant Investor Program	**4**	6	3
Brokerage commissions	**4**	3	3
Insurance	**3**	3	3
Trade finance import/export	**1**	3	3
Trustee fees	**1**	1	2
Other	**8**	7	4
Fee income	**187**	173	181
Less: fee expense	**(18)**	(22)	(20)
Net fee income	**169**	151	161

Net fee income for the fourth quarter of 2014 was $169m, an increase of $18m, or 12% compared with the fourth quarter of 2013 and an increase of $8m, or 5% compared with the third quarter of 2014. The increases were primarily due to increased fees from credit products and wealth management fees.

Net trading income

	Quarter ended		
	31 December 2014 $m	31 December 2013 $m	30 September 2014 $m
Trading activities	**27**	26	35
Net interest from trading activities	**11**	10	3
Hedge ineffectiveness	**1**	(2)	(3)
Net trading income	**39**	34	35

Net trading income for the fourth quarter of 2014 was $39m, an increase of $5m, or 15% compared with the fourth quarter of 2013, and an increase of $4m, or 11%, compared with the third quarter of 2014. Trading revenue for the fourth quarter was reduced by $4m resulting from the initial adoption of a fair value adjustment reflecting the funding of uncollateralized derivative exposures. Net trading income increased compared with previous periods, primarily due to hedge ineffectiveness recorded in comparable periods.

Other items of income

	Quarter ended		
	31 December 2014 $m	31 December 2013 $m	30 September 2014 $m
Net expense from financial instruments designated at fair value	**(1)**	(2)	(1)
Gains less losses from financial investments	**3**	6	7
Other operating income	**14**	19	15
Other items of income	**16**	23	21

Net expense from financial instruments designated at fair value for the fourth quarter of 2014 was a loss of $1m, compared with a loss of $2m in the fourth quarter of 2013 and unchanged from the third quarter of 2014.

Gains less losses from financial investments for the fourth quarter of 2014 were $3m, decreases of $3m and $4m respectively, compared with the fourth quarter of 2013 and the third quarter of 2014. Balance Sheet Management recognized lower gains on sales of available-for-sale debt securities as a result of the continued re-balancing of the portfolio for balance sheet management purposes.

Other operating income for the fourth quarter of 2014 was $14m, a decrease of $5m and $1m compared with the fourth quarter of 2013 and the third quarter of 2014 respectively.

Loan impairment charges and other credit risk provisions

	Quarter ended		
	31 December 2014 $m	31 December 2013 $m	30 September 2014 $m
Individually assessed allowances	**43**	31	11
Collectively assessed allowances/(allowance releases)	**(12)**	16	5
Loan impairment charges	**31**	47	16
Other credit risk provisions/(reversal of provisions)	**6**	(8)	1
Loan impairment charges and other credit risk provisions	**37**	39	17

Loan impairment charges and other credit risk provisions for the fourth quarter of 2014 were $37m, a decrease of $2m and an increase of $20m respectively, compared with the fourth quarter of 2013 and the third quarter of 2014. The increase in individually assessed allowances compared with both the same quarter last year and the prior quarter is primarily due to higher specifically assessed allowances raised against a small number of exposures. Loan impairment charges and other credit risk provisions were also impacted by changes in credit metrics relating to on and off balance sheet loans and other credit facilities.

Management's Discussion and Analysis (continued)

Operating expenses

	Quarter ended		
	31 December 2014 $m	31 December 2013 $m	30 September 2014 $m
Employee compensation and benefits	**152**	146	156
General and administrative expenses	**114**	112	105
Depreciation of property, plant and equipment	**8**	9	8
Amortization and impairment of intangible assets	**4**	3	3
Total operating expenses	**278**	270	272

Total operating expenses for the fourth quarter of 2014 were $278m, an increase of $8m, or 3%, and $6m or 2% compared with the fourth quarter of 2013 and the third quarter of 2014 respectively. Increases in risk and compliance staff increased employee compensation and benefits over the fourth quarter of 2013 but decreased over the third quarter of 2014 due to lower performance based incentives. General and administrative expenses for the fourth quarter of 2014 increased over the third quarter for 2014 due to higher expenses for marketing and information technology.

Share of profit in associates

Share of profit in associates for the fourth quarter of 2014 was $2m, a decrease of $15m compared with the fourth quarter of 2013 and an increase of $2m compared to the third quarter of 2014. Share of profit in associates in the fourth quarter of 2014 was lower compared with the same period in 2013 when two underlying investments performed particularly strongly and were realized.

Income tax expense

The effective tax rate in the fourth quarter of 2014 was 39.7%, compared with 21.7% in the fourth quarter of 2013 and 26.8% in the third quarter of 2014. Tax was higher in the fourth quarter of 2014 following resolution and closure of multiple tax issues covering a number of years with Canadian tax authorities.

Summary quarterly performance

Summary consolidated income statement

	2014				2013			
	Quarter ended				Quarter ended			
	Dec 31 $m	**Sep 30 $m**	**Jun 30 $m**	**Mar 31 $m**	Dec 31 $m	Sep 30 $m	Jun 30 $m	Mar 31 $m
Net interest income	**295**	**303**	**307**	**307**	316	319	340	336
Net fee income	**169**	**161**	**160**	**155**	151	152	154	146
Net trading income	**39**	**35**	**33**	**39**	34	42	45	57
Other operating income/(expense)	**16**	**21**	**39**	**31**	23	9	(8)	45
Net operating income before loan impairment charges and other credit risk provisions	**519**	**520**	**539**	**532**	524	522	531	584
Loan impairment charges and other credit risk provisions	**(37)**	**(17)**	**(27)**	**(26)**	(39)	(9)	(84)	(56)
Net operating income	**482**	**503**	**512**	**506**	485	513	447	528
Operating expenses	**(278)**	**(272)**	**(276)**	**(276)**	(270)	(271)	(266)	(263)
Operating profit	**204**	**231**	**236**	**230**	215	242	181	265
Share of profit in associates	**2**	**–**	**6**	**3**	17	9	1	4
Profit before income tax expense	**206**	**231**	**242**	**233**	232	251	182	269
Income tax expense	**(81)**	**(61)**	**(60)**	**(61)**	(50)	(65)	(52)	(80)
Profit for the period	**125**	**170**	**182**	**172**	182	186	130	189
Profit attributable to:								
common shareholder	**118**	**163**	**172**	**160**	164	168	113	171
preferred shareholders	**5**	**4**	**8**	**9**	16	15	15	15
non-controlling interests	**2**	**3**	**2**	**3**	2	3	2	3
Basic earnings per common share ($)	**0.24**	**0.32**	**0.35**	**0.32**	0.33	0.34	0.23	0.34

Management's Discussion and Analysis (continued)

Comments on trends over the past eight quarters
Seasonal factors did not have a significant impact on our results.

Net interest income declined from 2013 primarily as a result of the planned run-off of the consumer finance portfolio. Lower interest margins in a low interest rate environment also contributed to the decrease. This decline has been partially offset by growth in deposit volumes which reduced our cost of funding.

Net fee income trended upwards from 2013 due to higher funds under management fees, resulting from increased sales as well as improved markets and credit product fees.

Net trading income trended upwards through 2013 and downwards through 2014 in line with market volatility.

The gradual increase in operating expenses over the period resulted from investments related to HSBC's Global Standards and other risk and compliance activities.

Economic outlook for 2015

All about oil
In 2015 the Canadian economy is expected to expand at just 1.7%. This is down from a forecast of 2.1% that HSBC Bank Canada produced in December 2014. The key factor in the currently more cautious outlook is the decline in oil prices. In December, we assumed that the Brent crude oil price would be US$79 per barrel in 2015 and 2016. The most recent forecast assumes that Brent crude will average US$55 per barrel. However, the growth forecast reflects not just the drop in the spot price of oil, but also the potential for oil prices to stay lower for longer given the decline in the oil price forward curve.

Overall, we feel that the negative "terms of trade" effect from the decline in oil prices will be negative for the Canadian economy. The terms of trade refer to the price Canada receives for exports relative to the price it paid for imports. The decline in oil prices will lead to a decline in the price received for a key export relative to what is paid for imports. Hence, a decline in the terms of trade is sometimes considered a national wage cut. There is scarcely a part of the economy that won't feel the sting of lower oil prices. In particular, HSBC Bank Canada anticipates business investment falling in 2015 as energy firms delay capital expenditures and implement cost saving measures to reflect a more cautious outlook.

The impact of the decline in oil prices can be traced through the Canadian economy by considering that oil makes up over 50% of the Bank of Canada's commodity price index. Commodity prices, in turn, are closely linked to the terms of trade and the value of the Canadian dollar. Since late June 2014, the Bank of Canada's total commodity price index has declined by almost 39% through mid-January, and the Canadian dollar has dropped from almost US$0.95 to below US$0.80. We also anticipate the value of oil exports declining sharply. Based on declines in oil prices through January 2015, the value of oil exports is expected to tumble from $8.5bn in June 2014 to $5.5bn in January 2015, or a decline of 64%. This matters because energy is our largest export accounting for almost 20% of total exports.

Commodity prices also have a strong link with corporate profits and business investment in Canada. Based on our forecasts for oil and commodity prices, corporate profits are expected to drop by 30% year-over-year in 2015, particularly in oil-sensitive sectors. The decline in corporate profit reinforces a cautious backdrop for firms that will slow down investment. This matters because energy makes up almost 40% of business investment. Overall, it will not be easy to fill the gaps in exports and business investment.

While the drop in oil prices is considered negative for the Canadian economy, it is considered a positive for the US economy. We now forecast that the US economy will grow by 3.0% in 2015, up from 2.8% in December. We also expect the US to outpace in 2016 when we expect the Canadian economy to expand by 2.2% compared to 2.8% in the US. Hence, Canada is no longer expected to keep pace with US economic growth in the next few years.

A key reason for the divergent responses to the oil price decline is that Canada is an oil exporter, while the US is an oil importer. In both countries, the decline in oil prices has led to sharply lower gasoline prices that will provide a potential boost to consumers. However, in Canada, the benefit to consumers will fall far short of offsetting the fallout of lower oil prices on the economy.

Job market performances reinforce the diverging fortunes of the US and Canadian economies. In Canada, job creation was quick coming out of the recession, and has since slowed. In the US, job creation was quite slow until recently. Since the end of 2012, employment in Canada is up by 1.4%, compared to an increase of 2.9% in the US. The differences are starker if you look at full-time job creation, which accounts for over 80% of employment in both countries. In Canada, full-time employment since the end of 2012 has matched the expansion of total employment, whereas in the US full-time employment has grown by a solid 3.6%. Note as well that these job creation trends were in place even before the oil price shock. The headwinds facing firms as corporate profits decline and business investment slows have only intensified and we look for job creation of around 0.5% in Canada in the year ahead. Heading into 2015, US consumers are better positioned to carry a larger burden of GDP growth than are Canadian consumers.

Nonetheless, the quicker pace of growth in the US is seen as a crucial element in providing support to the Canadian economy. With domestic sources of growth not seen as capable of filling the gap left as the oil patch retrenches, non-energy, commodity-sensitive exports, particularly to the US are seen as a key source of growth.

With regard to monetary policy, we expect the Bank of Canada to cut rates by a further 50 basis points thus lowering its policy rate back to the effective lower bound of 0.25% by mid-year. The effective lower bound is what the Bank of Canada considers the floor for its policy rate so that financial markets can still operate effectively. Based on our outlook, administered rates would drop by a cumulative 75 basis points and unwind all of the tightening moves from 2010. Lowering rates would be consistent with actions of other central banks, particularly the Reserve Bank of Australia, which unwound all post financial crisis rate cuts in order to accommodate a slowdown in mining investment in response to lower iron ore prices. The Bank of Canada rate cuts would also highlight the downside risks to inflation and business sentiment. We look for the annual rate of consumer price inflation to flirt with zero, or deflation, in the first half of 2015, and already firms are building in expectations that inflation will remain below 2% over the next two years. With economic slack expected to increase in 2015, we think that there is a risk that inflation expectations becoming entrenched at too low a level (below 1%), could raise questions about the credibility of the Bank of Canada's 1% to 3% inflation targeting regime.

With the Bank of Canada to cut rates further, but with the US Federal Reserve still expected to tighten policy in 2015, the Canadian dollar is expected to weaken further. We look for the Canadian dollar to decline to just below US$0.75 by the end of 2015. While currency weakness might provide some support to non-energy, currency-sensitive exports, it is not, in our view, a solution to the competitiveness challenges that linger and that will potentially limit the pace of growth.

Though the price of oil will be very much in focus in the year ahead, Canada is also on federal election watch. While the next election is scheduled for October, it might well happen sooner. There is thus a great deal of focus on the upcoming federal budget that has been delayed until April. With little room to lower rates, timely fiscal policy could help ease the negative impact of the decline in oil prices on the economy. However, given that the federal government had been almost singularly focused on returning to surplus before the 2015 election, it is unclear if they are prepared to run deficits in the wake of the oil price shock. That said, there is room for some stimulus measures. With a debt-to-GDP ratio poised to drop to 25% later this decade, there is little risk to Canada's sovereign credit rating to some stimulus to offset the oil shock.

Critical accounting policies

Our results are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of our consolidated financial statements.

In view of the inherent uncertainties and the high level of subjectivity involved in the recognition or measurement of items discussed below, it is possible that the outcomes in the next financial year could differ from those on which management's estimates are based, resulting in materially different conclusions from those reached by management for the purposes of the 2014 consolidated financial statements. Management's selection of the bank's accounting policies discussed below reflects the materiality of the items to which the policies are applied, the high degree of judgment involved and estimation uncertainty:

Impairment of loans and advances

The bank's accounting policy for losses arising from the impairment of customer loans and advances is described in note1(i). Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at the balance sheet date.

Management's Discussion and Analysis (continued)

Management is required to exercise judgment in making assumptions and estimates when calculating loan impairment allowances on both individually and collectively assessed loans and advances.

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

The estimation methods use statistical analyses of historical information, supplemented with significant management judgment, to assess whether current economic and credit conditions are such that the actual level of incurred losses is likely to be greater or less than historical experience.

Where changes in economic, regulatory or behavioural conditions result in the most recent trends in portfolio risk factors being not fully reflected in the statistical models, risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

Risk factors include loan portfolio growth, product mix, unemployment rates, bankruptcy trends, geographical concentrations, loan product features, economic conditions such as national and local trends in housing markets, interest rates, account management policies and practices, changes in laws and regulations, and other influences on customer payment patterns.

The methodology and the assumptions used in calculating impairment losses are reviewed regularly in the light of differences between loss estimates and actual loss experience.

For individually assessed loans, judgment is required in determining whether there is objective evidence that a loss event has occurred, and if so, the measurement of the impairment allowance. Judgment is exercised in evaluating all relevant information on indicators of impairment, including whether payments are contractually past-due and other factors indicating deterioration in the financial condition and outlook of borrowers affecting their ability to pay. A higher level of judgment is required for loans to borrowers showing signs of financial difficulty in market sectors experiencing economic stress, particularly where the likelihood of repayment is affected by the prospects for refinancing or the sale of a specified asset. For those loans where objective evidence of impairment exists, management determine the size of the allowance required based on a range of factors such as the realisable value of security, the likely dividend available on liquidation or bankruptcy, the viability of the customer's business model and the capacity to trade successfully out of financial difficulties and generate sufficient cash flow to service debt obligations.

The bank might agree to modify the contractual payment terms of loans for borrowers experiencing financial difficulties in order to improve the management of customer relationships, maximize collection opportunities or avoid default or repossession. Where forbearance activities are significant, higher levels of judgment and estimation uncertainty are involved in determining their effects on loan impairment allowances.

Judgments are involved in differentiating the credit risk characteristics of forbearance cases, including those which return to performing status following renegotiation. Where collectively assessed loan portfolios include significant levels of loan forbearance, portfolios are segmented to reflect their specific credit risk characteristics, and estimates are made of the incurred losses inherent within each forbearance portfolio segments.

The exercise of judgment requires the use of assumptions which are highly subjective and very sensitive to the risk factors. Many of the factors have a high degree of interdependency and there is no single factor to which our loan impairment allowances as a whole are sensitive.

Valuation of financial instruments

The bank's accounting policy for determining the fair value of financial instruments is described in note 24. The best evidence of fair value is a quoted price in an actively traded principal market. In the event that the market for a financial instrument is not active, and the valuation technique uses only observable market data, the reliability of the fair value measurement is high. However, when valuation techniques include one or more significant unobservable inputs, they rely to a greater extent on management judgment and fair value derivative to become reliable.

In absence of observable valuation inputs, due to lack of or a reduced volume of similar transactions, management judgment is required to assess the price at which an arm's length transaction would occur under normal business conditions, in which case management may rely on historical prices for that particular financial instrument or on recent prices for similar instruments.

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

- the likelihood and expected timing of future cash flows on the instrument; and judgment may be required to assess the counterparty's ability to service the instrument in accordance with its contractual terms. Future cash flows may be sensitive to changes in market rates;
- selecting an appropriate discount rate for the instrument judgment is required to assess what a market participant would regard as the appropriate spread of the rate for an instrument over the appropriate risk-free rate; and
- judgment to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products.

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

As a result of changing practices in response to regulatory and accounting changes, as well as general market developments, the bank has previously adopted a number of methodologies for applying certain adjustments relating to the valuation of derivative instruments. Previously, this has included credit and debit valuation adjustments relating to counter-party and own credit risk in the measurement of the fair values of derivatives. Historically, the bank has valued uncollateralized derivatives by discounting expected future cash flows at a benchmark interest rate, typically Canadian Dealer Offered Rate or its equivalent. In line with evolving industry practice, HSBC changed this approach in the fourth quarter of 2014. HSBC now views the Overnight Indexed Swap ('OIS') curve as the base discounting curve for all derivatives, both collateralized and uncollateralized, and has adopted a fair value adjustment to reflect the funding of uncollateralized derivative exposure at rates other than OIS. As at 31 December 2014, this amount was $4m and the impact of initially adopting this fair value adjustment was a reduction in trading revenues in the fourth quarter of 2014 of the same amount. This is an area in which a full industry consensus has not yet emerged. HSBC will continue to monitor industry evolution and refine the calculation methodology as necessary.

Given the uncertainty and subjective nature of valuing financial instruments at fair value, it is possible that the outcomes in the next financial year could differ from the assumptions used, and this could result in a material adjustment to the carrying amount of financial instruments measured at fair value.

Deferred tax assets

The bank's accounting policy for the recognition of deferred tax assets is described in note 6. The recognition of a deferred tax asset relies on an assessment of the probability and sufficiency of future taxable profits, future reversals of existing taxable temporary differences and ongoing tax planning strategies.

Defined benefit obligations

The bank's accounting policy for the recognition of defined benefit obligations is described in note 4. As part of employee compensation, the bank provides certain employees with pension and other post-retirement benefits under defined benefit plans. In consultation with its actuaries, the bank make certain assumptions in measuring its obligations under its defined benefit plans as presented in note 4.

Changes in accounting policy during 2014

On 1 January 2014, the bank adopted 'Offsetting Financial Assets and Financial Liabilities' (Amendments to IAS 32) which clarify the requirements for offsetting financial instruments and addressed inconsistencies in current practice when applying the offsetting criteria in IAS 32. Financial Instruments: Presentation The amendment did not have a material effect on the bank's financial statements and as a result comparative information was not restated.

Management's Discussion and Analysis (continued)

Future accounting developments

The International Accounting Standards Board ('IASB') is working on project lease accounting which could together with the standards on revenue and financial instrument accounting issued in 2014 discussed below represent significant changes to accounting requirements in the future.

Revenue

In May 2014, the IASB issued IFRS 15 'Revenue from Contracts with Customers'. The standard is effective for annual periods beginning on or after 1 January 2017 with early adoption permitted. IFRS 15 provides a principles-based approach for revenue recognition, and introduces the concept of recognizing revenue for obligations as they are satisfied. The standard should be applied retrospectively, with certain practical expedients available. The bank is currently assessing the impact of this standard but it is not practicable to quantify the effect as at the date of the publication of these financial statements.

Financial instruments

In July 2014, the IASB issued IFRS 9 'Financial Instruments', which is the comprehensive standard to replace IAS 39 'Financial Instruments: Recognition and Measurement', and includes requirements for classification and measurement of financial assets and liabilities, impairment of financial assets and hedge accounting.

Classification and measurement

The classification and measurement of financial assets will depend on the entity's business model for their management and their contractual cash flow characteristics and result in financial assets being at amortized cost, fair value through other comprehensive income ('OCI'), or fair value through profit or loss. In many instances, the classification and measurement outcomes will be similar to IAS 39, although differences will arise, for example, equity securities will be measured at fair value through profit or loss or, in limited circumstances, at fair value through OCI. The combined effect of the application of the business model and the contractual cash flow characteristics tests may result in some differences in population of financial assets measured at amortized cost or fair value compared with IAS 39.

The classification of financial liabilities is essentially unchanged, except that, for certain liabilities measured at fair value, gains or losses relating to changes in the entity's own credit risk are to be included in OCI.

Impairment

The impairment requirements apply to financial assets measured at amortized cost, and fair value through OCI, lease receivables, certain loan commitments, and financial guarantee contracts. At initial recognition, allowance (or provision in the case of commitments and guarantees) is required for expected credit losses ('ECL') resulting from default events that are possible within the next 12 months ('12 month ECL'). In the event of a significant increase in credit risk, allowance (or provision) is required for ECL resulting from all possible default events over the expected life of the financial instrument ('lifetime ECL').

The assessment of whether credit risk has increased significantly since initial recognition is performed for each reporting period by considering the probability of default occurring over the remaining life of the financial instrument, rather than by considering an increase in ECL.

The assessment of credit risk, as well as the estimation of ECL, are required to be unbiased, probability-weighted and should incorporate all available information which is relevant to the assessment, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date. In addition, the estimation of ECL should take into account the time value of money. As a result, the recognition and measurement of impairment is intended to be more forward-looking than under IAS 39 and the resulting impairment charge will tend to be more volatile. It will also tend to result in an increase in the total level of impairment allowances, since all financial assets will be assessed for at least 12-month ECL and the population of financial assets to which lifetime ECL applies is likely to be larger than the population for which there is objective evidence of impairment in accordance with IAS 39.

Hedge Accounting

The general hedge accounting requirements aim to simplify hedge accounting, creating a stronger link between it and risk management strategy and permitting the former to be applied to a greater variety of hedging instruments and risks. The standard does not explicitly address macro hedge accounting strategies, which are being considered in a separate project. To remove the risk of any conflict between existing macro hedge accounting practice and the new general hedge accounting requirements, IFRS 9 includes an accounting policy choice to remain with IAS 39 hedge accounting.

The classification and measurement and impairment requirements are applied retrospectively by adjusting the opening balance sheet at the date of initial application, with no requirement generally to restate comparative periods. Hedge accounting is applied prospectively from that date.

The mandatory application date for the standard as a whole is 1 January 2018, but it is possible to apply the revised presentation for certain liabilities measured at fair value from an earlier date. The bank plans to early adopt the presentation of fair value gains and losses relating to an entity's own credit risk on certain liabilities, at the same time as the HSBC Group, whose early adoption is subject to endorsement by the European Union. In addition, early adoption of the presentation is subject to regulatory consent. If this presentation was applied at 31 December 2014, the effect would be to increase profit before tax by $2m and reduce other comprehensive income by the same amount with no effect on net assets. Further information on change in fair value attributable to changes in credit risk, including the bank's credit risk, is disclosed in note 21.

The bank is currently assessing the impact that the rest of IFRS 9 will have on the financial statements through an HSBC Group-wide project which has been in place since 2012, but due to the complexity of the classification and measurement, impairment, and hedge accounting requirements and their inter-relationships, it is not possible at this stage to quantify the potential effect.

Off-balance sheet arrangements

As part of our banking operations, we enter into a number of off-balance sheet financial transactions that have a financial impact, but may not be recognized in our financial statements. These types of arrangements are contingent and may not necessarily, but in certain circumstances could, involve us incurring a liability in excess of amounts recorded in our consolidated balance sheet. These arrangements include: guarantees, letters of credit, and derivatives.

Guarantees and letters of credit

We routinely issue financial and performance guarantees and documentary and commercial letters of credit on behalf of our customers to meet their banking needs. Guarantees are often provided on behalf of customers' contractual obligations, particularly providing credit facilities for customers' overseas trading transactions and in construction financings. Letters of credit are often used as part of the payment and documentation process in international trade arrangements.

Although guarantees and letters of credit are financial instruments, they are considered contingent obligations and the notional amounts are not included in our financial statements, as there are no actual advances of funds. Any payments actually made under these obligations are recorded as loans and advances to our customers. In accordance with accounting standards for financial instruments, we record the fair value of guarantees made on behalf of customers.

For credit risk management purposes, we consider guarantees and letters of credit to be part of our customers' credit facilities, which are subject to appropriate risk management procedures. Guarantees and letters of credit are considered to be part of our overall credit exposure, as set out in the analysis of our loan portfolio on page 34 of the MD&A.

Derivatives

As part of our overall risk management strategy, we enter into a variety of derivatives to manage or reduce our risks in certain areas. Derivatives are also offered as part of our product suite to meet the needs of our customers.

Forward foreign exchange transactions are transactions where we agree to exchange foreign currencies with our counterparties at a fixed rate on a future date. Interest rate swaps are agreements to exchange cash flows of differing interest rate characteristics. Other derivatives include equity, energy, commodity and other foreign exchange and interest rate based transactions.

We use derivatives to limit our exposure to interest rate risk on loans and deposits with differing maturity dates, or foreign currency assets and liabilities of differing amounts. Mismatches in currency or maturity dates could expose us to significant financial risks if there are adverse changes in interest rates or foreign exchange rates. The use of derivatives is subject to strict monitoring and internal control procedures as set out in our risk management section of the MD&A.

Our accounting policies on recording the impact of derivatives and quantitative information on our derivative instruments are set out in note 11.

Management's Discussion and Analysis (continued)

Disclosure controls and procedures and internal control over financial reporting

Disclosure controls and procedures are designed to provide reasonable assurance that all relevant information required to be disclosed in reports filed or submitted under Canadian securities laws is recorded, processed, summarized and reported within the time periods specified under those laws. These include controls and procedures that are designed to ensure that information is accumulated and communicated to management, including the Chief Executive Officer ('CEO') and the Chief Financial Officer ('CFO'), to allow timely decisions regarding required disclosure.

Internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and preparation of the consolidated financial statements in accordance with IFRS. Management is responsible for establishing and maintaining adequate internal control over financial reporting. These controls include those policies and procedures that:

– pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the bank;

– provide reasonable assurance that transactions are recorded as necessary to permit preparation of the consolidated financial statements in accordance with IFRS;

– that receipts and expenditures of the bank are being made only in accordance with authorizations of management; and

– provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the bank's assets that could have a material effect on the consolidated financial statements.

Because of the inherent limitations, internal control over financial reporting may not prevent or detect misstatements on a timely basis. Furthermore, projections of any evaluation of the effectiveness of internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

During 2014, management has evaluated, under the supervision of and with the participation of the CEO and the CFO, the effectiveness of our disclosure controls and procedures and the design and effectiveness of the internal control over financial reporting as required by the Canadian securities regulatory authorities under National Instrument 52-109. The evaluation of internal control over financial reporting was performed using the framework and criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ('COSO') in 1992. Based on these evaluations, management has concluded that that the design and operation of these disclosure controls and procedures and internal control over financial reporting was effective as at 31 December 2014.

In May 2013, COSO issued the 2013 'Internal Control – Integrated Framework' (Framework). The 2013 Framework superseded the original 1992 Framework on 15 December 2014. The bank is in the process of finalizing its migration to the 2013 Framework, which it plans to use with respect to the evaluation of its internal control over financial reporting for the year ended 31 December 2015.

Changes in internal control over financial reporting

There were no changes in our internal control over financial reporting during the year ended 31 December 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Related party transactions

We enter into transactions with other HSBC affiliates as part of the normal course of business, such as banking and operational services. In particular, as a member of one of the world's largest financial services organizations, we share in the expertise and economies of scale provided by the HSBC Group. We provide and receive services or enter into transactions with a number of HSBC Group companies, including sharing in the cost of development for technology platforms used around the world and benefit from worldwide contracts for advertising, marketing research, training and other operational areas. These related party transactions are on terms similar to those offered to non-related parties and are subject to formal approval procedures that have been approved by the bank's Conduct Review Committee. Further details can be found in note 31.

All our common shares are indirectly held by HSBC Holdings as a wholly-owned subsidiary.

Risk management

(Certain information within this section, where indicated, forms an integral part of the audited consolidated financial statements)

Risk Overview

Our risk management framework, employed at all levels of the organization, ensures our risk profile remains conservative and aligned to our risk appetite and strategy. Our risk profile is underpinned by our core philosophy of maintaining a strong balance sheet and liquidity position, and capital strength.

Risk and our strategic priorities

HSBC's three strategic priorities are reflected in our management of risk.

Grow the business and dividends – we ensure risk is maintained at an acceptable and appropriate level while creating value and generating profits.

Implement Global Standards – we are transforming how we detect, deter and protect against financial crime through deployment of Global Standards, which govern how we do business and with whom.

Streamline processes and procedures – By focusing on streamlining our processes and procedures, we will make HSBC less complex to operate, creating capacity for growth.

How we manage risk

All of our business activities involve the measurement, evaluation, acceptance and management of risk with the primary goal being to achieve the appropriate balance between the risk assumed and the reward. Our risk culture plays an important role in delivering our strategic objectives. It is reinforced by our HSBC Values and our Global Standards, and forms the basis on which the Board, the Audit and Risk Committee ('ARC'), a sub-committee of the Board, and the Risk Management Committee ('RMC') establish our risk appetite and the risk management framework. These are instrumental in aligning the behaviour of individuals with our attitude to assuming and managing risk.

We manage risk actively, employing five main elements that underpin our risk culture.

Running risk like a business

Running risk like a business means ensuring that the Risk function is dynamic and responsive to the needs of its stakeholders. This is aided by:

– ensuring systems are compatible so a complete picture of our risks is obtained;

– streamlining data production and re-engineering processes to create time to spend on risk management; and

– understanding the details behind our risks and costs.

Organization and structure

Robust risk governance and accountability are embedded throughout the bank, fostering a continuous monitoring of the risk environment and an integrated evaluation of risks and their interactions.

Our risk governance framework ensures accountability for the effective management of risk by the bank. The framework is integrated with the HSBC Group risk governance framework adding additional layers of oversight.

Risk governance is positioned at the uppermost level of the bank. The Board, assisted by the ARC, is responsible for overseeing a strong risk culture that is conservative yet competitive. On advice of the RMC and the ARC, the Board provides the risk discipline and structure necessary to achieve business objectives aligned with risk strategy. Regular and timely communication between the Board and executive management ensures that key risks are identified and key information is shared.

Three lines of defense

The risk governance framework is based on a risk management and internal control structure referred to as the 'three lines of defence' to ensure we achieve our commercial aims while meeting regulatory and legal requirements. It is a key part of our operational risk management framework. Refer to operational risk within this section for further information.

People

All staff play a role in the management of risk. They are required to identify, assess and manage risk within the scope of their assigned responsibilities, and as such they form part of the three lines of defence. Our Global Standards set the tone and are central to our approach to balancing risk and reward. Personal accountability is reinforced by HSBC's Values.

A suite of mandatory training on a range of critical risk and compliance topics helps to embed and strengthen the risk culture within HSBC. This training, which is updated regularly, ensures a clear and consistent message

Management's Discussion and Analysis (continued)

is communicated to staff. It covers technical aspects of the various risks assumed in the course of business and how these risks should be managed effectively, and serves to reinforce our attitude to risk and the behaviours expected of staff as described in our Global Standards and risk policies. Staff is supported by a disclosure line which enables them to raise concerns confidentially.

Our risk culture is reinforced by our approach to remuneration. Individual awards are based on compliance with HSBC Values and the achievement of financial and non-financial objectives which are aligned to our strategy.

Risk management processes and procedures

Risk management within the bank is driven by the following four processes:

– risk identification;

– risk appetite;

– mapping our risk profile; and

– stress testing.

Risk identification

We identify and monitor risks continuously. This process and the results of our stress testing program, give rise to the classification of certain key risks as top or emerging. Changes in our assessment of top and emerging risks may result in adjustments to our risk appetite and, potentially, our business strategy.

Primary risk categories monitored include credit, liquidity and funding, market, operational, and reputational risk. Operational risk encompasses a wide range of risks including compliance, legal, security and fraud, people and systems risk.

Risk appetite

The Risk Appetite Statement describes the types and levels of risk that we are prepared to accept in executing our strategy. The Statement is approved by the ARC on the advice of the RMC. It is a key component of our risk management framework and informs our annual operating plan.

Global lines of business are required to align their risk appetite statements with the bank's overall risk appetite statement.

Quantitative and qualitative metrics are assigned to key categories. Measurement against the metrics:

– guides underlying business activity, ensuring it is aligned to risk appetite statements;

– informs risk-adjusted remuneration;

– enables the key underlying assumptions to be monitored and, where necessary, adjusted through subsequent business planning cycles; and

– promptly identifies business decisions needed to mitigate risk.

Mapping our risk profile

Risks are assumed by our global lines of business in accordance with their risk appetite and are managed at both the bank and the global line of business level. All risks are recorded and monitored through our risk mapping process, which describes our risk profile by category.

Stress testing

Our stress testing and scenario analysis program is central to our risk management.

We conduct stress-testing scenarios which reflect our business strategy and resultant risk exposures. The results of the stress tests are used to assess the potential demand for regulatory capital under the various scenarios including but not limited to adverse macro-economic events, catastrophic events and a variety of projected operational risk events. We also participate, where appropriate, in scenario analyses requested by regulatory bodies.

The results of scenarios subject to stress testing in 2014 demonstrated that the bank would remain satisfactorily capitalized after taking account of assumed management actions.

Top and emerging risks

Senior management continuously monitors top and emerging risks that may affect the bank's operations and in particular financial results. A regular top and emerging risk report is presented to the RMC for discussion monthly and quarterly is presented to the ARC. Of particular concern during 2014 and looking forward are risks associated with cyber security, evolving regulatory requirements and geopolitical and macroeconomic environments.

Geopolitical risk has been heightened due to political instability and civil unrest in many parts of the world, including the Middle East and the Ukraine. This has wider implications for regional and global economies. Macro-economic risk has been of concern for some time given uncertainty regarding the global recovery and slower growth in emerging markets, as well as the decline in oil prices and the accompanying deflationary pressures in the second half of 2014.

The potential impact of the decline in oil and commodity prices attributed to global demand-supply imbalances has been an area of particular focus. The considerable fall in energy prices over relatively a short span of time changes both the nature and the distribution of risks. It sharpens fiscal and financing challenges for energy producers, and although it brings benefits for oil importers and consumers, it also accentuates deflationary risks among some of these, particularly in the Eurozone.

Cyber security is a key risk for the bank given significant adverse events in the marketplace, enhanced focus by regulators, and the potential for significant operational, financial and reputational impacts. Leveraging HSBC Group, the bank has robust cyber intelligence and defences, as well as business continuity plans. We ran a stress scenario to simulate the impacts of a cyber breach, looking at the potential impacts to services and remediation.

Credit risk

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under contract. It arises principally from direct lending, trade finance and the leasing business, but also from other products such as guarantees and credit derivatives and from holding assets in the form of debt securities.

Credit risk management

The bank's principal objectives of credit risk management are:

– to maintain a strong culture of responsible lending, supported by a robust risk policy and control framework;

– to both partner with and challenge businesses in defining and implementing and continually re-evaluating our risk appetite under actual and scenario conditions; and

– to ensure there is independent, expert scrutiny of credit risks, their costs and their mitigation.

Credit risk is managed in accordance with the bank's credit policy, which is established in consultation with HSBC Group and approved by the ARC. Risk limits and credit authorities are delegated to senior credit management staff. Credit exposures in excess of certain levels or other specific risk attributes are referred for concurrence to HSBC Group to ensure they remain within HSBC Group's global risk limits.

Credit risk rating framework

Under the Basel framework, two principal approaches are available for measuring credit risk: advanced internal ratings based ('AIRB') and Standardized. Most of the bank's credit risk exposure is measured using the AIRB approach.

Under the AIRB approach, the bank's credit risk rating framework incorporates the Probability of Default ('PD') of an obligor and loss severity expressed in terms of exposure at default ('EAD') and loss given default ('LGD'). These measures are used to calculate expected loss and minimum capital requirements. They are also used in conjunction with other inputs to inform rating assessments and other risk management decisions such as:

– Credit approval and monitoring: internal IRB models are used in the assessment of customer and portfolio risk in lending decisions;

– Risk appetite: IRB measures are an important element in identifying risk exposure at customer, sector, and portfolio level;

– Pricing: IRB parameters are used in wholesale pricing tools for new transactions and reviews; and

– Economic capital and portfolio management: IRB parameters are used in the economic capital model that has been implemented across HSBC.

For wholesale customer segments (central governments and central banks, financial institutions and corporate customers, and for certain individually assessed personal customers), obligor PD is estimated using a 23-grade Customer Risk Rating ('CRR') scale, of which 21 are non-default ratings representing varying degrees of strength of financial condition, and two are default ratings. The score generated by a credit risk rating model for the obligor is mapped to a corresponding PD and master-scale CRR. The CRR is then reviewed by a credit approver who, taking into account all relevant information, such as most recent events and market data, where available, makes the final decision on the rating. The rating assigned therefore reflects the approver's overall view of the obligor's credit standing and propensity to default.

EAD is estimated to a 12-month forward time horizon and represents the current exposure plus an estimate for future increases in exposure taking into account such factors as available but undrawn facilities, and the realization of contingent exposures post-default.

Management's Discussion and Analysis (continued)

LGD is based on the effects of facility and collateral structure on outcomes post-default. This includes such factors as the type of client, the facility seniority, the type and value of collateral, past recovery experience and priority under law. It is expressed as a percentage of EAD. For all retail business, excluding credit cards and the run-off consumer finance portfolio exposures are segmented into homogeneous pools of accounts with similar risk characteristics. PD, LGD and EAD parameters are estimated for each pool based on observed historical loss data. The segmentation of exposures into different pools is carried out every month based on the characteristics associated with the exposures at the time of monthly review while the risk measures applied to the exposures are based on the measures associated with the pools that have been derived using data over an entire economic cycle.

For credit cards and the run-off consumer finance portfolio, the simplified Standardized approach is applied within the Basel framework to calculate the risk weighting of credit exposures.

Credit portfolio management

The bank places the highest importance on the integrity and quality of its credit portfolio and has stringent policies to avoid undue concentration of risk. Our RMC and ARC meet regularly to review portfolio credit quality, geographic, product and industry distributions, large customer concentrations, adequacy of loan impairment allowances and rating system performance. Policies relating to large customer limits and industry, product and geographic concentration are approved by the ARC, in line with HSBC Group policy.

All new and renewed major authorized facilities, derivative exposures, 'watch-list' exposures and impaired facilities are also reported quarterly to the ARC. The appetite for credit risk is expressed through portfolio level limits on specific segments, e.g. commercial real estate and energy, as well as through Commercial and Personal Lending Guidelines that conform with HSBC Group guidelines. These are disseminated throughout our business along with various credit manuals. The ARC is advised of any material changes in guidelines through the quarterly monitoring process.

We have a disciplined approach to managing credit risk through ongoing monitoring of all credit exposures at branches, with weaker quality credits being reviewed at more frequent intervals. Problem and impaired loans are identified at an early stage and are actively managed by a separate dedicated Special Credit Management unit which possesses the relevant expertise and experience.

Exposure to banks and financial institutions involves consultation with a dedicated unit within the HSBC Group that controls and manages these exposures on a global basis. Similarly, cross border risk is also controlled globally by this unit through the imposition of country limits.

A review of all credit matters undertaken by our branch and head office credit managers is completed regularly to ensure all our policies, guidelines, practices, conditions and terms are followed.

We manage real estate lending within well-defined parameters, with an emphasis on relationship and project sponsorship for all new transactions. We are actively managing the exposure level and composition of this portfolio given its concentration in our credit portfolio.

Where we are dependent upon third parties for establishing asset values, consistent and transparent valuations are ensured through maintaining a list of approved professionals that meet our standards.

Top and emerging risks

Due to the volatility and uncertainty regarding the price of oil, we conducted stress tests to assess the impacts to our Energy portfolio. The results showed the bank is expected to have sufficient capital to absorb any potential increase in loan impairment charges and risk weighted assets due to sustained low prices of oil.

The portfolio and our clients are being closely monitored and managed. In view of the current geopolitical and macroeconomic instability direct and indirect exposures are continuously monitored by country. We have limited or no exposure to the Eurozone peripheral countries (Greece, Italy, Ireland, Portugal & Spain) and Russia.

Maximum exposure to credit risk

The following table presents the maximum exposure to credit risk of on-balance sheet and off-balance sheet financial instruments, before taking into account any collateral held or other credit enhancements. For on-balance sheet financial assets, the exposure to credit risk equals their carrying amount. For financial guarantees, the maximum exposure to credit risk is the maximum amount that we would have to pay if the guarantees were called upon. For loan commitments and other credit-related commitments that are not unconditionally cancellable, the maximum exposure to credit risk is the full amount of the committed facilities.

Maximum exposure to credit risk (Audited)

	2014 $m	2013 $m
On-balance sheet		
Balances at central bank	**3**	100
Items in the course of collection from other banks	**76**	107
Trading assets	**8,914**	6,728
Treasury and other eligible bills	**674**	467
Debt securities	**2,778**	2,528
Customer trading assets	**2,208**	885
Bankers acceptances	**3,254**	2,848
Derivatives	**4,082**	2,112
Reverse Repurchase agreements – non-trading	**6,714**	6,161
Loans and advances held at amortized cost	**42,483**	41,673
Loans and advances to banks	**1,264**	1,149
Loans and advances to customers	**41,219**	40,524
Financial investments – available-for-sale	**20,114**	21,805
Treasury and other similar bills	**422**	799
Debt securities	**19,694**	21,010
Equity securities	**4**	5
Less: Securities not exposed to credit risk	**(6)**	(9)
Other assets		
Customers' liability under acceptances	**5,023**	4,757
Accrued income and other	**261**	284
Total on-balance sheet	**87,670**	83,727
Off-balance sheet		
Financial guarantees	**5,230**	3,940
Loan and other credit-related commitments	**37,811**	35,128
Total maximum exposure to credit risk	**130,711**	122,795

Loan portfolio diversity

Concentration of credit risk may arise when the ability of a number of borrowers or counterparties to meet their contractual obligations are similarly affected by external factors. Diversification of credit risk is a key concept by which we are guided.

In assessing and monitoring for credit risk concentration, we aggregate exposures by product type, industry and geographic area as presented in the tables below. Exposures are measured at EAD, which reflects drawn balances as well as a factor for undrawn amounts of commitments and contingent exposures, and therefore would not agree to the financial statements.

Wholesale loan portfolio by geographic area (Audited)

	EAD **2014** **$m**	*EAD* 2013 $m
Sovereign		
Canada	**17,984**	19,929
United States of America	**1,240**	851
Other	**2,123**	2,211
	21,347	22,991
Banks		
Canada	**2,775**	2,509
United States of America	**1,675**	1,440
Other	**1,830**	2,220
	6,280	6,169
Corporate		
Canada		
British Columbia	**11,261**	11,551
Ontario	**11,264**	11,800
Alberta	**12,000**	10,565
Quebec	**6,025**	5,693
Saskatchewan and Manitoba	**1,718**	1,047
Atlantic provinces	**1,068**	716
United States of America	**1,214**	812
Other	**436**	269
	44,986	42,453
Total wholesale loan portfolio exposure	**72,613**	71,613

Wholesale loan portfolio by industry sector (Audited)

	EAD **2014** **$m**	*EAD* 2013 $m
Sovereign	**21,347**	22,991
Banks	**6,280**	6,169
Corporate		
Real estate	**8,050**	7,718
Energy	**8,648**	7,362
Manufacturing	**5,698**	4,845
Finance and insurance	**2,509**	3,943
Wholesale trade	**4,244**	3,679
Services	**2,856**	2,728
Transport and storage	**2,268**	2,114
Business services	**2,540**	2,073
Mining, logging and forestry	**1,771**	1,911
Construction services	**1,803**	1,705
Automotive	**1,271**	1,251
Retail trade	**1,492**	1,149
Hotels and accommodation	**691**	805
Agriculture	**720**	769
Sole proprietors	**423**	378
Government services	**2**	23
	44,986	42,453
Total wholesale loan portfolio exposure	**72,613**	71,613

Loan portfolio by product type (Audited)

	EAD **2014** **$m**	*EAD* 2013 $m
Wholesale loan portfolio		
Sovereign		
Drawn exposures	**21,186**	22,696
Undrawn commitments	**34**	17
Derivatives	**57**	278
Other off-balance sheet exposures	**70**	–
	21,347	22,991
Banks		
Drawn exposures	**3,269**	3,275
Repurchase type transactions	**8**	16
Derivatives	**2,375**	2,409
Other off-balance sheet exposures	**628**	469
	6,280	6,169
Corporate		
Drawn exposures	**27,950**	26,456
Undrawn commitments	**12,137**	11,636
Repurchase type transactions	**37**	133
Derivatives	**1,212**	1,278
Other off-balance sheet exposures	**3,650**	2,950
	44,986	42,453
Total wholesale loan portfolio	**72,613**	71,613
Retail loan portfolio		
Residential mortgages	**18,090**	17,347
Home equity lines of credit	**3,046**	4,916
Personal unsecured revolving loan facilities	**527**	1,060
Other personal loan facilities	**2,118**	2,600
Other small to medium enterprises loan facilities	**593**	624
Run-off consumer loan portfolio	**426**	670
Retail MasterCard	**372**	1,197
Total retail loan portfolio	**25,172**	28,414
Total loan portfolio exposure	**97,785**	100,027

Large customer concentrations

We monitor and manage credit risk from large customer concentrations, which we define as borrowing groups where approved facilities exceed 10% of our regulatory capital base, or $544m at 31 December 2014 (2013: $553m). At 31 December 2014, the aggregate approved facilities from large customers was $25,994m (2013: $22,143m), an average of $896m (2013: $963m) per customer. The increase in total approved facilities from large customers comprised primarily of increased facilities to Canadian provinces and to Canadian chartered banks.

Collateral and other credit enhancements

Although collateral can be an important mitigant of credit risk, it is the bank's practice to lend on the basis of the customer's ability to meet their obligations out of cash flow resources rather than rely on the value of security offered. Depending on the customer's standing and the type of product, some facilities may be unsecured. However, for other lending a charge over collateral is obtained and considered in determining the credit decision and pricing. In the event of default, the bank may utilize the collateral as a source of repayment.

Management's Discussion and Analysis (continued)

The principal collateral types are as follows:

- in the personal sector, mortgages over residential properties or charges over other personal assets being financed;
- in the commercial and industrial sector, charges over business assets such as land, buildings and equipment, inventory and receivables;
- in the commercial real estate sector, charges over the properties being financed; and
- in the financial sector, charges over financial instruments such as debt and equity securities in support of trading facilities.

Our credit risk management policies include appropriate guidelines on the acceptability of specific classes of collateral or credit risk mitigation. Valuation parameters are updated periodically depending on the nature of the collateral. Full covering corporate guarantees as well as bank and sovereign guarantees are recognized as credit mitigants for capital purposes.

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

Collateral held as security for financial assets other than loans is determined by the nature of the instrument. Government and other debt securities, including money market instruments, are generally unsecured, with the exception of asset-backed securities and similar instruments, which are secured by pools of financial assets.

The bank has policies in place to monitor the existence of undesirable concentration of the collateral supporting our credit exposures.

Credit quality

The bank uses the classification as outlined in the table below to measure the quality of its loans and advances.

Credit quality classification

	Wholesale and retail lending		
Quality classification	*External credit rating*	*Internal credit rating*	*12 month probability of default %*
Strong	A– and above	CRR1 to CRR2	0–0.169
Good	BBB+ to BBB–	CRR3	0.170–0.740
Satisfactory	BB+ to B+	CRR4 to CRR5	0.741–4.914
Sub-standard	B to C	CRR6 to CRR8	4.915–99.999
Impaired	Default	CRR9 to CRR10	100

Credit quality of wholesale portfolio (Audited)

	2014			2013		
	EAD Drawn **$m**	*EAD Undrawn* **$m**	*EAD Total* **$m**	*EAD Drawn* $m	*EAD Undrawn* $m	*EAD Total* $m
Strong	**31,806**	**2,757**	**34,563**	33,220	3,320	36,540
Good	**15,801**	**6,003**	**21,804**	16,049	6,014	22,063
Satisfactory	**11,047**	**3,123**	**14,170**	9,157	2,065	11,222
Sub-standard	**1,447**	**276**	**1,723**	1,180	224	1,404
Impaired	**340**	**13**	**353**	354	30	384
	60,441	**12,172**	**72,613**	59,960	11,653	71,613

During 2014 management refined the bank's policy and procedures relating to the assignment of internal risk ratings and adopted a more pro-active and conservative approach to the identification of potential problem accounts. As a result of this action the proportion of exposures categorized as Strong or Good decreased from 81.8% at 31 December 2013 to 77.6% at 31 December 2014. Despite this shift the overall average probability of default improved year over year as demonstrated by the level of impaired loans and lower loan impairment charges in 2014.

Credit quality of retail portfolio (Audited)

	2014			2013		
	EAD Drawn **$m**	***EAD Undrawn*** **$m**	***EAD Total*** **$m**	*EAD Drawn* $m	*EAD Undrawn* $m	*EAD Total* $m
Strong	**9,501**	**1**	**9,502**	10,586	829	11,415
Good	**10,717**	**1,262**	**11,979**	10,148	3,904	14,052
Satisfactory	**2,451**	**455**	**2,906**	1,842	269	2,111
Sub-standard	**642**	**48**	**690**	631	86	717
Impaired	**95**	**–**	**95**	119	–	119
	23,406	**1,766**	**25,172**	23,326	5,088	28,414

During 2014, there were a number of changes in the bank's IRB models applicable to retail exposures incorporating certain economic data updates to internal regulatory rating systems and also changes in model policy. In addition, there was a review of the terms of the bank's credit cards which impacted the credit conversion factor of customers' unused credit card limits. The impact of these changes resulted in a reduction of the EAD relating to undrawn exposures of $3.5bn compared to 2013 as well as a number of changes in the reported credit quality of those exposures.

Renegotiated loans

The carrying amount of loans that would otherwise be past-due or impaired whose terms have been renegotiated was $170m at 31 December 2014 (2013: $237m).

Loans past due but not impaired

Examples of exposures considered past due but not impaired include loans that have missed the most recent payment date but on which there is no evidence of impairment; loans fully secured by cash collateral; residential mortgages in arrears more than 90 days, but where the value of collateral is sufficient to repay both the principal debt and all potential interest for at least one year; and short-term trade facilities past due more than 90 days for technical reasons such as delays in documentation, but where there is no concern over the creditworthiness of the counterparty.

The aging analysis below includes past due loans on which collective impairment allowances have been assessed, though at their early stage of arrears, there is normally no identifiable impairment.

Days past due but not impaired loans and advances (Audited)

	2014 **$m**	2013 $m
Up to 29 days	**435**	546
30–59 days	**109**	93
60–89 days	**23**	28
90–179 days	**–**	–
Over 180 days	**4**	8
	571	675

Impaired loans and allowance for credit losses

When impairment losses occur, we reduce the carrying amount of loans through the use of an allowance account with a charge to income. The allowance for credit losses consists of both individually assessed and collectively assessed allowances, each of which is reviewed on a regular basis. The allowance for credit losses reduces the gross value of an asset to its net carrying value.

An allowance is maintained for credit losses which, in management's opinion, is considered adequate to absorb all incurred credit-related losses in our portfolio, of both on and off-balance sheet items, including deposits with other regulated financial institutions, loans, acceptances, derivative instruments and other credit-related contingent liabilities, such as letters of credit and guarantees.

Assessing the adequacy of the allowance for credit losses is inherently subjective as it requires making estimates that may be susceptible to significant change. This includes the amount and timing of expected future cash flows and incurred losses for loans that are not individually identified as being impaired.

Management's Discussion and Analysis (continued)

Individually significant accounts are treated as impaired as soon as there is objective evidence that an impairment loss has been incurred. The criteria used to determine that there is 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 realization; and
- a significant downgrading in credit rating by an external credit rating agency.

Individually assessed impairment allowances are recorded on these individual accounts on an account-by-account basis to reduce their carrying value to estimated realizable amount.

The collectively assessed impairment allowance is our best estimate of incurred losses in the portfolio for those individually significant accounts for which no evidence of impairment has been individually identified or for high-volume groups of homogeneous loans that are not considered individually significant. In determining an appropriate level of collectively assessed impairment, we apply the following methodologies:

- *Business and government* – For these loans, the underlying credit metrics including PD, LGD and EAD, for each customer are derived from the bank's internal rating system as a basis for the collectively assessed impairment allowance. The bank incorporates a quantitative management judgment framework which includes internal and external indicators, to establish an overall collective impairment allowance consistent with recent loss experience and uncertainties in the environment.
- *Residential mortgages* – Historic average loss rates are used to determine the general provision for these portfolios. Management may consider other current information should they believe that these historic loss rates do not fully reflect incurred losses in these portfolios.
- *Consumer Finance and other consumer loans* – Analysis of historical delinquency movements by product type is used as the basis for the collectively assessed impairment allowance for these loan portfolios. By tracking delinquency movement among pools of homogeneous loans, an estimate of incurred losses in each pool is determined. These estimates can be amended should management believe they do not fully reflect incurred losses. This judgemental adjustment employs an established framework and references both internal and external indicators of credit quality.

In addition to the methodologies outlined above, the balance of the collectively assessed impairment allowance is also analyzed as a function of risk-weighted assets and referenced to the allowances held by our peer group.

Impaired financial assets (Audited)

	EAD 2014 $m	EAD 2013 $m
Impaired wholesale portfolio[1]		
Real estate	**76**	121
Energy	**36**	53
Construction services	**21**	33
Manufacturing	**73**	27
Wholesale trade	**8**	22
Agriculture	**8**	19
Automotive	**16**	18
Hotels and accommodation	**12**	17
Mining, logging and forestry	**6**	15
Business services	**48**	13
Sole proprietors	**11**	13
Transportation and storage	**13**	13
Services	**17**	12
Finance and insurance	**4**	5
Retail trade	**4**	3
Total impaired wholesale portfolio	**353**	384
Impaired retail portfolio		
Residential mortgages	**58**	77
Other retail loans	**18**	18
Run off consumer finance portfolio	**20**	24
Total impaired retail portfolio	**96**	119
Total impaired financial assets	**449**	503

1 *Includes $20m (2013: $19m) of impaired acceptances, letters of credit and guarantees*

Impairment allowances (Audited)

	2014 $m	2013 $m
Gross loans and advances to customers		
Individually assessed impaired loans and advances[1] (A)	**403**	445
Collectively assessed loans and advances (B)	**41,178**	40,442
– impaired loans and advances[1]	**97**	101
– non-impaired loans and advances	**41,081**	40,341
Total gross loans and advances to customers (C)	**41,581**	40,887
Less: impairment allowances (c)	**362**	363
– individually assessed (a)	**170**	157
– collectively assessed (b)	**192**	206
Net loans and advances to customers	**41,219**	40,524
Individually assessed impaired loans and advances coverage		
– (a) as a percentage of (A)	**42.2%**	35.3%
Collectively assessed loans and advances coverage		
– (b) as a percentage of (B)	**0.5%**	0.5%
Total loans and advances coverage		
– (c) as a percentage of (C)	**0.9%**	0.9%

1 *Includes restructured loans with a higher credit quality than 'impaired' and for which there is insufficient evidence to demonstrate: a significant reduction in the risk of non-payment of future cash flows, or the absence of other indicators of impairment.*

Management's Discussion and Analysis (continued)

Movement in impairment allowances and provision for credit losses (Audited)

	2014			
	Customers individually assessed **$m**	*Customers collectively assessed* **$m**	*Provision for credit losses* **$m**	*Total* **$m**
Opening balance at the beginning of the year	**157**	**206**	**61**	**424**
Movement				
Loans and advances written off net of recoveries of previously written off amounts[1]	**(69)**	**(15)**	**–**	**(84)**
Charge/(release) to income statement	**90**	**2**	**15**	**107**
Interest recognized on impaired loans and advances	**(10)**	**–**	**–**	**(10)**
Other movements	**2**	**(1)**	**–**	**1**
Closing balance at the end of the year	**170**	**192**	**76**	**438**

	2013			
	Customers individually assessed $m	*Customers collectively assessed* $m	*Provision for credit losses* $m	*Total* $m
Opening balance at the beginning of the year	202	217	80	499
Movement				
Loans and advances written off net of recoveries of previously written off amounts[1]	(167)	(80)	–	(247)
Charge to income statement	138	69	(19)	188
Interest recognized on impaired loans and advances	(16)	–	–	(16)
Other movements	–	–	–	–
Closing balance at the end of the year	157	206	61	424

1 *Recovered $10m (2013: $6m) of loans and advances written off in prior periods*

Derivative portfolio

The credit equivalent amount of derivative exposure comprises the current replacement cost of positions plus an allowance for potential future fluctuation of interest rate or foreign exchange rate derivative contracts. We enter into derivatives primarily to support our customers' requirements and to assist us in the management of assets and liabilities, particularly relating to interest and foreign exchange rate risks as noted above.

Credit equivalent amount of our derivative portfolio (Audited)

	2014 **$m**	2013 $m
Interest rate contracts	**700**	1,076
Foreign exchange contracts	**2,755**	2,811
Commodity contracts	**51**	78
Net credit equivalent amount	**3,506**	3,965

A more detailed analysis of our derivative portfolio is presented in note 11.

Liquidity and funding risk

Liquidity and funding risk is the risk that the bank does not have sufficient financial resources to meet its obligations as they fall due, or will have to do so at an excessive cost. This risk arises from mismatches in the timing of cash flows.

Liquidity and funding risk management

The objective of our liquidity and funding management strategy is to ensure that all foreseeable funding commitments, including deposit withdrawals, can be met when due, and that access to the wholesale markets is coordinated and cost-effective.

The ARC is responsible for defining the bank's liquidity risk tolerances within the HSBC Group's liquidity risk framework, which mandates that each site manages its liquidity and funding on a self-sustaining basis. The ARC also reviews and approves the bank's liquidity and funding policy and is responsible for its oversight.

The bank's Asset and Liability Committee ('ALCO') is responsible for the development of policies and practices to manage liquidity and funding risk. Its mandate is established by HSBC Group policy, the ARC, and the bank's RMC.

ALCO is responsible for the oversight of liquidity and funding risk management, establishing liquidity risk parameters, and monitoring metrics against risk appetite, funding costs, and early warning indicators of a liquidity stress. ALCO is also responsible for ensuring the operational effectiveness of the bank's liquidity contingency plan.

The management of liquidity and funding is carried out by our Balance Sheet Management group in accordance with practices and limits approved by ALCO, the ARC and HSBC Group. Compliance with policies is monitored by ALCO.

The objective of our liquidity framework is to allow us to withstand very severe liquidity stresses. It is designed to be adaptable to changing business models, markets and regulations.

Our liquidity and funding risk management framework requires:

- liquidity to be managed on a stand-alone basis with no implicit reliance on the HSBC Group or central banks;
- compliance with the limit for the advances to core funding ratio; and
- maintaining cumulative positive cash flows in each time band within the specified time horizons in respect of idiosyncratic and market-wide stress scenarios, respectively.

Our liquidity and funding management processes include:

- projecting cash flows under various stress scenarios and considering the level of liquid assets necessary in relation thereto;
- monitoring the balance sheet liquidity ratios against internal measures;
- maintaining a diverse range of funding sources;
- managing the concentration and profile of debt maturities;
- managing contingent liquidity commitment exposures within predetermined caps;
- maintaining debt financing plans;
- monitoring depositor concentration in order to avoid undue reliance on large individual depositors and ensuring a satisfactory overall funding mix; and
- maintaining liquidity and funding contingency plans.

Liquidity regulation

In May 2014, OSFI finalized its Liquidity Adequacy Requirements ('LAR') guideline. The LAR guideline, which incorporates the Basel liquidity standards including the Liquidity Coverage Ratio ('LCR') and Net Stable Funding Ratio ('NSFR'), introduces a suite of additional liquidity monitoring tools, and formalizes OSFI's use of the Net Cumulative Cash Flow ('NCCF') supervisory tool. The LCR estimates the adequacy of liquidity over a 30 day stress period while the NSFR will require a stable funding profile to be maintained in relation to the composition of assets and off-balance sheet activities. The NCCF calculates a horizon for net positive cash flows in order to capture the risk posed by funding mismatches between assets and liabilities. LCR and NCCF will be in force as of 1 January 2015 and banks will be required to maintain an LCR above 100% effective 1 January 2015. As at 31 December 2014 the bank exceeds the LCR minimum. The NSFR will be effective 1 January 2018.

Management's Discussion and Analysis (continued)

Advances to core funding ratio

The bank emphasizes the importance of core current accounts and savings accounts as a source of stable funding to finance lending to customers, and discourages reliance on short-term professional funding. This is achieved by placing limits to restrict the bank's ability to increase loans and advances to customers without corresponding growth in current accounts and savings accounts or long-term debt funding with a residual maturity beyond one year. This measure is referred to as the 'advances to core funding' ratio.

The advances to core funding ratio describes loans and advances to customers as a percentage of the total of core customer current and savings accounts and term funding with a remaining term to maturity in excess of one year. Loans and advances to customers which are part of reverse repurchase arrangements, and where the bank receives securities which are deemed to be liquid, are excluded from the advances to core funding ratio, as are current accounts and savings accounts from customers deemed to be 'non-core'. The categorization of customer deposits into core and non-core takes into account the nature of the customer and the size and pricing of the deposit.

The distinction between core and non-core deposits generally means that the bank's measure of advances to core funding is more restrictive than that which could be inferred from the published financial statements.

The table below shows the extent to which loans and advances to customers were financed by reliable and stable sources of funding.

Advances to core funding ratio (Unaudited)

	2014	2013
	%	%
Year-end	**100**	93
Maximum	**102**	100
Minimum	**93**	93
Average	**99**	96

Stress testing

The bank runs a range of stressed cash flow scenarios as its primary liquidity risk measures, spanning various idiosyncratic and market-wide stress scenarios. Stressed cash flow scenarios are further supplemented by regular enterprise-wide stress testing and reverse stress testing. The results of all liquidity stress tests are reviewed and monitored by ALCO.

We would meet any unexpected cash outflows primarily from our cash, by selling or entering into repurchase agreements ('repos') with the securities assessed as liquid assets, and by maturing interbank loans and reverse repos. In general, customer advances are assumed to be renewed and as a result are not assumed to generate a stressed cash inflow or represent a liquidity resource.

Contingent liquidity risk is the risk associated with the need to provide additional funds to clients. We include estimates of contingent liquidity cash outflows within all stressed cash flow scenarios.

The stressed coverage ratios tabulated below express stressed cash inflows as a percentage of stressed cash outflows over one-month and three-month time horizons. Inflows included in the numerator of the stressed coverage ratio are those that are assumed to be generated from monetization of liquid assets net of assumed haircuts, and cash inflows related to assets contractually maturing within the stressed cash flow horizon and not already reflected as a monetization of a liquid asset.

Stressed one-month coverage ratios (Unaudited)

	2014	2013
	%	%
Year-end	**130**	137
Maximum	**136**	137
Minimum	**125**	120
Average	**128**	130

Stressed three-month coverage ratios (Unaudited)

	2014	2013
	%	%
Year-end	**113**	118
Maximum	**121**	118
Minimum	**109**	110
Average	**114**	113

Liquid Assets

The table below shows the estimated liquidity value (before assumed haircuts) of assets categorized as liquid used for the purpose of calculating one and three month stressed coverage ratio.

Any unencumbered asset held as a consequence of a reverse repo transaction with a residual contractual maturity within the relevant stress testing horizon and unsecured interbank loans maturing within three months are not included in liquid assets, as these assets are reflected as contractual cash inflows.

Estimated liquidity value (Unaudited)

	2014	2013
	\$m	\$m
Level 1[1]	**17,342**	17,955
Level 2[2]	**4,095**	3,960
	21,437	21,915

1 *Includes debt securities of central governments, central banks, supranationals and multilateral development banks.*
2 *Includes debt securities of local and regional governments, public sector entities and secured covered bonds.*

Net contractual cash flows

The following table quantifies the gross contractual cash flows from interbank and intra-Group loans and deposits, and reverse repo, repo (including intergroup transactions) and short positions of the one and three-month stressed coverage ratios and should be considered alongside the level of liquid assets.

Cash inflows (outflows) within three months (Unaudited)

	2014	2013
	\$m	\$m
Interbank and intra-Group loans and deposits	**2,484**	855
Reverse repo, repo and outright short positions (including intra-Group)	**(1,298)**	1,057

Contingent liquidity risk arising from committed lending facilities

The bank provides commitments to various counterparts. In terms of liquidity risk, the most significant risk relates to committed lending facilities which, whilst undrawn, give rise to contingent liquidity risk, as these could be drawn during a period of liquidity stress. Commitments are given to customers and committed lending facilities are provided to conduits, established to enable clients to access a flexible market-based source of finance.

The table on page 44 shows the level of undrawn commitments outstanding to conduits and customers for the five largest single facilities and the largest market sector.

Management's Discussion and Analysis (continued)

The bank's contractual undrawn exposures monitored under the contingent liquidity risk structure (Unaudited)

	2014	2013
	$m	$m
Commitments to conduits		
Total lines	**245**	1,035
Largest individual lines	**194**	765
Commitments to customers		
Five largest	**1,928**	1,553
Largest market sector	**4,012**	3,644

Sources of funding

Current accounts and savings deposits, payable on demand or on short notice, form a significant part of our funding. We place considerable importance on maintaining the stability and growth of these deposits, which provide a diversified pool of funds.

We also access professional markets to maintain a presence in local money markets and to optimize the funding of asset maturities not naturally matched by core deposit funding. As part of our wholesale funding arrangements, we have a number of fund raising programs, so that undue reliance is not placed on any one source of funding.

No reliance is placed on unsecured money market wholesale funding as a source of core funding. Only wholesale funding with a residual term to maturity of one year or greater is counted towards the core funding base. In addition, our stress testing assumptions require an equivalent amount of liquid assets to be held against wholesale funding maturing within the relevant stress testing horizon.

Cash flows payable by the bank under financial liabilities by remaining contractual maturities (Audited)

	On demand and due within 3 months	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*Total*
	$m	$m	$m	$m	$m
At 31 December 2014					
Deposits by banks	**681**	**–**	**–**	**–**	**681**
Customer accounts	**40,970**	**8,066**	**1,946**	**–**	**50,982**
Repurchase agreements	**4,059**	**–**	**–**	**–**	**4,059**
Trading liabilities	**4,227**	**–**	**–**	**–**	**4,227**
Financial liabilities designated at fair value	**5**	**14**	**49**	**421**	**489**
Derivatives	**3,489**	**11**	**223**	**160**	**3,883**
Debt securities in issue	**1,568**	**3,245**	**4,126**	**2,416**	**11,355**
Subordinated liabilities[1]	**3**	**8**	**22**	**252**	**285**
Other financial liabilities	**5,979**	**585**	**1,318**	**–**	**7,882**
	60,981	**11,929**	**7,684**	**3,249**	**83,843**
Loan commitments	**37,767**	**39**	**–**	**–**	**37,806**
Financial guarantee contracts	**510**	**1,413**	**405**	**13**	**2,341**
	99,258	**13,381**	**8,089**	**3,262**	**123,990**

1 *Excludes interest payable exceeding 15 years.*

Certain balances in the above table will not agree directly to the balances in the consolidated balance sheet as the table incorporates cash flows for both principal and interest, on an undiscounted basis, except for derivatives and trading liabilities.

Cash flows payable in respect of deposits are primarily contractually repayable on demand or on short notice. However, in practice, short-term deposit balances remain stable as cash inflows and outflows broadly match.

Trading derivatives and trading liabilities have been included in the 'On demand and due within 3 months' time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The undiscounted cash flows on hedging derivative liabilities are classified according to their contractual maturity.

Furthermore, loan commitments and financial guarantee contracts are not recognized on the consolidated balance sheet. The undiscounted cash flows potentially payable under financial guarantee contracts are classified on the basis of the earliest date they can be drawn down.

Encumbered assets

In the normal course of business, the bank will pledge or otherwise encumber assets. The pledging of assets will occur to meet the bank's payments and settlement system obligations, as security in a repurchase transaction, to support secured debt instruments or as margining requirements. Limits are in place to control such pledging.

The bank actively monitors its pledging positions. Encumbered assets are not counted towards the bank's liquid assets used for internal stress testing scenarios. We further estimate the impact of credit rating downgrade triggers, and exclude the estimated impact from liquid assets within the bank's liquidity stress testing scenarios.

Contractual obligations

As part of our normal business operations we have contractual obligations liability payments. Amounts included in unsecured long-term funding in the table below are wholesale term deposits with an original term to maturity of more than one year, based on contractual repayment dates. Also included are obligations related to commitments not recorded in the consolidated balance sheet, such as those relating to operating leases.

Summary of future contractual payments (Unaudited)

	Less than 1 year $m	*1 to 5 years* $m	*After 5 years* $m	*Total* $m
At 31 December 2014				
Subordinated debentures[1]	–	–	639	639
Operating leases	49	145	53	247
Committed purchase obligations	225	353	60	638
Unsecured long-term funding[1]	3,084	3,248	2,336	8,668
Total contractual obligations	3,358	3,746	3,088	10,192

1 *Includes principal amounts only.*

Committed purchase obligations include long-term arrangements for the provision of technology and data processing services by HSBC Group companies. Not included in the table are any commitments relating to customers utilizing undrawn portions of their loan facilities. As a result of our ongoing funding and liquidity management process which we monitor regularly, we expect to be able to meet all of our funding and other commitments in the normal course of our operations.

Market risk

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

Market risk management

The objective of market risk management is to identify, measure and control market risk exposures in order to optimize return on risk within the bank's risk appetite.

We separate exposures to market risk into trading and non-trading portfolios. Trading portfolios include those positions arising from market-making, proprietary position-taking and other positions designated as held-for-trading.

Market risk is managed in accordance with policies and risk limits set out by RMC and approved by the Board as well as centrally by HSBC Group Risk Management. We set risk limits for each of our trading operations dependent upon the size, financial and capital resources of the operations, market liquidity of the instruments traded, business plan, experience and track record of management and dealers, internal audit ratings, support function resources and support systems. Risk limits are reviewed and set by RMC on an annual basis at a minimum.

We use a range of tools to monitor and limit market risk exposures. These include: present value of a basis point, Value at Risk ('VaR'), foreign exchange exposure limits, maximum loss limits, credit spread limits, and issuer limits.

Management's Discussion and Analysis (continued)

Value at Risk

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

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

The historical simulation models used incorporate the following features:

– potential market movements are calculated with reference to data from the past two years;

– historical market rates and prices are calculated with reference to foreign exchange rates, credit spreads, interest rates, equity prices and the associated volatilities;

– VaR is calculated to a 99 % confidence level; and

– VaR is calculated for a one-day holding period.

Statistically, we would expect to see losses in excess of VaR only one percent of the time over a one-year period. Although a valuable guide to risk, VaR should always be viewed in the context of its limitations:

– the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;

– the use of a one-day holding period assumes that all positions can be liquidated or hedged in one day, which may not fully reflect the market risk arising at times of severe illiquidity, when a one day holding period may be insufficient to liquidate or hedge all positions fully;

– the use of a 99 % confidence level, by definition, does not take into account losses that might occur beyond this level of confidence;

– VaR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures; and

– VaR is unlikely to reflect loss potential on exposures that only arise under significant market moves.

VaR disclosed in the tables and graph below is the bank's total VaR for both trading and non-trading books and remained within the bank's limits.

Average non-trading VaR for the year ended 31 December 2014 was little changed compared to the prior year while non-trading VaR as at 31 December, 2014 was up by $4m. The increase was mainly from interest rate (IR) VaR and credit spread (CS) VaR. IR VaR increase is due to position changes in risk curve profiles while the total IR sensitivities remained flat and roll of the historical time period used to calculate VaR. CS VaR increased due to improved granularity on mapping historical credit spreads allocated to risky bonds.

Non-trading VaR (Unaudited)

	2014	2013
	$m	$m
End of year	**13**	9
Average	**12**	11
Minimum	**7**	8
Maximum	**17**	17

VaR by risk type for trading activities[1] (Unaudited)

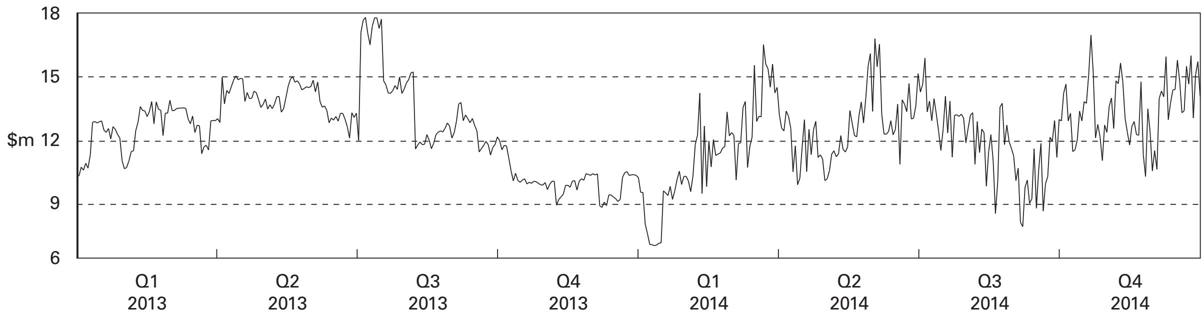
	Foreign exchange and commodity $m	*Interest rate* $m	*Equity* $m	*Credit Spread* $m	*Portfolio diversification*[2] $m	*Total*[3] $m
January–December 2014						
At year end	**0.0**	**0.4**	**0.0**	**1.0**	**(0.4)**	**1.0**
Average	**0.2**	**0.4**	**0.0**	**0.9**	**(0.5)**	**1.1**
Minimum	**0.0**	**0.1**	**0.0**	**0.3**		**0.4**
Maximum	**1.1**	**1.3**	**0.1**	**2.4**		**2.4**
January–December 2013						
At year end	0.1	0.3	0.0	1.4	(0.4)	1.5
Average	0.1	0.8	0.0	1.8	(0.7)	2.0
Minimum	0.0	0.2	0.0	0.7		0.8
Maximum	0.5	1.7	0.4	4.1		4.2

1 *Trading portfolios comprise positions arising from the market-making and warehousing of customer derived positions.*

2 *Portfolio diversification is the market risk dispersion effect of holding a portfolio containing different risk types. It represents the reduction in unsystematic market risk that occurs when combining a number of different risk types, for example, interest rate, equity and foreign exchange, together in one portfolio. It is measured as the difference between the sum of the VaR by individual risk type and the combined total VaR. A negative number represents the benefit of portfolio diversification. As the maximum and minimum occur on different days for different risk types, it is not meaningful to calculate a portfolio diversification benefit for these measures. Some small differences in figures presented are due to rounding.*

3 *The total VaR is non-additive across risk types due to diversification effects.*

Daily VaR (Unaudited)



Structural interest rate risk

Structural interest rate risk arises primarily out of differences in the term to maturity or repricing of our assets and liabilities, both on- and off-balance sheet.

The principal objective of structural interest rate risk is to optimize net interest income.

Structural interest rate risk is managed in accordance with policies and risk limits set out by ALCO.

We use a variety of cash and derivative instruments to manage our interest rate risk within prescribed limits. We use derivatives to modify the interest rate characteristics of related balance sheet instruments and to hedge anticipated exposures when market conditions are considered beneficial.

The risk is measured based on contractual re-pricing, as well as incorporating embedded optionality of early redemption, prepayment or re-pricing (such as redeemable deposit products, mortgages with prepayment options and fixed rate mortgage commitments). Non-maturity products are laddered out over an assumed maturity profile, based on historical behaviour. These behavioural and optionality assumptions are approved by ALCO.

Management's Discussion and Analysis (continued)

We use two primary interest rate risk metrics to measure and monitor the risk:

1) Economic value of equity sensitivity – the change in the notional equity value of the non-trading portfolio resulting from an immediate parallel shift in all relevant yield curves.

2) Earnings at risk sensitivity – the change in projected net interest income over a 12 month horizon, resulting from a ramped +/–100 basis point change in all relevant yield curves.

Sensitivity of Structural Interest Rate Risk in the non-trading portfolio (Unaudited)

At 31 December	**2014**		2013	
	Economic value of equity **$m**	*Earnings at risk* **$m**	*Economic value of equity* $m	*Earnings at risk* $m
Impact as a result of 100 basis point change in interest rate:				
Increase	**(167)**	**35**	(118)	39
Decrease	**42**	**(54)**	66	(67)

Reputational risk

Reputational risk encompasses negative reaction to activities which may be illegal or against regulations, or counter to societal standards, values and expectations. It can arise from a wide variety of causes including how we conduct our business and the way in which clients to whom we provide services conduct themselves.

Reputational risk is measured by reference to our reputation as indicated by our dealings with all relevant stakeholders, including media, regulators, customers and employees. It is managed by every member of staff and is covered by a number of policies and guidelines.

Each of the lines of business is required to have a procedure to assess and address reputational risks potentially arising from proposed business transactions and client activity. Potential risks are directed to the RMC for review. Where necessary, the RMC reports reputational risks to the ARC quarterly.

Reputational risks are considered and assessed by the ARC, RMC and senior management during the formulation of policy and the establishment of our standards. These polices are communicated through manuals and statements of policy through internal communications and training. The policies set out our risk appetite and operational procedures in all areas of reputation risk, including money laundering deterrence, counterterrorist financing, environmental impact, anti-bribery and corruption measures and employee relations.

Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Operational risk is relevant to every aspect of our business, and covers a wide spectrum of issues, in particular legal, compliance, security and fraud. Losses arising from breaches of regulation and law, unauthorized activities, error, omission, inefficiency, fraud, systems failure or external events all fall within the definition of operational risk.

Responsibility for minimizing operational risk lies with the bank's management and staff. Each business unit and functional head is required to maintain oversight over the operational risks and internal controls for the business and operational activities that they are responsible for.

Operational risk management framework

The Operational Risk function and the operational risk management framework ('ORMF') directs business management in discharging their responsibilities. The ORMF defines minimum standards and processes, and the governance structure for operational risk and internal control in our businesses and functions.

To implement the ORMF a ‘three lines of defence’ model is used for the management of risk, as described below:

– *First line of defence:* Every employee is responsible for the risks that are a part of their day-to-day jobs. The first line of defence ensures all key risks within their operations are identified, mitigated and monitored by appropriate internal controls within an overall control environment.

– *Second line of defence:* Consists of Functions such as Risk, Finance and Human Resources who are responsible for providing assurance, challenge and oversight of the activities conducted by the first line.

– *Third line of defence:* Internal Audit provides independent assurance over the first and second lines of defence.

The ORMF has been codified in a high level standards manual supplemented with detailed policies, which describe our approach to identifying, assessing, monitoring and controlling operational risk and give guidance on mitigating action to be taken when weaknesses are identified.

Activity to embed the use of our operational risk management framework continued in 2014. At the same time, we are streamlining operational risk management processes and harmonizing framework components and risk management processes. This is expected to lead to a stronger operational risk management culture and more forward-looking risk insights to enable businesses to determine whether material risks are being managed within the bank’s risk appetite and whether further action is required. In addition, the Security and Fraud Risk and Financial Crime Compliance functions have built a Financial Intelligence Unit (‘FIU’) which provides intelligence on the potential risks of financial crime posed by customers and business prospects to enable better risk management decision-making. The FIU provides context and expertise to identify, assess and understand financial crime risks holistically in clients, sectors and markets.

Business and Functional management is responsible for maintaining an acceptable level of internal control, commensurate with the scale and nature of operations, and for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The ORMF helps managers to fulfil these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational incident information. A centralized database is used to record the results of the operational risk management process.

The standard operational risk and control assessments are performed by individual business units and functions. The risk and control assessment process is designed to provide 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. Risk and control assessments are reviewed and updated at least annually.

Articulating our risk appetite for material operational risks helps the business understand the level of risk our organization is willing to accept. Monitoring operational risk exposure against risk appetite on a regular basis and implementing our risk acceptance process drives risk awareness in a more forward-looking manner and assists management in determining whether further action is required.

An Operational Risk Management function, reporting to the Chief Risk Officer, provides end-to-end oversight, challenge and review of the ORMF. The function works closely with the Bank’s Operational Risk Management Group whose mission is to provide governance and strategic oversight of the bank’s operational risk management framework. We actively manage operational risk to reduce exposure to events that could lead to negative impacts.

Compliance risk

Compliance risk is the risk that we fail to observe the letter and spirit of all relevant laws, codes, rules, regulations and standards of good market practice, and incur fines or penalties and suffer damage to our business as a consequence. We have committed to adopt and enforce industry leading compliance standards and have put in place a robust compliance risk management infrastructure to help us achieve this.

In 2014 we completed the restructuring of our previous Compliance sub-function within Risk into two new sub-functions: Financial Crime Compliance and Regulatory Compliance. This restructuring allows us to:

– manage different types of regulatory and financial crime compliance risk more effectively;

– focus our efforts appropriately in addressing issues highlighted by regulatory investigations and reviews, internal audits and risk assessments of our past business activities; and

– ensure we have in place clear, robust accountability and appropriate expertise and processes for all areas of compliance risk.

Management's Discussion and Analysis (continued)

Financial Crime Compliance focuses on setting policy and managing risks in the following areas:

– anti-money laundering, counter terrorist financing and proliferation finance;

– sanctions; and

– anti-bribery and corruption.

Regulatory Compliance focuses on setting policy and managing risks in the following areas:

– conduct of business;

– market conduct; and

– general regulatory compliance management.

Security and fraud risk

Security and fraud risk includes: Fraud Risk, Information Security Risk, and Business Continuity.

The Fraud Risk function is responsible for ensuring that effective protection measures are in place against all forms of fraudulent activity, whether initiated internally or externally, and is available to support any part of the business. To achieve that and to attain the level of integration needed to face the threat, the management of all types of fraud (e.g. card fraud, non-card fraud and internal fraud, including investigations), is established within one management structure and is part of the overall Risk function. We have increased monitoring, root cause analysis and review of internal controls to enhance our defences against external attacks and reduce the level of loss in these areas. Security and Fraud Risk is working closely with the businesses to continually assess fraud threats as they evolve and adapt our controls to mitigate these risks. We have developed a holistic and effective anti-fraud strategy comprising fraud prevention policies and practices, the implementation of strong internal controls, and investigations response team and liaison with law enforcement where appropriate.

Information Security Risk protects bank information assets against the risk of loss, operational discontinuity, misuse, unauthorized disclosure, inaccessibility and damage. It also protects against the ever-increasing potential for civil or legal liability that the bank could face as a result of information inaccuracy and loss, or the absence of due care in its protection. Information Security Risk covers all information processes, regardless of whether they involve people and technology or relationships with trading partners, customers and third parties. Information Security Risk addresses information protection, confidentiality, availability and integrity throughout the life cycle of information and its use within the bank. The security of our information and technology infrastructure is crucial for maintaining our banking applications and processes while protecting our customers and the HSBC brand.

The Business Continuity Management function is responsible for ensuring that our businesses and functions have the resilience to maintain continuity in the face of major disruptive events. Within this wider risk, Business Continuity Management pre-plans and considers strategies to minimize the adverse effects of major business disruption against a range of actual or emerging risks. The pre-planning concentrates on the protection of customer services, our staff, reputation, revenue generation and the integrity of data and documents. Each business and function has its own recovery plan, which is developed following the completion of a Business Impact Analysis. This determines how much time the business could sustain an outage before the level of losses becomes unacceptable, i.e. its criticality. These plans are reviewed and tested every year. The planning is undertaken against Group policy and standards and each business confirms in an annual compliance certificate that all have been met. Should there be exceptions, these are raised and their short-term resolution is overseen by Group and regional business continuity teams.

Fiduciary risk

Fiduciary risk is the risk associated with failing to offer services honestly and properly to clients where we act in a fiduciary capacity. We define a fiduciary duty as any duty where we hold, manage, oversee or have responsibilities for assets of a third party that involves a legal and/or regulatory duty to act with the highest standard of care and with utmost good faith. A fiduciary must make decisions and act in the best interests of the third parties and must place the wants and needs of the client first, above the needs of the organization.

Fiduciary risk is managed within the designated businesses via a policy framework and monitoring of key indicators. The bank's principal fiduciary businesses (designated businesses) are:

– HSBC Trust Company (Canada), where it is exposed to fiduciary risk via trustee's responsibilities, and

– HSBC Global Asset Management (Canada) Limited and HSBC Private Wealth Services (Canada) Inc. which are exposed to fiduciary risks via investment management activities on behalf of clients.

Factors that may affect future results

The risk management section in the MD&A describes the most significant risks to which the bank is exposed, and which if not managed appropriately could have a material impact on our future financial results. This section outlines additional factors which may affect future financial results.

General economic and market conditions

Factors such as the general health of capital and/or credit markets, including liquidity, level of activity, volatility and stability, could have a material impact on our business. As well, interest rates, foreign exchange rates, consumer saving and spending, housing prices, consumer borrowing and repayment, business investment, government spending and the rate of inflation affect the business and economic environment in which we operate.

In addition, the financial services industry is characterized by interrelations among financial services companies. As a result, defaults by other financial services companies could adversely affect our earnings. Given the interconnectedness of global financial markets and the importance of trade flows, deterioration of the still-unresolved European sovereign debt situation could affect the supply and cost of credit and constrain the pace of economic growth in Canada.

Fiscal, monetary and interest rate policies

Our earnings are affected by fiscal, monetary, interest rate and economic policies that are adopted by Canadian regulatory authorities. Such policies can have the effect of increasing or reducing competition and uncertainty in the markets. Such policies may also adversely affect our customers and counterparties, causing a greater risk of default by these customers and counterparties. As well, expectations in the bond and money markets about inflation and central bank monetary policy have an impact on the level of interest rates. Changes in market expectations and monetary policy are difficult to anticipate and predict. Fluctuations in interest rates that result from these changes can have an impact on our earnings. The current prolonged low interest rate policies have had a negative impact on results and a continuation of such policies would likely continue to pressure earnings.

Changes in laws, regulations and approach to supervision

Regulators in Canada are very active on a number of fronts, including consumer protection, capital markets activities, anti-money laundering, and the oversight and strengthening of risk management. Regulations are in place to protect our customers and the public interest. Considerable changes in laws and regulations that relate to the financial services industry have been proposed and enacted, including changes related to capital and liquidity requirements. Changes in laws and regulations, including their interpretation and application, and changes in approaches to supervision could adversely affect our earnings. For example, such changes could limit the products or services we can provide and the manner in which we provide them and, potentially, lower our ability to compete, while also increasing the costs of compliance.

As such, they could have a negative impact on earnings and return on equity. These changes could also affect the levels of capital and liquidity we choose to maintain.

In addition to the factors outlined here, our failure to comply with laws and regulations could result in sanctions and financial penalties that could adversely affect our strategic flexibility, reputation and earnings.

Level of competition

The level of competition among financial services companies is high. Furthermore, non-financial companies have increasingly been offering services traditionally provided by banks. Customer loyalty and retention can be influenced by a number of factors, including service levels, prices for products or services, our reputation and the actions of our competitors. Changes in these factors or any subsequent loss of market share could adversely affect our earnings.

Changes to our credit rating

Credit ratings are important to our ability to raise both capital and funding to support our business operations. Maintaining strong credit ratings allows us to access the capital markets at competitive pricing. Should our credit ratings experience a material downgrade, our costs of funding would likely increase significantly and our access to funding and capital through capital markets could be reduced.

Management’s Discussion and Analysis (continued)

Operational and infrastructure risks

We are exposed to many operational risks including the risk of fraud by employees or others, unauthorized transactions by employees, and operational or human error. We face the risk of loss due to cyber-attack and also face the risk that computer or telecommunications systems could fail, despite our efforts to maintain these systems in good working order. Some of our services (such as online banking) or operations may face the risk of interruption or other security risks arising from the use of the internet in these services or operations, which may impact our customers and infrastructure. Given the high volume of transactions we process on a daily basis, certain errors may be repeated or compounded before they are discovered and rectified. Shortcomings or failures of our internal processes, employees or systems, or those provided by third parties, including any of our financial, accounting or other data processing systems, could lead to financial loss and damage to our reputation. In addition, despite the contingency plans we have in place, our ability to conduct business may be adversely affected by a disruption in the infrastructure that supports both our operations and the communities in which we do business, including but not limited to disruption caused by public health emergencies or terrorist acts.

Capital

(Certain information within this section, where indicated, forms an integral part of the audited consolidated financial statements)

Our objective in the management of capital is to maintain appropriate levels of capital to support our business strategy and meet our regulatory requirements.

Capital management

The bank manages its capital in accordance with the principles contained within its capital management policy and its annual capital plan, which includes the results of its Internal Capital Adequacy Assessment Process (‘ICAAP’). The bank determines an optimal amount and composition of regulatory and working capital required to support planned business growth, taking into consideration economic capital and the costs of capital, accepted market practices and the volatility of capital and business levels in its annual operating plan.

The bank maintains a capital position commensurate with its overall risk profile and control environment as determined by the ICAAP. The ICAAP supports capital management and ensures that the bank carries sufficient capital to meet regulatory requirements and internal targets to cover current and future risks; and, survive periods of severe economic downturn (stressed scenarios). The key elements of the bank’s ICAAP process include: a risk appetite framework; the identification and assessment of the risks the bank is exposed to; and, an assessment of capital adequacy against regulatory requirements as well as under stressed scenarios.

Management has established appropriate governance structures and internal control to ensure the ICAAP remains effective in supporting the bank’s capital management objectives.

The bank met its regulatory requirements throughout 2014.

Basel III capital and liquidity rules

From 1 January 2013, the bank assessed capital adequacy against standards established in guidelines issued by OSFI in accordance with the Basel III capital adequacy framework.

The Basel III capital adequacy framework significantly revised the definitions of regulatory capital and introduced the requirement that all regulatory capital must be able to absorb losses in a failed financial institution. Capital instruments issued prior to adoption that do not meet the new requirements are being phased out as regulatory capital over a ten year period from 2013 to 2022.

The framework emphasizes common equity as the predominant component of tier 1 capital by adding a minimum common equity tier 1 (‘CET1’) capital ratio. In addition, for the purposes of calculating CET1 capital, certain other regulatory adjustments including those relating to goodwill, intangible assets, pension assets and deferred tax assets are being phased in over a five year period from 2014 to 2018. The Basel III rules also require institutions to hold capital buffers designed to avoid breaches of minimum regulatory requirements during periods of stress.

OSFI has announced that the leverage requirement it imposes on banks – the assets-to-capital multiple – will be replaced effective January 2016 with a leverage ratio that is consistent with the leverage requirement being implemented under the Basel III framework.

In guidance issued in December 2013, OSFI established "all-in" capital targets (including capital conservation buffer) that all institutions are expected to attain or exceed early in the transition period, as follows: CET1 capital ratio of 7% by the first quarter of 2014, and tier 1 capital ratio of 8.5% and total capital ratio of 10.5% by the first quarter of 2015.

Regulatory capital ratios

Actual regulatory capital ratios and capital requirements (Unaudited)

	2014	2013
Actual regulatory capital ratios[1]		
Common equity tier 1 capital ratio	**10.6%**	11.0%
Tier 1 capital ratio	**12.0%**	13.2%
Total capital ratio	**13.5%**	15.0%
Actual assets-to-capital multiple[2]	**17.1x**	15.1x
Required regulatory capital limits[3]		
Minimum Common equity tier 1 capital ratio	**7.0%**	7.0%
Minimum Tier 1 capital ratio	**8.5%**	8.5%
Minimum Total capital ratio	**10.5%**	10.5%

1 *Presented under a Basel III 'all-in' basis per OSFI guidelines which applies Basel III regulatory adjustments from 1 January 2014, however phases out of non-qualifying capital instruments over 10 years starting 1 January 2013.*

2 *Presented under a Basel III on a 'transitional' basis per OSFI guidelines which phases in Basel III regulatory adjustments over 4 years starting 1 January 2015 and phases out of non-qualifying capital instruments over 10 years starting 1 January 2013.*

3 *On an 'all-in' basis.*

Regulatory capital

Regulatory capital and risk weighted assets (Unaudited)

Presented under a Basel III 'all-in' basis which applied Basel III regulatory adjustments from 1 January 2013, and the phase out of non-qualifying capital instruments over 10 years starting from the same date.

	2014 $m	2013 $m
Tier 1 capital	**4,830**	4,857
Common equity tier 1 capital	**4,280**	4,057
Gross common equity[1]	**4,450**	4,285
Regulatory adjustments	**(170)**	(228)
Additional tier 1 eligible capital[2]	**550**	800
Tier 2 capital[3]	**611**	677
Total capital available for regulatory purposes	**5,441**	5,534
Total risk-weighted assets	**40,269**	36,862

1 *Includes common share capital, retained earnings and accumulated other comprehensive income.*

2 *Includes directly issued capital instruments and instruments issued by a subsidiary which are subject to phase out.*

3 *Includes directly issued capital instruments subject to phase out and collective allowances.*

Management's Discussion and Analysis (continued)

Dividends

Dividends on our shares declared and paid, and distributions per unit on our HSBC HaTS™ in each of the last three years were as follows:

	2014	2013	2012
Common shares ($m)	**400**	360	330
Preferred shares ($ per share)			
Class 1, Series C	**1.275**	1.275	1.275
Class 1, Series D	**1.250**	1.250	1.250
Class 1, Series E[1]	**0.825**	1.650	1.650
Class 2, Series B[2]	**n.a.**	0.310	0.310
HSBC HaTS™ – Series 2015 ($ per unit)	**51.50**	51.50	51.50

1 *Preferred shares – Class 1, Series E were redeemed on June 30, 2014.*

2 *Preferred shares – Class 2, Series B were redeemed on 27 December 2013.*

Change of auditors

KPMG has been the Group's auditor since 1991, when HSBC Holdings became the ultimate holding company of the Group. A global tender process was recently undertaken resulting in a recommendation, which was endorsed by the Board of HSBC Holdings, that PricewaterhouseCoopers LLP ('PwC') be appointed as the Group's external auditor for the financial year commencing 1 January 2015.

Accordingly, on 20 February 2015, the bank's Audit Committee recommended, and the bank's shareholder approved, the decision to appoint PwC as its new auditor effective as of 1 January 2015.

KPMG LLP issued unqualified audit opinions on the financial statements of the bank for the two years ended 31 December 2014. There have been no reportable events through to 20 February 2015, as defined in National Instrument 51-102.

Statement of Management's Responsibility for Financial Information

The presentation and preparation of the annual consolidated financial statements, Management's Discussion and Analysis ('MD&A') and all other information in the Annual Report is the responsibility of the management of HSBC Bank Canada ('the bank'). The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ('IFRS'). The consolidated financial statements and information in the MD&A necessarily include amounts based on informed judgments and estimates of the expected effects of current events and transactions with appropriate consideration to materiality.

In meeting its responsibility for the reliability of financial information, management relies on comprehensive internal accounting, operating and system controls. The bank's overall controls include: an organizational structure providing for effective segregation of responsibilities, delegation of authority and personal accountability; written communication of policies and procedures of corporate conduct throughout the bank, and careful selection and training of personnel; regular updating and application of written accounting and administrative policies and procedures necessary to ensure adequate internal control over transactions, assets and records; and a continuing program of extensive internal audit covering all aspects of the bank's operations. These controls are designed to provide reasonable assurance that financial records are reliable for preparing the consolidated financial statements and maintaining accountability for assets, that assets are safeguarded against unauthorized use or disposition and that the bank is in compliance with all regulatory requirements.

At least once a year, the Office of the Superintendent of Financial Institutions Canada ('OSFI'), makes such examination and enquiry into the affairs of the bank as deemed necessary to ensure that the provisions of the Bank Act, having reference to the rights and interests of the depositors and the creditors of the bank, are being complied with and that the bank is in a sound financial condition.

The bank's Board of Directors oversees management's responsibilities for financial reporting through the Audit and Risk Committee, which is composed of directors who are not officers or employees of the bank. The Audit and Risk Committee reviews the bank's interim and annual consolidated financial statements and MD&A. The committee approves the interim statements and recommends the Annual statements for approval by the Board of Directors. Other key responsibilities of the Audit and Risk Committee include monitoring the bank's system of internal control, monitoring its compliance with legal and regulatory requirements, considering the appointment of the Shareholders' auditors and reviewing the qualifications, independence and performance of Shareholders' auditors and internal auditors.

As at 31 December 2014, we, the bank's Chief Executive Officer and Chief Financial Officer, have certified the effectiveness of our internal control over financial reporting as defined by the Canadian Securities Administrators under National Instrument 52-109 (Certification of Disclosure in Issuer's Annual and Interim Filings).

The Shareholders' auditors, the bank's Chief Auditor and OSFI have full and free access to the Board of Directors and its committees to discuss audit, financial reporting and related matters.

Paulo Maia
President and Chief Executive Officer
HSBC Bank Canada

Jacques Fleurant
Chief Financial Officer
HSBC Bank Canada

Vancouver, Canada
20 February 2015

Independent Auditors' Report

To the Shareholders of HSBC Bank Canada

We have audited the accompanying consolidated financial statements of HSBC Bank Canada, which comprise the consolidated balance sheet as at 31 December 2014 and 31 December 2013, the consolidated income statement and statements of comprehensive income, changes in equity and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with IFRS, and for such internal control as management determines is necessary to enable the preparation of consolidated 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 audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated balance sheet of HSBC Bank Canada as at 31 December 2014 and 31 December 2013, and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards.

KPMG LLP

Chartered Accountants

Vancouver, Canada
20 February 2015

Consolidated Financial Statements

Consolidated Financial Statements and Notes on the Financial Statements

Consolidated income statement

For the year ended 31 December *(in millions of dollars except per share amounts)*

	Notes	**2014 $m**	2013 $m
Interest income		**1,886**	2,065
Interest expense		**(674)**	(754)
Net interest income		**1,212**	1,311
Fee income		**723**	694
Fee expense		**(78)**	(91)
Net fee income		**645**	603
Trading income excluding net interest income		**128**	135
Net interest income on trading activities		**18**	43
Net trading income		**146**	178
Net expense from financial instruments designated at fair value		**(5)**	(5)
Gains less losses from financial investments		**56**	58
Other operating income		**56**	16
Total operating income		**2,110**	2,161
Loan impairment charges and other credit risk provisions		**(107)**	(188)
Net operating income	3	**2,003**	1,973
Employee compensation and benefits	4, 5	**(619)**	(614)
General and administrative expenses		**(434)**	(408)
Depreciation of property, plant and equipment		**(33)**	(34)
Amortization and impairment of intangible assets		**(16)**	(14)
Total operating expenses		**(1,102)**	(1,070)
Operating profit		**901**	903
Share of profit in associates		**11**	31
Profit before income tax expense		**912**	934
Income tax expense	6	**(263)**	(247)
Profit for the year		**649**	687
Profit attributable to common shareholder		**613**	616
Profit attributable to preferred shareholders		**26**	61
Profit attributable to shareholders		**639**	677
Profit attributable to non-controlling interests		**10**	10
Average number of common shares outstanding (000's)		**498,668**	498,668
Basic earnings per common share		**$ 1.23**	$ 1.24

The accompanying notes and the audited sections of 'Risk Management' and 'Capital' within Management's Discussion and Analysis form an integral part of these consolidated financial statements.

Consolidated statement of comprehensive income

For the year ended 31 December *(in millions of dollars)*

	Notes	**2014** **$m**	2013 $m
Profit for the year		**649**	687
Other comprehensive income			
Available-for-sale investments[1]		**21**	(86)
– fair value gains/(loss)		**84**	(57)
– fair value gains transferred to income statement on disposal		**(56)**	(58)
– income taxes		**(7)**	29
Cash flow hedges[1]		**(38)**	(61)
– fair value gains		**39**	71
– fair value gains transferred to income statement		**(90)**	(153)
– income taxes		**13**	21
Remeasurement of defined benefit plans[2]		**(31)**	16
– before income taxes	4	**(41)**	21
– income taxes	6	**10**	(5)
Other comprehensive loss for the year, net of tax		**(48)**	(131)
Total comprehensive income for the year		**601**	556
Total comprehensive income for the year attributable to:			
– shareholders		**591**	546
– non-controlling interests		**10**	10
		601	556

1 *Other comprehensive income/(loss) items that can be reclassified into income.*
2 *Other comprehensive income/(loss) items that cannot be reclassified into income.*

The accompanying notes and the audited sections of 'Risk Management' and 'Capital' within Management's Discussion and Analysis form an integral part of these consolidated financial statements.

Consolidated balance sheet

At 31 December *(in millions of dollars)*

	Notes	**2014 $m**	2013 $m
ASSETS			
Cash and balances at central bank		**73**	165
Items in the course of collection from other banks		**76**	107
Trading assets	10	**8,914**	6,728
Derivatives	11	**4,082**	2,112
Loans and advances to banks		**1,264**	1,149
Loans and advances to customers		**41,219**	40,524
Reverse repurchase agreements – non-trading	2	**6,714**	6,161
Financial investments	12	**20,122**	21,814
Other assets	17	**345**	332
Prepayments and accrued income		**186**	206
Customers' liability under acceptances		**5,023**	4,757
Property, plant and equipment	15	**124**	137
Goodwill and intangible assets	18	**62**	68
Total assets		**88,204**	84,260
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks		**681**	635
Customer accounts		**50,843**	50,926
Repurchase agreements – non-trading	2	**4,054**	1,487
Items in the course of transmission to other banks		**105**	53
Trading liabilities	19	**4,227**	4,396
Financial liabilities designated at fair value	21	**425**	428
Derivatives	11	**3,885**	1,746
Debt securities in issue	20	**10,610**	11,348
Other liabilities	22	**2,279**	2,338
Acceptances		**5,023**	4,757
Accruals and deferred income		**524**	551
Retirement benefit liabilities	4	**309**	271
Subordinated liabilities	23	**239**	239
Total liabilities		**83,204**	79,175
Equity			
Common shares	26	**1,225**	1,225
Preferred shares	26	**350**	600
Other reserves		**117**	134
Retained earnings		**3,108**	2,926
Total shareholders' equity		**4,800**	4,885
Non-controlling interests	27	**200**	200
Total equity		**5,000**	5,085
Total equity and liabilities		**88,204**	84,260

The accompanying notes and the audited sections of 'Risk Management' and 'Capital' within Management's Discussion and Analysis form an integral part of these consolidated financial statements.

Approved on behalf of the Board of Directors:

Samuel Minzberg
Chairman
HSBC Bank Canada

Paulo Maia
President and Chief Executive Officer
HSBC Bank Canada

Consolidated statement of cash flows

For the year ended 31 December *(in millions of dollars)*

	Notes	**2014 $m**	2013 $m
Cash flows from operating activities			
Profit before tax		**912**	934
Adjustments for:			
– non-cash items included in profit before tax	28	**189**	265
– change in operating assets	28	**(3,337)**	(584)
– change in operating liabilities	28	**1,920**	1,847
– tax paid		**(230)**	(215)
Net cash (used in)/from operating activities		**(546)**	2,247
Cash flows from investing activities			
Purchase of financial investments		**(11,549)**	(17,009)
Proceeds from the sale and maturity of financial investments		**13,255**	15,517
Purchase of property, plant and equipment		**(28)**	(37)
Net cash flow from the sale of held for sale assets		**–**	371
Purchase of intangibles		**(5)**	(11)
Net cash from/(used in) investing activities		**1,673**	(1,169)
Cash flows from financing activities			
Dividends paid to shareholders		**(426)**	(421)
Distributions to non-controlling interests		**(10)**	(10)
Redemption of preferred shares		**(250)**	–
Purchase of preferred shares		**–**	(419)
Subordinated liabilities repaid		**–**	(85)
Net cash used in financing activities		**(686)**	(935)
Increase in cash and cash equivalents		**441**	143
Cash and cash equivalents at the beginning of the year		**1,896**	1,753
Cash and cash equivalents at the end of the year	28	**2,337**	1,896

The accompanying notes and the audited sections of 'Risk Management' and 'Capital' within Management's Discussion and Analysis form an integral part of these consolidated financial statements.

Consolidated statement of changes in equity

For the year ended 31 December *(in millions of dollars)*

			Other reserves					
	Share capital[1] $m	*Retained earnings* $m	*Available-for-sale fair value reserve* $m	*Cash flow hedging reserve* $m	*Total other reserves* $m	*Total shareholders' equity* $m	*Non-controlling interests* $m	*Total equity* $m
At 1 January 2014	**1,825**	**2,926**	**35**	**99**	**134**	**4,885**	**200**	**5,085**
Profit for the year	**–**	**639**	**–**	**–**	**–**	**639**	**10**	**649**
Other comprehensive income/(loss), net of tax	**–**	**(31)**	**21**	**(38)**	**(17)**	**(48)**	**–**	**(48)**
Available-for-sale investments	**–**	**–**	**21**	**–**	**21**	**21**	**–**	**21**
Cash flow hedges	**–**	**–**	**–**	**(38)**	**(38)**	**(38)**	**–**	**(38)**
Remeasurement of defined liability/asset	**–**	**(31)**	**–**	**–**	**–**	**(31)**	**–**	**(31)**
Total comprehensive income for the year	**–**	**608**	**21**	**(38)**	**(17)**	**591**	**10**	**601**
Dividends paid on common shares	**–**	**(400)**	**–**	**–**	**–**	**(400)**	**–**	**(400)**
Dividends paid on preferred shares	**–**	**(26)**	**–**	**–**	**–**	**(26)**	**–**	**(26)**
Distributions to unit holders	**–**	**–**	**–**	**–**	**–**	**–**	**(10)**	**(10)**
Redemption of preferred shares	**(250)**	**–**	**–**	**–**	**–**	**(250)**	**–**	**(250)**
At 31 December 2014	**1,575**	**3,108**	**56**	**61**	**117**	**4,800**	**200**	**5,000**

			Other reserves					
	Share capital[1] $m	*Retained earnings* $m	*Available-for-sale fair value reserve* $m	*Cash flow hedging reserve* $m	*Total other reserves* $m	*Total shareholders' equity* $m	*Non-controlling interests* $m	*Total equity* $m
At 1 January 2013	2,171	2,694	121	160	281	5,146	230	5,376
Profit for the year	–	677	–	–	–	677	10	687
Other comprehensive income/(loss), net of tax	–	16	(86)	(61)	(147)	(131)	–	(131)
Available-for-sale investments	–	–	(86)	–	(86)	(86)	–	(86)
Cash flow hedges	–	–	–	(61)	(61)	(61)	–	(61)
Remeasurement of defined liability/asset	–	16	–	–	–	16	–	16
Total comprehensive income for the year	–	693	(86)	(61)	(147)	546	10	556
Dividends paid on common shares	–	(360)	–	–	–	(360)	–	(360)
Dividends paid on preferred shares	–	(61)	–	–	–	(61)	–	(61)
Distributions to unit holders	–	–	–	–	–	–	(10)	(10)
Purchase of preferred shares	(346)	(43)	–	–	–	(389)	(30)	(419)
Other movements	–	3	–	–	–	3	–	3
At 31 December 2013	1,825	2,926	35	99	134	4,885	200	5,085

1 *Share capital is comprised of common shares $1,225m and preferred shares $350m (2013: $600m).*

The accompanying notes and the audited sections of 'Risk Management' and 'Capital' within Management's Discussion and Analysis form an integral part of these consolidated financial statements.

Notes on the Consolidated Financial Statements

31 December 2014 and 2013 *(all tabular amounts are in millions of dollars unless stated otherwise)*

1 Basis of preparation and significant accounting policies

a *Compliance with International Financial Reporting Standards*

International Financial Reporting Standards ('IFRSs') comprise accounting standards as issued or adopted by the International Accounting Standards Board ('IASB') as well as interpretations issued or adopted by the IFRS Interpretations Committee.

HSBC Bank Canada ('the bank', 'we', 'our') is an indirectly wholly-owned subsidiary of HSBC Holdings plc ('the Parent', 'HSBC Holdings'). In these consolidated financial statements, HSBC Group means the Parent and its subsidiary companies. The consolidated financial statements of the bank have been prepared in accordance with IFRSs and accounting guidelines as issued by the Office of the Superintendent of Financial Institutions Canada ('OSFI'), as required under Section 308(4) of the *Bank Act*.

Standard adopted during the year ended 31 December 2014

On 1 January 2014, the bank adopted 'Offsetting Financial Assets and Financial Liabilities (Amendments to IAS 32)', 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 did not have a material effect on the bank's financial statements and as a result comparative information was not restated.

b *Future accounting developments*

In addition to the projects to complete financial instrument accounting, discussed below, the IASB is working on a project on lease accounting which could represent significant changes to accounting requirements in the future.

In May 2014, the IASB issued IFRS 15 'Revenue from Contracts with Customers'. The standard is effective for annual periods beginning on or after 1 January 2017 with early adoption permitted. IFRS 15 provides a principles-based approach for revenue recognition, and introduces the concept of recognizing revenue for obligations as they are satisfied. The standard should be applied retrospectively, with certain practical expedients available. The bank is currently assessing the impact of this standard but it is not practicable to quantify the effect as at the date of the publication of these financial statements.

In July 2014, the IASB issued IFRS 9 'Financial Instruments', which is the comprehensive standard to replace IAS 39 'Financial Instruments: Recognition and Measurement', and includes requirements for classification and measurement of financial assets and liabilities, impairment of financial assets and hedge accounting.

Classification and measurement

The classification and measurement of financial assets will depend on the entity's business model for their management and their contractual cash flow characteristics and result in financial assets being at amortized cost, fair value through Other Comprehensive Income ('OCI') or fair value through profit or loss. In many instances, the classification and measurement outcomes will be similar to IAS 39, although differences will arise, for example, equity securities will be measured at fair value through profit or loss or, in limited circumstances, at fair value through OCI. The combined effect of the application of the business model and the contractual cash flow characteristics tests may result in some differences in population of financial assets measured at amortized cost or fair value compared with IAS 39. The classification of financial liabilities is essentially unchanged, except that, for certain liabilities measured at fair value, gains or losses relating to changes in the entity's own credit risk are to be included in OCI.

Impairment

The impairment requirements apply to financial assets measured at amortized cost and fair value through OCI, lease receivables, certain loan commitments, and financial guarantee contracts. At initial recognition, allowance (or provision in the case of commitments and guarantees) is required for expected credit losses ('ECL') resulting from default events that are possible within the next 12 months ('12 month ECL'). In the event of a significant increase in credit risk, allowance (or provision) is required for ECL resulting from all possible default events over the expected life of the financial instrument ('lifetime ECL').

The assessment of whether credit risk has increased significantly since initial recognition is performed for each reporting period by considering the probability of default occurring over the remaining life of the financial instrument, rather than by considering an increase in ECL.

Notes on the Consolidated Financial Statements (continued)

1 Basis of preparation and significant accounting policies *(continued)*

b *Future accounting developments (continued)*

Impairment *(continued)*

The assessment of credit risk, as well as the estimation of ECL, are required to be unbiased, probability-weighted and should incorporate all available information which is relevant to the assessment, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date. In addition, the estimation of ECL should take into account the time value of money. As a result, the recognition and measurement of impairment is intended to be more forward-looking than under IAS 39 and the resulting impairment charge will tend to be more volatile. It will also tend to result in an increase in the total level of impairment allowances, since all financial assets will be assessed for at least 12-month ECL and the population of financial assets to which lifetime ECL applies is likely to be larger than the population for which there is objective evidence of impairment in accordance with IAS 39.

Hedge accounting

The general hedge accounting requirements aim to simplify hedge accounting, creating a stronger link between it and risk management strategy and permitting the former to be applied to a greater variety of hedging instruments and risks. The standard does not explicitly address macro hedge accounting strategies, which are being considered in a separate project. To remove the risk of any conflict between existing macro hedge accounting practice and the new general hedge accounting requirements, IFRS 9 includes an accounting policy choice to remain with IAS 39 hedge accounting.

The classification and measurement and impairment requirements are applied retrospectively by adjusting the opening balance sheet at the date of initial application, with no requirement to restate comparative periods. Hedge accounting is generally applied prospectively from that date.

The mandatory application date for the standard as a whole is 1 January 2018, but it is possible to apply the revised presentation for certain liabilities measured at fair value from an earlier date. The bank plans to early adopt the presentation of fair value gains and losses relating to an entity's own credit risk on certain liabilities, at the same time as the HSBC Group, whose early adoption is subject to endorsement by the European Union. In addition, early adoption of the presentation is subject to regulatory consent. If this presentation was applied at 31 December 2014, the effect would be to increase profit before tax by $2m and reduce other comprehensive income by the same amount with no effect on net assets. Further information on change in fair value attributable to changes in credit risk, including the bank's credit risk, is disclosed in note 21.

The bank is currently assessing the impact that the rest of IFRS 9 will have on the financial statements through an HSBC Group-wide project which has been in place since 2012, but due to the complexity of the classification and measurement, impairment, and hedge accounting requirements and their inter-relationships, it is not possible at this stage to quantify the potential effect.

c *Changes to the presentation of the Financial Statements and Notes on the Financial Statements*

In our Annual Report and Accounts 2013, we presented a summary of the bank's significant accounting policies in note 2 on the financial statements. In order to make the financial statements and notes thereon easier to understand, the bank's significant accounting policies have been placed, whenever possible, within the relevant notes on the financial statements, and the changes in wording are intended to more clearly set out the accounting policies. These changes in the wording do not represent changes in accounting policies. In applying materiality to financial statement disclosures, we consider both the amount and nature of each item. The new approach meets the reporting requirements of IAS 1 'Presentation of Financial Statements'.

The bank, together with the HSBC Group, has chosen to present non-trading reverse repurchase and repurchase agreements separately on the face of the balance sheet. These items are classified for accounting purposes as loans and receivables or financial liabilities measured at amortized cost. Previously they were presented on an aggregate basis together within 'Loans and advances to banks', 'Loans and advances to customers', 'Deposits by banks', and 'Customer accounts'. The separate presentation aligns disclosure of reverse repurchase and repurchase agreements with market practice and provides more meaningful information in relation to loans and advances. Further explanation is provided in note 2 on the financial statements. Comparative periods have been presented accordingly. There is no other effect of this change in presentation.

1 Basis of preparation and significant accounting policies *(continued)*

c *Changes to the presentation of the Financial Statements and Notes on the Financial Statements (continued)*

The bank has decided to present an intersegment category on the balance sheet in note 8 Segment Analysis. Previously the bank has presented the assets and liabilities on a net basis for transactions between global lines of business. To enhance the segment disclosure, we have chosen to present assets and liabilities on a gross basis to reflect the dedicated balances of each global line of business. Comparative periods have been presented accordingly. There is no other effect of this change in presentation.

d *Presentation of information*

Disclosures required under IFRS 7 'Financial Instruments: Disclosures' concerning the nature and extent of risks relating to financial instruments have been included in the audited information within the 'Risk Management' section within MD&A.

Capital disclosures under IAS 1 'Presentation of financial statements' have been included in the audited information in the 'Capital' section within MD&A.

The bank's consolidated financial statements are presented in Canadian dollars which is also its functional currency. The abbreviation '$m' represents millions of dollars. All tabular amounts are in millions of dollars except where otherwise noted. Certain prior period amounts have been reclassified to conform with the current period presentation.

e *Critical accounting estimates and assumptions*

The preparation of financial information requires the use of estimates and judgments about future conditions. In view of the inherent uncertainties and the high level of subjectivity involved in the recognition or measurement of items listed below, it is possible that the outcomes in the next financial year could differ from those on which management's estimates are based, resulting in materially different conclusions from those reached by management for the purposes of the 2014 Financial Statements. Management's selection of the bank's accounting policies which contain critical estimates and judgments is listed below and discussed in the 'Critical accounting estimates and assumption' section of MD&A. It reflects the materiality of the items to which the policies are applied, the high degree of judgment involved and estimation uncertainty:

- Impairment of loans and advances: refer to note 1(i);
- Valuation of financial instruments: refer to note 24;
- Deferred tax assets: refer to note 6;
- Defined benefit obligations: refer to note 4.

f *Consolidation and related disclosures*

The bank controls and consequently consolidates an entity when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. Control is initially assessed based on consideration of all facts and circumstances, and is subsequently reassessed when there are significant changes to the initial setup.

Where an entity is governed by voting rights, the bank would consolidate when it holds, directly or indirectly, the necessary voting rights to pass resolutions by the governing body. In all other cases, the assessment of control is more complex and requires judgment of other factors, including having exposure to variability of returns, power over the relevant activities or holding the power as agent or principal.

Business combinations are accounted for using the acquisition method. 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 recognized as an expense in the income statement in the period in which they are incurred. The acquired identifiable assets, liabilities and contingent liabilities are generally measured at their fair values at the date of acquisition. Goodwill is measured as the excess of the aggregate of the consideration transferred, the amount of non-controlling interest and the fair value of the bank'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.

Notes on the Consolidated Financial Statements (continued)

1 Basis of preparation and significant accounting policies *(continued)*

f *Consolidation and related disclosures (continued)*

All intra-bank transactions are eliminated on consolidation.

The consolidated financial statements of the bank also include the attributable share of the results and reserves of associates.

g *Foreign currencies*

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 in effect at the balance sheet date. Any resulting exchange differences are included in the income statement. 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 recognized either in other comprehensive income or in the income statement depending where the gain or loss on the underlying non-monetary item is recognized.

h *Loans and advances to banks and customers*

These include loans and advances originated by the bank, not classified as held for trading or designated at fair value. They are recognized when cash is advanced to a borrower and are derecognized when either the borrower repays its obligations, or the loans are sold or written off, or substantially all the risks and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortized cost using the effective interest method, less impairment allowance.

Loans and advances are reclassified to 'Assets held for sale' when they meet the criteria; however, their measurement continues to be in accordance with this policy.

The bank may commit to underwrite loans on fixed contractual terms for specified periods of time. Where the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a derivative. On drawdown, the loan is classified as held for trading. Where the bank intends to hold the loan, a provision on the loan commitment is only recorded where it is probable that the bank will incur a loss. On inception of the loan, the loan to be held is recorded at its fair value and subsequently measured at amortized cost. For certain transactions, such as leveraged finance and syndicated lending activities, the cash advanced may not be the best evidence of the fair value of the loan. For these loans, where the initial fair value is lower than the cash amount advanced, the difference is charged to the income statement in other operating income. The write-down will be recovered over the life of the loan, through the recognition of interest income, unless the loan becomes impaired.

i *Impairment of loans and advances and available-for-sale assets*

Impairment of loans and advances

Losses for impaired loans are recognized promptly when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment allowances are calculated on individual loans or on groups of loans assessed collectively, are recorded as charges to the income statement and are recorded against the carrying amount of impaired loans on the balance sheet. Losses which may arise from future events are not recognized.

Individually assessed loans and advances

The factors considered in determining whether a loan is individually significant for the purposes of assessing impairment include the size of the loan, the number of loans in the portfolio, and the importance of the individual loan relationship, and how this is managed.

Loans that meet the above criteria will be individually assessed for impairment, except when volumes of defaults and losses are sufficient to justify collective assessment.

i *Impairment of loans and advances and available-for-sale assets (continued)*

Loans considered as individually significant are typically to corporate and commercial customers, are for larger amounts and are managed on an individual basis. Retail lending portfolios are generally assessed for impairment collectively as the portfolios generally are large homogeneous loans pools. These loans are assessed individually at each balance sheet date whether objective evidence of impairment exists based on the following criteria:

– known cash flow difficulties experienced by the borrower;

– contractual payments of either principal or interest being past due;

– the probability that the borrower will enter bankruptcy or other financial realization;

– a concession granted to the borrower for economic or legal reasons relating to the borrower's financial difficulty that results in forgiveness or postponement of principal, interest or fees, where the concession is not insignificant; and

– there has been deterioration in the financial condition or outlook of the borrower such that its ability to repay is considered doubtful.

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

– the bank's aggregate exposure to the customer;

– the viability of the customer's business model and their capacity 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 equally with the bank, and the likelihood of other creditors continuing to support the company;

– the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;

– the realizable value of security (or other credit mitigants) and likelihood of successful repossession;

– the likely deduction of any costs involved in recovery of amounts outstanding;

– the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency; and

– when available, the secondary market price of the debt.

The realizable value of security is determined based on the current market value when the impairment assessment is performed. The value is not adjusted for expected future changes in market prices; however, adjustments are made to reflect local conditions such as forced sale discounts.

Impairment losses are calculated by discounting the expected future cash flows of a loan, which includes expected future receipts of contractual interest, at the loan's 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. Individually assessed impairment allowances are only released when there is reasonable and objective evidence of a reduction in the established loss estimate.

Collectively assessed loans and advances

Impairment is assessed collectively to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment or for homogeneous groups of loans that are not considered individually significant.

Notes on the Consolidated Financial Statements (continued)

1 Basis of preparation and significant accounting policies *(continued)*

i *Impairment of loans and advances and available-for-sale assets (continued)*

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of impairment has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for a collective impairment assessment. These credit risk characteristics may include type of business involved, type of products offered, security obtained or other relevant factors. This assessment captures impairment losses that the bank has incurred as a result of events occurring before the balance sheet date, which the bank is not able to identify on an individual loan basis, and that can be reliably estimated. When information becomes available which identifies losses on individual loans within the group, those loans are removed from the group and assessed individually.

The collective impairment allowance is determined after taking into account:

– historical loss experience in portfolios of similar credit risk characteristics (for example, by industry sector, loan grade or product);

– the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and

– management's experienced judgment 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 based on economic and market conditions, customer behaviour, portfolio management information, credit management techniques and collection and recovery experiences in the market. The estimated period may vary over time as these factors change.

Homogeneous groups of loans and advances

Statistical methods are used to determine collective impairment losses for homogeneous groups of loans not considered individually significant. Losses in these groups of loans are recorded individually when individual loans are removed from the group and written off. The methods that are used to calculate collective allowances are:

– When appropriate empirical information is available, the bank utilizes roll-rate methodology, which employs statistical analyses of historical data and experience of delinquency and default to reliably estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date and which the bank is not able to identify individually. Individual loans are grouped using ranges of past due days; statistical analysis is then used to estimate the likelihood that loans in each range will progress through the various stages of delinquency and become irrecoverable. Additionally, individual loans are segmented based on their credit characteristics as described above. In applying this methodology, adjustments are made to estimate the periods of time between a loss event occurring and its discovery, for example through a missed payment, (known as the emergence period) and the period of time between discovery and write-off (known as the outcome period). Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio.

– When the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, the bank adopts a basic formulaic approach based on historical loss rate experience, or a discounted cash flow model. Where a basic formulaic approach is undertaken, management estimates that typically it takes between six and twelve months between a loss occurring and its identification.

The inherent loss within each portfolio is assessed on the basis of statistical models using historical data observations, which are updated periodically to reflect recent portfolio and economic trends. When the most recent trends arising from changes in economic, regulatory or behavioural conditions are not fully reflected in the statistical models, they are taken into account by adjusting the impairment allowances derived from the statistical models to reflect these changes as at the balance sheet date. Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

i *Impairment of loans and advances and available-for-sale assets (continued)*

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 realization of security. In circumstances where the net realizable value of any collateral has been determined and there is no reasonable expectation of further recovery, write-off may be earlier.

Reversals of impairment

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

Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans as part of an orderly realization are recorded as assets held for sale and reported in 'Other assets' if those assets are classified held for sale. The asset acquired is recorded at the lower of its fair value less costs to sell and the carrying amount of the loan (net of impairment allowance) at the date of exchange. No depreciation is charged in respect of assets held for sale. Impairment and reversals of previous impairments are recognized in the income statement, in 'Other operating income', together with any realized gains or losses on disposal.

Renegotiated loans

Loans subject to collective impairment assessment whose terms have been renegotiated are no longer considered past due, but are treated as up to date loans for measurement purposes once a minimum number of payments required have been received. They 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. The carrying amounts of loans that have been classified as renegotiated retain this classification until maturity or derecognition, including write-off.

A loan that is renegotiated is derecognized if the existing agreement is cancelled and a new agreement made on substantially different terms, or if the terms of an existing agreement are modified, such that the renegotiated loan is substantially a different financial instrument. Any new agreements arising due to a derecognition event will continue to be disclosed as renegotiated loans.

Impairment of available-for-sale financial assets

Available-for sale financial assets are assessed at each balance sheet date for objective evidence of impairment. If such evidence exists 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 has an impact, which can be reliably measured, on the estimated future cash flows of the financial asset an impairment loss is recognized.

If the available-for-sale financial asset is impaired, the difference between its acquisition cost (net of any principal repayments and amortization) and its current fair value, less any previous impairment loss recognized in the income statement, is recognized in the income statement.

Notes on the Consolidated Financial Statements (continued)

1 Basis of preparation and significant accounting policies *(continued)*

i *Impairment of loans and advances and available-for-sale assets (continued)*

Impairment losses are recognized in the income statement within 'Loan impairment charges and other credit risk provisions' for debt instruments and within 'Gains less losses from financial investments' for equities. The impairment methodologies for available-for-sale financial assets are set out in more detail below:

– **Available-for-sale debt securities**. In assessing objective evidence of impairment at the reporting date, the bank considers all available evidence, including observable data or information about events specifically relating to the securities which may result in a shortfall in recovery of future cash flows. Financial difficulties of the issuer, as well as other factors such as information about the issuers' liquidity, business and financial risk exposures, levels of and trends in default for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees may be considered individually, or in combination, to determine if there is objective evidence of impairment.

  In addition, the performance of underlying collateral and the extent and depth of market price declines is relevant when assessing objective evidence of impairment of available-for-sale asset-backed securities ('ABS's). The primary indicators of potential impairment are considered to be adverse fair value movements and the disappearance of an active market for a security, while changes in credit ratings are of secondary importance.

– **Available-for-sale equity securities**. Objective evidence of impairment may include specific information about the issuer as detailed above, but may also include information about significant changes in technology, markets, economics or the law that provides evidence that the cost of the equity securities may not be recovered.

  A significant or prolonged decline in the fair value of the equity below its cost is also objective evidence of impairment. In assessing whether it is significant, the decline in fair value is evaluated against the original cost of the asset at initial recognition. In assessing whether it is prolonged, the decline is evaluated against the continuous period in which the fair value of the asset has been below its original cost at initial recognition.

Once an impairment loss has been recognized, the subsequent accounting treatment for changes in the fair value of that asset differs depending on the type of asset:

– for an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognized in the income statement when there is further objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in the fair value of the financial asset is recognized 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 recognized in the income statement, or the instrument is no longer impaired, the impairment loss is reversed through the 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 recognized in other comprehensive income. Impairment losses recognized on the equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognized in the income statement, to the extent that further cumulative impairment losses have been incurred.

j *Operating income*

Interest income and expense

Interest income and expense for financial instruments not carried at fair value: Interest income and expense for all financial instruments except for those classified as held for trading or designated at fair value (except for debt securities issued by the bank and derivatives managed in conjunction with those debt securities) are recognized in 'Interest income' and 'Interest expense' in the income statement using the effective interest method. The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments through the expected life of the financial instrument or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability.

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

1 Basis of preparation and significant accounting policies *(continued)*

j *Operating income (continued)*

Non-interest income and expense

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

- income earned on the execution of a significant act is recognized as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as an arrangement for the acquisition of shares or other securities);
- income earned from the provision of services is recognized 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 recognized as an adjustment to the effective interest rate (for example, certain loan commitment fees) and recorded in 'Interest income'.

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

Net income/(expense) from financial instruments designated at fair value includes:

- all gains and losses from changes in the fair value of financial assets and liabilities designated at fair value;
- all gains and losses from changes in the fair value of derivatives that are managed in conjunction with financial assets and liabilities designated at fair value; and
- interest income and expense in respect of financial assets and liabilities designated at fair value as well as derivatives managed in conjunction with the above. However, interest arising from debt securities issued by the bank, and derivatives managed in conjunction with those debt securities is recognized in 'Interest expense'.

2 Non-trading reverse repurchase and repurchase agreements

Accounting policy

When securities are sold subject to a commitment to repurchase them at a predetermined price, they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to sell are not recognized on the balance sheet and the right to receive back the initial consideration paid is recorded in 'Non-trading reverse repurchase agreements' or 'Trading assets' as appropriate. The difference between the sale and repurchase price is treated as interest and recognized in net interest income over the life of the agreement.

Non-trading repurchase agreements and reverse repurchase agreements measured at amortized cost are presented as separate lines in the balance sheet. This separate presentation was adopted with effect from 1 January 2014 and comparatives are re-presented accordingly. Previously, non-trading reverse repurchase agreements were included within 'Loans and advances to banks' and 'Loans and advances to customers' and non-trading repurchase agreements were included within 'Deposits by banks' and 'Customer accounts'.

The extent to which reverse repos and repos represents loans to/from customers and banks is set out below.

	2014 $m	2013 $m
Assets		
Banks	**744**	333
Customers	**5,970**	5,828
Reverse repurchase agreements – non-trading	**6,714**	6,161
Liabilities		
Banks	**765**	569
Customers	**3,289**	918
Repurchase agreements – non-trading	**4,054**	1,487

Notes on the Consolidated Financial Statements (continued)

3 Net operating income

Net operating income is stated after the following items of income, expense, and loan impairment charges and other credit risk provisions:

	2014 $m	2013 $m
Income		
Interest recognized on impaired financial assets	**10**	16
Fees earned on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	**360**	340
Fees earned on trust and other fiduciary activities where the bank holds or invests assets on behalf of its customers	**169**	141
Expense		
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	**(665)**	(724)
Fees payable on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	**(45)**	(58)
Fees payable on trust and other fiduciary activities where the bank holds or invests assets on behalf of its customers	**(14)**	(10)
Loan impairment charge and other credit risk provisions		
Net impairment charge on loans and advances	**(92)**	(207)
(Other credit risk provisions)/reversal of provisions	**(15)**	19

4 Employee compensation and benefits

Accounting policy

The bank operates a number of pension and other post-employment benefit plans. These plans include both defined benefit and defined contribution plans and various other post-employment benefits such as post-employment healthcare. The pension plans are funded by contributions from the bank or its employees, while the supplemental pension arrangements are not funded.

Payments to defined contribution plans are charged as an expense as the employees render service.

The defined benefit pension costs and the present value of defined benefit obligations are calculated at the reporting date by the schemes' actuaries using the Projected Unit Credit Method. The net charge to the income statement mainly comprises the service cost and the net interest on the net defined benefit liability and is presented in operating expenses.

The past service cost which is charged immediately to the income statement, is the change in the present value of the defined benefit obligation for employee service in prior periods, resulting from a plan amendment (the introduction or withdrawal of, or changes to, a defined benefit plan) or curtailment (a significant reduction by the entity in the number of employees covered by a plan). A settlement is a transaction that eliminates all further legal and constructive obligations for part or all of the benefits provided under a defined benefit plan, other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions.

Re-measurements of the net defined benefit liability, which comprise actuarial gains and losses, return on plan assets (excluding interest) and the effect of the asset ceiling (if any, excluding interest), are recognized immediately in other comprehensive income.

Actuarial gains and losses comprise experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), as well as the effects of changes in actuarial assumptions.

The defined benefit liability recognized on the balance sheet represents the present value of defined benefit obligations reduced by the fair value of plan assets. Any net defined benefit surplus is limited to the present value of available refunds and reductions in future contributions to the plan.

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

4 Employee compensation and benefits *(continued)*

Total employee compensation

	2014	2013
	$m	$m
Wages and salaries	**502**	504
Post-employment benefits	**62**	62
Other	**55**	48
	619	614

Post-employment benefits

We sponsor a number of defined benefit and defined contribution plans providing pension, other retirement and post-employment benefits to eligible employees. Non-pension plans are comprised of healthcare and other post-employment benefits and are not funded.

Income statement charge	**2014**	2013
	$m	$m
Defined benefit plans		
Pension plans	**19**	20
Non-pension plans	**12**	12
Defined contribution pension plans	**31**	30
Post-employment benefits	**62**	62

Post-employment defined benefit plans

Principal actuarial assumptions

The principal actuarial financial assumptions used to calculate the bank's obligations under its defined plans are presented in the table below. The 2014 and 2013 assumptions will also form and have formed the basis for measuring periodic costs under the plans in 2015 and 2014 respectively.

	Pension plans		Non-pension plans	
	2014	2013	**2014**	2013
	%	%	**%**	%
Discount rate	**3.75–4.00**	4.50–4.75	**3.75–4.00**	4.50–4.75
Rate of pay increase	**3.00**	3.4	**3.00**	3.4
Healthcare cost trend rates – Initial rate	**n/a**	n/a	**8.00**	7.2
Healthcare cost trend rates – Ultimate rate[1]	**n/a**	n/a	**5.00**	4.9

1 *The non-pension 'Healthcare cost trend rates – Ultimate rate' is applied from 2020.*

The bank determines the discount rates to be applied to its obligations in consultation with the plans' local actuaries, on the basis of the current average yield of high quality Canadian corporate bonds, with maturities consistent with those of the defined benefit obligations. At 31 December 2014, the weighted average duration of the defined benefit obligation was 16.8 years.

Notes on the Consolidated Financial Statements (continued)

4 Employee compensation and benefits *(continued)*

Mortality assumption

Assumptions regarding future mortality have been based on published mortality tables. The life expectancies underlying the defined benefit obligation at the reporting dates are as follows:

	Average years from age 65	
	2014	2013
For a male currently aged 65	**22**	22
For a male currently aged 45	**23**	23
For a female currently aged 65	**24**	24
For a female currently aged 45	**25**	25

Actuarial assumption sensitivities

The following table shows the effect of a ¼ percentage point change ('25bps') in key assumptions on the present value of defined benefit obligation at 31 December:

Pension plans

	2014	2013
	$m	$m
Discount rate		
Change in defined benefit obligation at year end from a 25 bps increase	**(26)**	(22)
Change in defined benefit obligation at year end from a 25 bps decrease	**27**	23
Rate of pay increase		
Change in defined benefit obligation at year end from a 25 bps increase	**6**	9
Change in defined benefit obligation at year end from a 25 bps decrease	**(6)**	(9)

Non-pension plans

	2014	2013
Change in defined benefit obligation at year end from a 25 bps increase in the discount rate	**(8)**	(6)
Increase in defined benefit obligation from each additional year of longevity assumed	**9**	6

Plan Assets

	2014	2013
	$m	$m
Fair value of plan assets		
Equities	**175**	233
Bonds	**368**	245
Other – principally bank balances and short term investments	**1**	8
	544	486

Substantially all the equities and bonds are Level 1 (note 24). Bank balances and short term investments are considered Level 2.

4 Employee compensation and benefits *(continued)*

Fair value of plan assets and present value of defined benefit obligations

	Pension plans		Non-pension plans	
	2014	2013	**2014**	2013
	$m	$m	**$m**	$m
Fair value of plan assets				
At 1 January	**486**	410	**–**	–
Interest on plan assets	**23**	18	**–**	–
Contributions by the bank	**30**	45	**4**	4
Contributions by employees	**1**	1	**–**	–
Experience gains	**34**	38	**–**	–
Benefits paid	**(26)**	(25)	**(4)**	(4)
Non-investment expenses	**(1)**	(1)	**–**	–
Distributed on settlements	**(3)**	–	**–**	–
At 31 December	**544**	486	**–**	–
Present value of defined benefit obligations				
At 1 January	**(579)**	(566)	**(157)**	(152)
Current service cost	**(12)**	(13)	**(5)**	(5)
Interest cost	**(27)**	(24)	**(7)**	(7)
Contributions by employees	**(1)**	(1)	**–**	–
Actuarial gains/(losses) arising from changes in:				
– Demographic assumptions	**(4)**	(26)	**(1)**	(7)
– Financial assumptions	**(67)**	27	**(24)**	6
– Experience adjustments	**10**	(1)	**–**	4
Benefits paid	**26**	25	**5**	4
Past service cost	**(1)**	–	**–**	–
Liabilities extinguished on curtailments and settlements	**2**	–	**–**	–
At 31 December	**(653)**	(579)	**(189)**	(157)
Funded	**(592)**	(523)	**–**	–
Unfunded	**(61)**	(56)	**(189)**	(157)
Other – effect of limit on plan surpluses	**(11)**	(21)	**–**	–
Net liability	**(120)**	(114)	**(189)**	(157)

The actual return on plan assets for the year ended 31 December 2014 was $57m (2013: $56m).

Actuarial valuations for the majority of the bank's pension plans are prepared annually and for non-pension arrangements triennially. The most recent actuarial valuations of the defined benefit pension plans for funding purposes were conducted as at 31 December 2013 and the most recent actuarial valuation of the non-pension arrangements was as at 1 July 2012. Based on the most recent valuations of the plans, the bank expects to make $20m of contributions to defined benefit pension plans during 2015.

The defined benefit pension plans expose the bank to risks, including: interest rate risk to the extent that the assets are not invested in bonds that match the plans' obligations, general market risk in respect of its equity investments, and longevity risk in respect of pensioners and beneficiaries living longer than assumed. These risks would be realized through higher pension costs and a higher defined benefit liability.

The bank takes steps to manage these risks through an asset liability management program, which includes reducing interest rate and market risk over time by increasing its asset allocation to bonds that more closely match the plan's obligations.

4 Employee compensation and benefits *(continued)*

Summary of remeasurement, net on defined benefit obligations

	Pension plans		Non-pension plans	
	2014	2013	**2014**	2013
	$m	$m	**$m**	$m
Experience gain on plan assets	**34**	38	**–**	–
Demographic assumptions	**(4)**	(26)	**–**	(7)
Financial assumptions	**(67)**	27	**(24)**	6
Experience adjustments	**10**	(1)	**(1)**	4
Effect of increase in limit on plan surpluses	**11**	(20)	**–**	–
	(16)	18	**(25)**	3

5 Share-based payments

Accounting policy

HSBC Holdings is the grantor of its equity instruments awarded to employees of the bank. The bank is required to partially fund share-based payment arrangements awarded to its employees. 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 recognized as an expense on a straight-line basis over the vesting period. As a result of the bank's share-based payment arrangements being accounted for as equity-settled, the difference between the share-based payment expense, and the fair value of the equity instruments expected to be issued to satisfy those arrangements, is recognized in 'Retained Earnings' over the vesting period.

Fair value is determined by using appropriate valuation models, taking into account the terms and conditions of the award. Vesting conditions include service conditions and performance conditions; any other features of the arrangement are non-vesting conditions. Market performance conditions and non-vesting conditions are taken into account when estimating the fair value of the award at the grant date. They are taken into account by adjusting the number of equity instruments included in the measurement of the transaction.

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

Share-based payments income statement charge

	2014	2013
	$m	$m
Restricted share awards	**11**	8
Savings-related share option plans	**1**	1
	12	9

During 2014, $12m was charged to the income statement in respect of share-based payment transactions (2013: $9m) mostly relating to restricted share awards. These awards are generally granted to employees early in the year following the year to which the award relates. The charge for these awards is recognized from the start of the period to which the service relates to the end of the vesting period. The vesting period is the period over which the employee satisfies certain service conditions in order to become entitled to the award. Due to the staggered vesting profile of certain deferred share awards, the employee becomes entitled to a portion of the award at the end of each year during the vesting period. The income statement charge reflects this vesting profile.

The purpose of restricted share awards is to support retention of key employees, and to reward employee performance and potential. Vesting of restricted share awards is generally subject to continued employment with a vesting period of three years and may be subject to performance conditions.

5 Share-based payments *(continued)*

The weighted average fair value of shares awarded by the HSBC Group for restricted share awards in 2014 was $11.40 per share (2013: $11.20 per share). Fair value is measured at the prevailing market price at the date of the share award.

The bank carries a liability in respect of restricted share awards of $19m as at 31 December 2014 (2013: $20m) to its parent, HSBC Holdings, for the funding of awards that will vest in the future. The liability is measured at fair value with changes recorded within equity.

6 Tax expense

Accounting policy

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

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantively enacted by the balance sheet date, and any adjustment to tax payable in respect of previous years. The bank provides for potential current tax liabilities that may arise on the basis of the amounts expected to be paid to the tax authorities. Current tax assets and liabilities are offset when the bank intends to settle on a net basis and the legal right to offset exists.

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

Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realized or the liabilities settled, based on tax rates and laws enacted, or substantively enacted, by the balance sheet date. Deferred tax assets and liabilities are offset when the bank has a legal right to offset.

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

	2014	2013
	$m	$m
Current taxation		
Federal	**141**	136
Provincial	**105**	100
	246	236
Deferred taxation		
Origination and reversal of temporary differences	**17**	11
Tax expense	**263**	247

Notes on the Consolidated Financial Statements (continued)

6 Tax expense *(continued)*

The provision for income taxes shown in the consolidated income statement is at a rate that is different than the combined federal and provincial statutory income tax rate for the following reasons:

Analysis of tax expense	**2014**	2013
	%	%
Combined federal and provincial income tax rate	**26.2**	26.1
Adjustments resulting from:		
Adjustments related to prior years	**3.5**	–
Substantively enacted tax rate changes	**–**	(0.2)
Other, net	**(0.5)**	0.8
Effective tax rate	**29.2**	26.7

In addition to the amount charged to the income statement, the aggregate amount of current and deferred taxation relating to items that are taken directly to equity was $17m increase in equity (2013: $47m decrease in equity).

Deferred taxation

Movement in deferred taxation during the year:

	2014	2013
	$m	$m
At 1 January	**120**	138
Income statement charge	**(17)**	(11)
Other movements	**(1)**	–
Other comprehensive income:		
Actuarial gains and losses	**10**	(7)
At 31 December	**112**	120

The amount of deferred taxation accounted for in the balance sheet comprised the following deferred tax assets and liabilities:

	2014	2013
	$m	$m
Deferred tax assets		
Retirement benefits	**81**	72
Loan impairment allowances	**37**	33
Assets leased to customers	**(88)**	(71)
Property, plant and equipment	**–**	(1)
Share-based payments	**5**	5
Relief for tax losses carried forward	**38**	40
Other temporary differences	**39**	42
	112	120
Deferred tax liabilities		
Cash flow hedges	**(1)**	(1)
Net deferred tax asset	**111**	119

The amount of temporary differences for which no deferred tax asset is recognized in the balance sheet is $4m (2013: $4m). This amount is in respect of capital losses where the recoverability of potential benefits is not considered likely. The entire amount has no expiry date.

6 Tax expense *(continued)*

Deferred tax is not recognized in respect of the bank's investments in subsidiaries where remittance of retained earning is not contemplated, and for those associates where it has been determined that no additional tax will arise. The aggregate amount of temporary differences associated with investments where no deferred tax liability is recognized is $290m (2013: $481m).

On the evidence available, including management's updated analysis and projection of income, there will be sufficient taxable income generated by the bank to support the recognition of its net deferred tax asset.

7 Dividends

Dividends on our shares declared and paid, and distributions per unit on our HSBC HaTS™ in each of the last two years were as follows:

	2014		2013	
	$per share/unit	**$m**	$per share/unit	$m
Common Shares		**400**		360
Preferred Shares Class 1				
Series C	**1.275**	**9**	1.275	9
Series D	**1.250**	**9**	1.250	9
Series E[1]	**0.825**	**8**	1.650	16
Preferred Shares Class 2				
Series B[2]	**–**	**–**	0.310	27
HSBC HaTS™				
Series 2015	**51.50**	**10**	51.50	10

1 *Preferred shares – Class 1, Series E were redeemed on 30 June 2014*
2 *Preferred shares – Class 2, Series B were redeemed on 27 December 2013*

8 Segment analysis

Accounting policy

The bank's operations are managed according to the following global lines of business: Commercial Banking, Global Banking and Markets, as well as Retail Banking and Wealth Management. Measurement of segmental assets, liabilities, income and expenses is in accordance with the bank's accounting policies. Segmental income and expenses include transfers between segments and these transfers are conducted on arm's length. Shared costs are included in segments on the basis of the actual recharges made.

We manage and report our operations according to the following global lines of business: Commercial Banking, Global Banking and Markets, as well as Retail Banking and Wealth Management. Various estimate and allocation methodologies are used in the preparation of the global lines of business financial information. We allocate expenses directly related to earning revenues to the global lines of business that earned the related revenue. Expenses not directly related to earning revenue, such as overhead expenses, are allocated to global lines of business using appropriate allocation formulas. Global lines of business net interest income reflects internal funding charges and credits on the global lines of business assets, liabilities and capital, at market rates, taking into account relevant terms. The offset of the net impact of these charges and credits is reflected in Global Banking and Markets.

Notes on the Consolidated Financial Statements (continued)

8 Segment analysis *(continued)*

A description of each customer group is as follows:

Commercial Banking

Commercial Banking segments include: Large Corporate Banking, serving large, multi-national companies with more sophisticated financial needs; Mid-Market, providing tailored solutions both domestically and internationally; and, Business Banking, serving small and medium-sized enterprises. Client offering includes Credit and Lending; International trade and receivables finance; Payments and Cash Management; and Global Banking and Markets.

Global Banking and Markets

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

Retail Banking and Wealth Management

Retail Banking and Wealth Management provides banking and wealth management services for our personal customers to help them to manage their finances and protect and build their financial future. Customer offerings include: liability-driven services (deposits and account services), asset-driven services (credit and lending), and fee-driven and other services (wealth advisory and asset management).

Other

'Other' contains the results of movements in fair value of own debt, income related to information technology services provided to HSBC Group companies on an arm's length basis with associated recoveries and other transactions which do not directly relate to our global lines of business.

8 Segment analysis *(continued)*

	2014 $m	2013 $m
Commercial Banking		
Net interest income	**658**	675
Net fee income	**324**	317
Net trading income	**26**	28
Gains less losses from financial investments	**16**	–
Other operating income/(loss)	**19**	(31)
Total operating income	**1,043**	989
Loan impairment charges and other credit risk provisions	**(79)**	(124)
Net operating income	**964**	865
Total operating expenses	**(408)**	(373)
Operating profit	**556**	492
Share of profit in associates	**11**	31
Profit before income tax expense	**567**	523
Global Banking and Markets		
Net interest income	**179**	159
Net fee income	**98**	83
Net trading income	**68**	103
Gains less losses from financial investments	**40**	54
Other operating income	**1**	1
Net operating income	**386**	400
Loan impairment charges and other credit risk provisions	**(5)**	–
Net operating income	**381**	400
Total operating expenses	**(117)**	(113)
Profit before income tax expense	**264**	287
Retail Banking and Wealth Management		
Net interest income	**413**	505
Net fee income	**223**	203
Net trading income	**18**	19
Gains less losses from financial investments	**–**	4
Other operating income	**8**	13
Total operating income	**662**	744
Loan impairment charges and other credit risk provisions	**(23)**	(64)
Net operating income	**639**	680
Total operating expenses	**(533)**	(549)
Profit before income tax expense	**106**	131
Other		
Net interest expense	**(38)**	(28)
Net trading income	**34**	28
Net expense from financial instruments designated at fair value	**(5)**	(5)
Other operating income	**28**	33
Total operating income	**19**	28
Total operating expenses	**(44)**	(35)
Loss before income tax expense	**(25)**	(7)

Notes on the Consolidated Financial Statements (continued)

8 Segment analysis *(continued)*

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

	Commercial Banking $m	*Global Banking and Markets* $m	*Retail Banking and Wealth Management* $m	*Other* $m	*Total* $m
Year ended 31 December 2014					
Net operating income	**964**	**381**	**639**	**19**	**2,003**
External	**915**	**332**	**737**	**19**	**2,003**
Inter-segment	**49**	**49**	**(98)**	**–**	**–**
Year ended 31 December 2013					
Net operating income	865	400	680	28	1,973
External	845	315	785	28	1,973
Inter-segment	20	85	(105)	–	–

Balance sheet information

	Commercial Banking $m	*Global Banking and Markets* $m	*Retail Banking and Wealth Management* $m	*Other* $m	*Intersegment* $m	*Total* $m
At 31 December 2014						
Loans and advances to customers (net)	**16,093**	**1,642**	**23,484**	**–**	**–**	**41,219**
Customers' liability under acceptances	**4,168**	**855**	**–**	**–**	**–**	**5,023**
Total assets	**29,210**	**44,194**	**27,585**	**421**	**(13,206)**	**88,204**
Customer accounts	**21,645**	**4,939**	**24,259**	**–**	**–**	**50,843**
Acceptances	**4,168**	**855**	**–**	**–**	**–**	**5,023**
Total liabilities	**26,312**	**42,853**	**26,824**	**421**	**(13,206)**	**83,204**
At 31 December 2013						
Loans and advances to customers (net)	15,881	1,203	23,440	–	–	40,524
Customers' liability under acceptances	3,941	816	–	–	–	4,757
Total assets	29,283	39,230	26,467	400	(11,120)	84,260
Customer accounts	21,986	6,185	22,755	–	–	50,926
Acceptances	3,941	816	–	–	–	4,757
Total liabilities	26,426	38,051	25,418	400	(11,120)	79,175

9 Analysis of financial assets and liabilities by measurement basis

Financial assets and financial liabilities are measured on an ongoing basis at either fair value or amortized cost. The following tables analyze the carrying amount of financial assets and liabilities by category as defined in IAS 39 and by balance sheet heading:

	2014						
	Held for trading $m	*Designated at fair value* $m	*Available-for-sale securities* $m	*Financial assets and liabilities at amortized cost* $m	*Derivatives designated as fair value hedging instruments* $m	*Derivatives designated as cash flow hedging instruments* $m	*Total* $m
Financial assets							
Cash and balances at central bank	–	–	–	73	–	–	73
Items in the course of collection from other banks	–	–	–	76	–	–	76
Trading assets	8,914	–	–	–	–	–	8,914
Derivatives	3,591	–	–	–	33	458	4,082
Loans and advances to banks	–	–	–	1,264	–	–	1,264
Loans and advances to customers	–	–	–	41,219	–	–	41,219
Reverse repurchase agreements	–	–	–	6,714	–	–	6,714
Financial investments	–	–	20,122	–	–	–	20,122
Other assets	–	–	–	102	–	–	102
Accrued income	–	–	–	159	–	–	159
Customers' liability under acceptances	–	–	–	5,023	–	–	5,023
Total financial assets	12,505	–	20,122	54,630	33	458	87,748
Financial liabilities							
Deposits by banks	–	–	–	681	–	–	681
Customer accounts	–	–	–	50,843	–	–	50,843
Repurchase agreements	–	–	–	4,054	–	–	4,054
Items in the course of transmission to other banks	–	–	–	105	–	–	105
Trading liabilities	4,227	–	–	–	–	–	4,227
Financial liabilities designated at fair value	–	425	–	–	–	–	425
Derivatives	3,478	–	–	–	163	244	3,885
Debt securities in issue	–	–	–	10,610	–	–	10,610
Other liabilities	–	–	–	2,219	–	–	2,219
Acceptances	–	–	–	5,023	–	–	5,023
Accruals	–	–	–	524	–	–	524
Subordinated liabilities	–	–	–	239	–	–	239
Total financial liabilities	7,705	425	–	74,298	163	244	82,835

Notes on the Consolidated Financial Statements (continued)

9 Analysis of financial assets and liabilities by measurement basis *(continued)*

	2013						
	Held for trading $m	*Designated at fair value* $m	*Available-for-sale securities* $m	*Financial assets and liabilities at amortized cost* $m	*Derivatives designated as fair value hedging instruments* $m	*Derivatives designated as cash flow hedging instruments* $m	*Total* $m
Financial assets							
Cash and balances at central bank	–	–	–	165	–	–	165
Items in the course of collection from other banks	–	–	–	107	–	–	107
Trading assets	6,728	–	–	–	–	–	6,728
Derivatives	1,604	–	–	–	60	448	2,112
Loans and advances to banks	–	–	–	1,149	–	–	1,149
Loans and advances to customers	–	–	–	40,524	–	–	40,524
Reverse repurchase agreements	–	–	–	6,161	–	–	6,161
Financial investments	–	–	21,814	–	–	–	21,814
Other assets	–	–	–	103	–	–	103
Accrued income	–	–	–	182	–	–	182
Customers' liability under acceptances	–	–	–	4,757	–	–	4,757
Total financial assets	8,332	–	21,814	53,148	60	448	83,802
Financial liabilities							
Deposits by banks	–	–	–	635	–	–	635
Customer accounts	–	–	–	50,926	–	–	50,926
Repurchase agreements	–	–	–	1,487	–	–	1,487
Items in the course of transmission to other banks	–	–	–	53	–	–	53
Trading liabilities	4,396	–	–	–	–	–	4,396
Financial liabilities designated at fair value	–	428	–	–	–	–	428
Derivatives	1,518	–	–	–	70	158	1,746
Debt securities in issue	–	–	–	11,348	–	–	11,348
Other liabilities	–	–	–	2,258	–	–	2,258
Acceptances	–	–	–	4,757	–	–	4,757
Accruals	–	–	–	551	–	–	551
Subordinated liabilities	–	–	–	239	–	–	239
Total financial liabilities	5,914	428	–	72,254	70	158	78,824

10 Trading assets

Accounting policy

Financial assets are classified as held for trading if they have been acquired principally for the purpose of selling or repurchasing in the near term, or they form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking. They are recognized on trade date, when the bank enters into contractual arrangements with counterparties, and are normally derecognized when sold. They are initially measured at fair value, with transaction costs taken to the income statement. Subsequent changes in their fair values and interest earned are recognized in the income statement in 'Net trading income'.

	2014 $m	2013 $m
Trading assets:		
not subject to repledge or resale by counterparties	**7,938**	6,294
which may be repledged or resold by counterparties	**976**	434
	8,914	6,728
Canadian and Provincial Government bonds[1]	**1,963**	2,086
Debt securities	**815**	442
Total debt securities	**2,778**	2,528
Bankers' acceptances	**3,254**	2,848
Customer trading assets	**2,208**	885
Treasury and other eligible bills	**674**	467
	8,914	6,728

1 *Including government guaranteed bonds*

	2014 $m	2013 $m
Term to maturity of debt securities		
Less than 1 year	**695**	216
1–5 years	**1,333**	1,422
5–10 years	**514**	651
Over 10 years	**236**	239
	2,778	2,528

11 Derivatives

Accounting policy

Derivatives

Derivatives are initially recognized, and are subsequently re-measured, at fair value. Fair values of derivatives are obtained either from quoted market prices or by using valuation techniques. Derivatives are only offset for accounting purposes if the offsetting criteria are met.

Embedded derivatives are treated as separate derivatives ('bifurcated') when their economic characteristics and risks are not clearly and closely related to those of the host non-derivative contract, their contractual terms would otherwise meet the definition of a stand-alone derivative and the combined contract is not held for trading or designated at fair value. The bifurcated embedded derivatives are measured at fair value with changes therein recognized in the income statement.

Derivatives are classified as assets when their fair value is positive or as liabilities when their fair value is negative. Derivative assets and liabilities arising from different transactions are 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.

Notes on the Consolidated Financial Statements (continued)

11 Derivatives *(continued)*

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

When derivatives are designated as hedges, the bank classifies them as either: (i) hedges of the change in fair value of recognized assets or liabilities or firm commitments ('fair value hedges'); or (ii) hedges of the variability in highly probable future cash flows attributable to a recognized asset or liability, or a forecast transaction ('cash flow hedges').

Hedge accounting

At the inception of a hedging relationship, the bank documents the relationship between the hedging instruments and the hedged items, its risk management objective and its strategy for undertaking the hedge. The bank requires a documented assessment, both at hedge inception and on an ongoing basis, of whether or not the hedging instruments are highly effective in offsetting the changes attributable to the hedged risks in the fair values or cash flows of the hedged items.

Fair value hedge:

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement, along with changes in the fair value of the hedged assets, liabilities or group thereof that contain the hedged risk. If a hedging relationship no longer meets the criteria for hedge accounting, the hedge accounting is discontinued: the cumulative adjustment to the carrying amount of the hedged item is amortized to the income statement on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognized.

Cash flow hedge:

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognized in other comprehensive income; the residual change in fair value is recognized immediately in the income statement.

The accumulated gains and losses recognized in other comprehensive income are reclassified to the income statement in the periods in which the hedged item affects profit or loss. In hedges of forecasted transactions that result in recognition of a non-financial asset or liability, previous gains and losses recognized in other comprehensive income are included in the initial measurement of the asset or liability.

When a hedging relationship is discontinued, any previous cumulative gain or loss recognized in other comprehensive income remains in equity until the forecast transaction is recognized in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss previously recognized in other comprehensive income is immediately reclassified to the income statement.

Hedge effectiveness testing

To qualify for hedge accounting, the bank requires that, at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective both prospectively and retrospectively, on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed and 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, with the effectiveness range being defined as 80% to 125%. Hedge ineffectiveness is recognized in the income statement in 'Net trading income'.

Derivatives that do not qualify for hedge accounting

Non-qualifying hedges are economic hedges entered into as part of documented interest rate management strategies for which hedge accounting was not applied. Changes in fair value of non-qualifying hedges do not alter the cash flows expected as part of the documented management strategies for both the non-qualifying hedge instruments and the related assets and liabilities.

Fair values of derivatives by product contract type held

	2014					
	Assets			**Liabilities**		
	Trading **$m**	*Hedging* **$m**	*Total* **$m**	*Trading* **$m**	*Hedging* **$m**	*Total* **$m**
Foreign exchange	**2,872**	**328**	**3,200**	**2,789**	**177**	**2,966**
Interest rate	**603**	**163**	**766**	**573**	**230**	**803**
Commodity	**116**	**–**	**116**	**116**	**–**	**116**
Gross total fair values	**3,591**	**491**	**4,082**	**3,478**	**407**	**3,885**

	2013					
	Assets			Liabilities		
	Trading $m	*Hedging* $m	*Total* $m	*Trading* $m	*Hedging* $m	*Total* $m
Foreign exchange	1,077	288	1,365	1,030	93	1,123
Interest rate	492	220	712	453	135	588
Commodity	35	–	35	35	–	35
Gross total fair values	1,604	508	2,112	1,518	228	1,746

Notes on the Consolidated Financial Statements (continued)

11 Derivatives *(continued)*

The following tables summarize the notional amounts by remaining term to maturity of the derivative portfolio.

2014

	Trading				**Hedging**				**Total**
	Less than 1 year **$m**	*1 to 5 years* **$m**	*More than 5 years* **$m**	*Total trading* **$m**	*Less than 1 year* **$m**	*Between 1–5 years* **$m**	*Over 5 years* **$m**	*Total hedging* **$m**	**$m**
Interest rate contracts									
Futures	**1,501**	**1,585**	**86**	**3,172**	**–**	**–**	**–**	**–**	**3,172**
Swaps	**7,643**	**22,542**	**9,584**	**39,769**	**6,112**	**17,449**	**6,206**	**29,767**	**69,536**
Caps	**–**	**627**	**–**	**627**	**–**	**–**	**–**	**–**	**627**
Other interest rate contracts	**3,759**	**66**	**–**	**3,825**	**–**	**–**	**–**	**–**	**3,825**
	12,903	**24,820**	**9,670**	**47,393**	**6,112**	**17,449**	**6,206**	**29,767**	**77,160**
Foreign exchange contracts									
Spot contracts	**2,966**	**–**	**–**	**2,966**	**–**	**–**	**–**	**–**	**2,966**
Forward contracts	**73,791**	**3,979**	**66**	**77,836**	**–**	**–**	**–**	**–**	**77,836**
Currency swaps and options	**40,469**	**7,836**	**2,950**	**51,255**	**57**	**3,403**	**–**	**3,460**	**54,715**
	117,226	**11,815**	**3,016**	**132,057**	**57**	**3,403**	**–**	**3,460**	**135,517**
Other derivative contracts									
Commodity contracts	**155**	**12**	**–**	**167**	**–**	**–**	**–**	**–**	**167**
	130,284	**36,647**	**12,686**	**179,617**	**6,169**	**20,852**	**6,206**	**33,227**	**212,844**

2013

	Trading				Hedging				Total
	Less than 1 year $m	*1 to 5 years* $m	*More than 5 years* $m	*Total trading* $m	*Less than 1 year* $m	*Between 1–5 years* $m	*Over 5 years* $m	*Total hedging* $m	$m
Interest rate contracts									
Futures	1,580	–	–	1,580	–	–	–	–	1,580
Swaps	7,844	20,864	4,028	32,736	3,342	19,469	3,701	26,512	59,248
Caps	2	303	–	305	–	–	–	–	305
Other interest rate contracts	3,124	–	–	3,124	–	–	–	–	3,124
	12,550	21,167	4,028	37,745	3,342	19,469	3,701	26,512	64,257
Foreign exchange contracts									
Spot contracts	3,866	–	–	3,866	–	–	–	–	3,866
Forward contracts	56,352	2,904	471	59,727	–	–	–	–	59,727
Currency swaps and options	12,765	7,386	3,590	23,741	870	2,033	213	3,116	26,857
	72,983	10,290	4,061	87,334	870	2,033	213	3,116	90,450
Other derivative contracts									
Commodity contracts	437	130	–	567	–	–	–	–	567
	85,970	31,587	8,089	125,646	4,212	21,502	3,914	29,628	155,274

Use of derivatives

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

The bank'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 in accordance with the bank's approved risk management policies, with matching deals being used to achieve this where necessary. When entering into derivative transactions, the bank employs the same credit risk management procedures that are used for traditional lending to assess and approve potential credit exposures.

Trading derivatives

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

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

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

11 Derivatives *(continued)*

An analysis of the derivative portfolio and related credit exposure

	2014			2013		
	Notional amount[1] $m	Credit equivalent amount[2] $m	Risk-weighted balance[3] $m	Notional amount[1] $m	Credit equivalent amount[2] $m	Risk-weighted balance[3] $m
Interest rate contracts						
Future	**3,172**	**–**	**–**	1,580	–	–
Swaps	**69,536**	**691**	**267**	59,248	1,070	337
Caps	**627**	**2**	**1**	305	6	–
Other interest rate contracts	**3,825**	**7**	**1**	3,124	–	1
	77,160	**700**	**269**	64,257	1,076	338
Foreign exchange contracts						
Spot contracts	**2,966**	**–**	**–**	3,866	–	–
Forward contracts	**77,836**	**967**	**252**	59,727	1,341	226
Currency swaps and options	**54,715**	**1,788**	**476**	26,857	1,470	447
	135,517	**2,755**	**728**	90,450	2,811	673
Other derivative contracts						
Commodity contracts	**167**	**51**	**7**	567	78	25
	212,844	**3,506**	**1,004**	155,274	3,965	1,036

1 *Notional amounts are the contract amounts used to calculate the cash flows to be exchanged. They are a common measure of the volume of outstanding transactions, but do not represent credit or market risk exposure.*

2 *Credit equivalent amount is the current replacement cost plus an amount for future credit exposure associated with the potential for future changes in currency and interest rates. The future credit exposure is calculated using a formula prescribed by OSFI in its capital adequacy guidelines.*

3 *Risk-weighted balance represents a measure of the amount of regulatory capital required to support the derivative activities. It is estimated by risk weighting the credit equivalent amounts according to the credit worthiness of the counterparties using factors prescribed by OSFI in its capital adequacy guidelines*

Interest rate and currency futures are exchange-traded. All other contracts are over-the-counter. The notional or contractual amounts of these instruments indicate the nominal value of transactions outstanding at the reporting date; they do not represent amounts at risk.

Hedging instruments

The bank 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 bank to optimize the overall cost to the bank 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 bank'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 recognized in the income statement. If the hedge relationship is terminated, the fair value adjustment to the hedged item continues to be reported as part of the basis of the item and is amortized to the income statement as a yield adjustment over the remainder of the hedging period.

11 Derivatives *(continued)*

Fair value of derivatives designated as fair value hedges

	2014		2013	
	Assets	*Liabilities*	*Assets*	*Liabilities*
	$m	**$m**	$m	$m
Interest rate	**32**	**163**	60	69

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

	2014	2013
	$m	$m
Gains/(losses)		
– on hedging instruments	**(146)**	81
– on hedged items attributable to the hedged risk	**144**	(80)

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

Cash flow hedges

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

Fair value of derivatives designated as cash flow hedges

	2014		2013	
	Assets	*Liabilities*	*Assets*	*Liabilities*
	$m	**$m**	$m	$m
Foreign exchange	**327**	**176**	288	93
Interest rate	**130**	**67**	160	66

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

	2014			
	3 months or less	*More than 3 months but less than 1 year*	*More than 1 year but less than 5 years*	*5 years or more*
	$m	**$m**	**$m**	**$m**
Assets	**14,033**	**12,249**	**10,028**	**574**
Liabilities	**(6,756)**	**(6,615)**	**(6,340)**	**(785)**
Net cash inflow/(outflow) exposure	**7,277**	**5,634**	**3,688**	**(211)**

Notes on the Consolidated Financial Statements (continued)

11 Derivatives *(continued)*

	2013			
	3 months or less $m	*More than 3 months but less than 1 year* $m	*More than 1 year but less than 5 years* $m	*5 years or more* $m
Assets	12,480	11,827	11,207	376
Liabilities	(8,113)	(7,049)	(6,461)	(762)
Net cash inflow/(outflow) exposure	4,367	4,778	4,746	(386)

The gains and losses on ineffective portions of such derivatives are recognized immediately in 'Net trading income'. During 2014, a gain of $7m (2013: gain of $5m) was recognized due to hedge ineffectiveness.

The following tables summarize the fair values of the bank's derivative portfolio at 31 December segregated between derivatives that are in a favourable or receivable position and those in an unfavourable or payable position. Fair values of derivative instruments are determined using observable inputs (note 24).

	2014						
	Trading			**Hedging**			
	Favourable position **$m**	*Unfavourable position* **$m**	*Net position* **$m**	*Favourable position* **$m**	*Unfavourable position* **$m**	*Net position* **$m**	*Total net position* **$m**
Interest rate contracts							
Swaps	**600**	**(571)**	**29**	**163**	**(230)**	**(67)**	**(38)**
Caps	**3**	**(3)**	**–**	**–**	**–**	**–**	**–**
Other interest rate contracts	**–**	**–**	**–**	**–**	**–**	**–**	**–**
	603	**(574)**	**29**	**163**	**(230)**	**(67)**	**(38)**
Foreign exchange contracts							
Spot contracts	**3**	**(6)**	**(3)**	**–**	**–**	**–**	**(3)**
Forward contracts	**1,239**	**(1,180)**	**59**	**–**	**–**	**–**	**59**
Currency swaps and options	**1,619**	**(1,602)**	**17**	**328**	**(177)**	**151**	**168**
	2,861	**(2,788)**	**73**	**328**	**(177)**	**151**	**224**
Other derivative contracts							
Commodity contracts	**116**	**(116)**	**–**	**–**	**–**	**–**	**–**
	3,580	**(3,478)**	**102**	**491**	**(407)**	**84**	**186**

11 Derivatives *(continued)*

	2013						
	Trading			Hedging			
	Favourable position $m	*Unfavourable position* $m	*Net position* $m	*Favourable position* $m	*Unfavourable position* $m	*Net position* $m	*Total net position* $m
Interest rate contracts							
Swaps	483	(436)	47	220	(135)	85	132
Caps	4	(4)	–	–	–	–	–
Other interest rate contracts	5	(13)	(8)	–	–	–	(8)
	492	(453)	39	220	(135)	85	124
Foreign exchange contracts							
Spot contracts	3	(6)	(3)	–	–	–	(3)
Forward contracts	602	(565)	37	–	–	–	37
Currency swaps and options	472	(459)	13	288	(93)	195	208
	1,077	(1,030)	47	288	(93)	195	242
Other derivative contracts							
Commodity contracts	35	(35)	–	–	–	–	–
	1,604	(1,518)	86	508	(228)	280	366

12 Financial investments

Accounting policy

Treasury bills, debt securities and equity securities intended to be held on a continuing basis, other than those designated at fair value, are classified as available-for-sale. They are recognized on trade date when the bank enters into contractual arrangements to purchase those instruments, and are normally derecognized when either the securities are sold or redeemed.

Available-for-sale financial assets are initially measured at fair value plus direct and incremental transaction costs. They are subsequently re-measured at fair value, and changes therein are recognized in other comprehensive income until they are either sold or become impaired. When available-for-sale financial assets are sold, cumulative gains or losses previously recognized in other comprehensive income are recognized in the income statement as ‘Gains less losses from financial investments’.

Interest income is recognized over the debt asset’s expected life. Premiums and/or discounts arising on the purchase of dated debt securities are included in the interest recognized. Dividends from equity assets are recognized in the income statement when the right to receive payment is established.

The accounting policy related to impairment of available-for-sale securities is presented in note 1(i)

Notes on the Consolidated Financial Statements (continued)

12 Financial investments *(continued)*

Financial investments comprise the following:

	2014 $m	2013 $m
Financial investments		
Not subject to repledge or resale by counterparties	**17,648**	20,468
Which may be repledged or resold by counterparties	**2,474**	1,346
	20,122	21,814
Available-for-sale		
Canadian and Provincial Government bonds[1]	**14,846**	16,534
International Government bonds[1]	**2,947**	3,248
Other debt securities issued by banks and other financial institutions	**1,901**	1,224
Treasury and other eligible bills	**422**	799
Other debt securities	**6**	9
	20,122	21,814

1 *Includes government guaranteed bonds.*

The term to maturity of financial investments are as follows:

	2014 $m	2013 $m
Term to maturity		
Less than 1 year	**4,088**	5,534
1–5 years	**11,417**	13,271
5–10 years	**4,617**	3,004
No specific maturity	**–**	5
	20,122	21,814

13 Interest rate sensitivity

The following table provides an analysis of the interest rate sensitivity position based on contractual repricing dates of assets and liabilities.

	2014									
	Floating rate $m	*Within 3 months* $m	*3–12 months* $m	*Average interest rate* %	*1–5 years* $m	*Average interest rate* %	*Greater than 5 years* $m	*Average interest rate* %	*Non-interest sensitive* $m	*Total* $m
Cash and balances at central bank	–	–	–		–		–		73	73
Items in the course of collection from other banks	–	–	–		–		–		76	76
Trading assets	5,661	3,239	14	1.1	–		–		–	8,914
Derivatives	–	–	–		–		–		4,082	4,082
Loans and advances to banks	–	918	–	1.0	–		–		346	1,264
Loans and advances to customers	23,721	6,577	3,230	3.2	7,407	3.6	146	4.3	138	41,219
Reverse repurchase agreements	–	6,714	–	1.0	–		–		–	6,714
Financial investments	–	3,329	3,256	1.6	9,015	1.4	4,515	2.7	7	20,122
Acceptances	–	–	–		–		–		5,023	5,023
Other assets	–	–	–		–		–		717	717
Total assets	29,382	20,777	6,500		16,422		4,661		10,462	88,204
Deposits by banks	–	116	–	0.2	–		–		565	681
Customer accounts	27,715	3,817	8,007	1.0	1,889	2.4	–		9,415	50,843
Repurchase agreements	–	4,054	–	1.0	–		–		–	4,054
Items in the course of transmission to other banks	–	–	–		–		–		105	105
Trading liabilities	4,227	–	–	1.0	–		–		–	4,227
Financial liabilities designated at fair value	–	–	–		425	4.8	–		–	425
Derivatives	–	–	–		–		–		3,885	3,885
Debt securities in issue	–	3,054	1,824	2.1	3,397	2.9	2,335	3.0	–	10,610
Acceptances	–	–	–		–		–		5,023	5,023
Subordinated liabilities	–	39	–	1.6	200	5.0	–		–	239
Other liabilities	–	–	–		–		–		3,112	3,112
Shareholders' equity	–	–	–		350	5.1	–		4,450	4,800
Non controlling interest	–	–	200	5.2	–		–		–	200
Total liabilities and shareholders' equity	31,942	11,080	10,031		6,261		2,335		26,555	88,204
On-balance sheet gap	(2,560)	9,697	(3,531)		10,161		2,326		(16,093)	–
Off-balance sheet positions	–	(800)	218		4,263		(3,681)		–	–
Total interest rate gap	(2,560)	8,897	(3,313)		14,424		(1,355)		(16,093)	–

Notes on the Consolidated Financial Statements (continued)

13 Interest rate sensitivity *(continued)*

	2013									
	Floating rate $m	*Within 3 months* $m	*3–12 months* $m	*Average interest rate* %	*1–5 years* $m	*Average interest rate* %	*Greater than 5 years* $m	*Average interest rate* %	*Non-interest sensitive* $m	*Total* $m
Cash and balances at central bank	–	–	–		–		–		165	165
Items in the course of collection from other banks	–	–	–		–		–		107	107
Trading assets	3,880	2,821	27	1.1	–		–		–	6,728
Derivatives	–	–	–		–		–		2,112	2,112
Loans and advances to banks	–	605	–	1.0	–		–		544	1,149
Loans and advances to customers	23,913	5,633	2,978	3.1	7,777	3.5	105	4.5	118	40,524
Reverse repurchase agreements	–	6,161	–	1.0	–		–		–	6,161
Financial investments	–	4,364	3,920	1.5	10,571	1.5	2,959	2.6	–	21,814
Acceptances	–	–	–		–		–		4,757	4,757
Other assets	–	–	–		–		–		743	743
Total assets	27,793	19,584	6,925		18,348		3,064		8,546	84,260
Deposits by banks	–	153	–	1.0	–		–		482	635
Customer accounts	26,040	4,722	8,167	1.0	2,969	2.6	–		9,028	50,926
Repurchase agreements	–	1,487	–	1.0	–		–		–	1,487
Items in the course of transmission to other banks	–	–	–		–		–		53	53
Trading liabilities	4,269	–	–	1.0	–		–		127	4,396
Financial liabilities designated at fair value	–	–	–		428	4.8	–		–	428
Derivatives	–	–	–		–		–		1,746	1,746
Debt securities in issue	–	4,070	1,297	1.7	4,643	3.1	1,338	3.1	–	11,348
Acceptances	–	–	–		–		–		4,757	4,757
Subordinated liabilities	–	39	–	1.7	200	5.0	–		–	239
Other liabilities	–	–	–		–		–		3,160	3,160
Shareholders' equity	–	–	250	6.6	350	5.1	–		4,285	4,885
Non controlling interest	–	–	–		200	5.2	–		–	200
Total liabilities and shareholders' equity	30,309	10,471	9,714		8,790		1,338		23,638	84,260
On-balance sheet gap	(2,516)	9,113	(2,789)		9,558		1,726		(15,092)	–
Off-balance sheet positions	–	1,696	(1,088)		1,330		(1,938)		–	–
Total interest rate gap	(2,516)	10,809	(3,877)		10,888		(212)		(15,092)	–

14 Transfers of financial assets not qualifying for derecognition

Accounting policy

Derecognition of financial assets

Financial assets are derecognized when the contractual right to receive cash flows from the assets has expired; or when the bank 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 bank has neither retained nor transferred substantially all the risks and rewards, but has not retained control.

The following table analyzes the carrying amount of financial assets as at 31 December that did not qualify for derecognition during the year and their associated financial liabilities:

Financial assets and associated liabilities transferred not qualifying for derecognition are as follows:

	2014				2013	
	Fair value of assets **$m**	*Fair value of associated liabilities* **$m**	*Carrying amount of assets* **$m**	*Carrying amount of associated liabilities* **$m**	*Carrying amount of assets* $m	*Carrying amount of associated liabilities* $m
Nature of transaction						
Assets securitized..	**1,919**	**1,931**	**1,858**	**1,915**	4,163	4,230
Mortgages sold with recourse...	**1,763**	**1,763**	**1,757**	**1,757**	1,881	1,881
Repurchase agreements	**6,714**	**4,054**	**6,714**	**4,054**	1,487	1,487
	10,396	**7,748**	**10,329**	**7,726**	7,531	7,598

In addition to assets securitized as noted above, the bank has also created $878m (2013: $1,084m) of securitized assets which remain on the bank's balance sheet and have not been transferred.

15 Property, plant and equipment

Accounting policy

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

– freehold land is not depreciated;

– freehold buildings are depreciated over their estimated useful lives, which are generally between 20 and 40 years; and

– leasehold improvements are depreciated over the shorter of their unexpired lease terms of the leases or their remaining useful lives.

Equipment, fixtures and fittings (including equipment on operating leases where the bank is the lessor) are stated at cost less impairment losses and depreciation over their useful lives, which are generally between 3 and 5 years.

Property, plant and equipment is subject to an impairment review if their carrying amount may not be recoverable.

Notes on the Consolidated Financial Statements (continued)

15 Property, plant and equipment *(continued)*

	Freehold land and buildings $m	Leasehold improvements $m	Equipment, fixtures and fittings $m	Total $m
Cost				
At 1 January 2014	**3**	**163**	**97**	**263**
Additions at cost	**–**	**11**	**9**	**20**
Disposals and write-offs	**–**	**(11)**	**(19)**	**(30)**
At 31 December 2014	**3**	**163**	**87**	**253**
Accumulated depreciation and impairment				
At 1 January 2014	**(2)**	**(71)**	**(53)**	**(126)**
Depreciation charge for the year	**–**	**(16)**	**(17)**	**(33)**
Disposals and write-offs	**–**	**11**	**19**	**30**
At 31 December 2014	**(2)**	**(76)**	**(51)**	**(129)**
Net carrying amount at 31 December 2014	**1**	**87**	**36**	**124**

	Freehold land and buildings $m	Leasehold improvements $m	Equipment, fixtures and fittings $m	Total $m
Cost				
At 1 January 2013	3	153	100	256
Additions at cost	–	18	14	32
Disposals and write-offs	–	(8)	(17)	(25)
At 31 December 2013	3	163	97	263
Accumulated depreciation and impairment				
At 1 January 2013	(2)	(62)	(52)	(116)
Depreciation charge for the year	–	(16)	(18)	(34)
Disposals and write-offs	–	7	17	24
At 31 December 2013	(2)	(71)	(53)	(126)
Net carrying amount at 31 December 2013	1	92	44	137

16 Investments in subsidiaries and other entities

Accounting policy

Subsidiaries

The bank classifies investments in entities which it controls as subsidiaries. The bank's consolidation policy is described in note 1(f).

Structured entities

A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, for example when any voting rights relate to administrative tasks only, and key activities are directed by contractual arrangements. Structured entities often have restricted activities and a narrow and well defined objective.

Structured entities are assessed for consolidation in accordance with the accounting policy as set out in note 1(f).

The bank is considered to sponsor another entity if, in addition to ongoing involvement with the entity, it had a key role in establishing that entity or in bringing together the relevant counterparties to a structured transaction. The bank is not considered to be a sponsor if the only involvement with the entity is to provide services at arm's length and it ceases to be a sponsor once it has no ongoing involvement with the structured entity.

16 Investments in subsidiaries and other entities *(continued)*

At 31 December 2014, HSBC Bank Canada wholly-owned the following principal subsidiaries:

Subsidiary	*Place of incorporation*	*Issued equity capital*
HSBC South Point Investments (Barbados) LLP	St. Michael, Barbados	989
HSBC Finance Mortgages Inc.	Toronto, Ontario, Canada	410
HSBC Trust Company (Canada)[1]	Vancouver, British Columbia, Canada	192
HSBC Securities (Canada) Inc.	Toronto, Ontario, Canada	187
HSBC Mortgage Corporation (Canada)	Vancouver, British Columbia, Canada	50
HSBC Global Asset Management (Canada) Limited	Vancouver, British Columbia, Canada	19
HSBC Loan Corporation (Canada)[1]	Vancouver, British Columbia, Canada	10
HSBC Private Wealth Services (Canada) Inc.	Toronto, Ontario, Canada	9
HSBC Capital (Canada) Inc.	Vancouver, British Columbia, Canada	8

1 *Effective 1 January 2015, HSBC Loan Corporation Ltd was amalgamated with HSBC Trust (Canada). This has no impact on the bank's consolidated balance sheet.*

The bank sponsored and organized Performance Trust ('PT'), a multi-seller asset-backed commercial paper conduit, designed to provide collateralized asset-backed financing primarily to its corporate and institutional clients in Canada. The asset-backed commercial paper structure involves PT purchasing financial instruments issued by client-sponsored special purpose entities for cash or PT providing asset-backed financing directly to its clients. PT funds the eligible assets through a Funding Agreement between PT and Regency Trust Inc. ('Regency'), a multi-seller asset-backed commercial paper conduit sponsored by and consolidated into another HSBC group entity.

The bank is the financial services agent for PT for a market-based fee. As the agent, we are responsible for arranging transactions between clients and PT. As at 31 December, 2014, PT had no outstanding activity or balances. The bank provided liquidity facilities to Regency to backstop the liquidity risk of the commercial paper issued by Regency to fund their clients.

See also note 27 in respect of HSBC Canada Asset Trust.

17 Other assets

Accounting policy

Interests in associates

The bank classifies investments in entities over which it has significant influence, and that are not subsidiaries (note 16), as associates.

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

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

	2014 **$m**	2013 $m
Deferred tax	**111**	120
Accounts receivable and other	**92**	75
Investments in associates	**93**	67
Current tax	**29**	34
Due from clients, dealers and clearing corporations	**12**	29
Other non-financial assets	**8**	7
	345	332

Notes on the Consolidated Financial Statements (continued)

18 Goodwill and intangible assets

Accounting policy

Intangible assets

The bank's intangible assets include both purchased and internally generated computer software. The cost of internally generated software comprises all directly attributable costs necessary to create, produce and prepare the software to be capable of operating in the manner intended by management. Costs incurred in the ongoing maintenance of software are expensed immediately as incurred.

Intangible assets are subject to impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable. Computer software is stated at cost less amortization and accumulated impairment losses and is amortized over the estimated useful life of between 3 and 5 years.

	2014 **$m**	2013 $m
Goodwill	**23**	23
Computer software	**39**	45
	62	68

No goodwill impairment was recognized in 2014 or 2013.

19 Trading liabilities

Accounting policy

Trading liabilities 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 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. They are recognized on trade date, when the bank enters into contractual arrangements with counterparties, and are normally derecognized when extinguished. They are initially measured at fair value, with subsequent changes in fair value and interest paid recognized in the income statement in 'Net trading income'.

	2014 **$m**	2013 $m
Other liabilities – net short positions	**3,910**	3,617
Customer trading liabilities	**282**	442
Trading liabilities due to other banks	**18**	300
Other debt securities in issue	**17**	37
	4,227	4,396

20 Debt securities in issue

Accounting policy

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

	2014	2013
	$m	$m
Bonds and medium-term notes	**10,029**	10,299
Money market instruments	**581**	1,049
	10,610	11,348

Debt securities are recorded at cost

Term to maturity		
Less than 1 year	**3,712**	3,365
1–5 years	**5,553**	6,659
Over 5 years	**1,345**	1,324
	10,610	11,348

21 Financial liabilities designated at fair value

Accounting policy

Financial instruments, other than those held for trading, are classified in this category if they meet the necessary criteria set out below, and are so designated irrevocably at inception. The bank may designate financial instruments at fair value when the designation:

- eliminates or significantly reduces measurement or recognition inconsistencies that would otherwise arise from measuring financial instruments, or recognizing gains and losses on different bases from related positions. Under this criterion, the main classes of financial liabilities designated by the bank are issued debt securities and subordinated debt. The interest payable on certain fixed rate long-term debt instruments issued has been matched with certain interest rate swaps as part of a documented interest rate risk management strategy. An accounting mismatch would arise if the debt instruments issued were accounted for at amortized cost, and this mismatch is eliminated through the fair value designation;

- applies to groups of financial instruments that are managed, and their performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, and where information about the groups of financial instruments is reported to management on that basis;

- relates to financial instruments containing one or more non-closely related embedded derivatives.

The fair value designation, once made, is irrevocable. Designated financial liabilities are recognized when the bank enters into the contracts with counterparties, which is generally on trade date, and are normally derecognized when extinguished.

	2014	2013
	$m	$m
Subordinated debentures (note 23)	**425**	428

The carrying amount at 31 December 2014 of financial liabilities designated at fair value was $25m higher (2013: $28m higher) than the contractual amount at maturity. At 31 December 2014, the cumulative amount of change in fair value attributable to changes in credit risk was a gain of $2m (2013: $2m gain).

Notes on the Consolidated Financial Statements (continued)

22 Other liabilities

Accounting policy

Provisions

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

	2014 **$m**	2013 $m
Mortgages sold with recourse	**1,756**	1,882
Accounts payable	**346**	274
Provisions and other non-financial liabilities	**143**	153
Share-based payment liability	**19**	20
Current tax	**15**	9
	2,279	2,338

23 Subordinated liabilities

Subordinated debentures, which are unsecured and subordinated in right of payment to the claims of depositors and certain other creditors, comprise:

		Carrying amount	
Interest rate (%)	*Year of maturity*	**2014** **$m**	2013 $m
Issued to third parties			
4.94[1]	2021	**200**	200
4.80[2]	2022	**425**	428
30 day bankers' acceptance rate plus 0.50%	2083	**39**	39
Total debentures		**664**	667
Less: designated at fair value (note 21)		**(425)**	(428)
Debentures at amortized cost		**239**	239

1 *The interest rate is fixed at 4.94% until March 2016 and thereafter the rate reprices at the 90 day average bankers' acceptance rate plus 1%.*

2 *Interest rate is fixed at 4.8% until April 2017 and thereafter interest is payable at an annual rate equal to the 90 day bankers' acceptance rate plus 1%. These debentures are designated as held for trading under the fair value option*

24 Fair values of financial instruments

Accounting policy

Valuation of financial instruments

All financial instruments are recognized initially at fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value of a financial instrument on initial recognition is the transaction price (that is, the fair value of the consideration given or received). However, sometimes the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates.

The fair value of financial instruments is generally measured on an individual basis. However, in cases where the bank manages a group of financial assets and liabilities according to its net market or credit risk exposure, the bank measures the fair value of the group of financial instruments on a net basis but presents the underlying financial assets and liabilities separately in the financial statements, unless they satisfy the IFRS offsetting criteria as described in note 32.

24 Fair values of financial instruments *(continued)*

Control framework

Fair values are subject to a control framework designed to ensure that they are either determined, or validated, by a function independent of the risk-taker. To this end, ultimate responsibility for the determination of fair values lies with the bank's finance department, ('Finance'). Finance establishes the accounting policies and procedures governing valuation, and is responsible for ensuring that they comply with all relevant accounting standards.

For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is utilized. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the bank will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, inter alia:

- the extent to which prices may be expected to represent genuine traded or tradable prices;
- the degree of similarity between financial instruments;
- the degree of consistency between different sources;
- the process followed by the pricing provider to derive the data;
- the elapsed time between the date to which the market data relates and the reporting date; and
- the manner in which the data was sourced.

Models provide a logical framework for the capture and processing of necessary valuation inputs. For fair values determined using a valuation model, the control framework may include, as applicable, independent development or validation of (i) the logic within valuation models; (ii) the inputs to those models; (iii) any adjustments required outside the valuation models; and, (iv) where possible, model outputs. Valuation models are subject to a process of due diligence and calibration before becoming operational and are calibrated against external market data on an ongoing basis.

Determination of fair value

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal, or in its absence, the most advantageous market to which the Bank has access at that date. The fair value of a liability reflects its non-performance risk.

Fair values are determined according to the following hierarchy:

(a) *Level 1 – quoted market price:* financial instruments with quoted prices for identical instruments in active markets.

(b) *Level 2 – valuation technique using observable inputs*: financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

(c) *Level 3 – valuation technique with significant unobservable inputs*: financial instruments valued using models where one or more significant inputs are unobservable.

The best evidence of fair value is a quoted price in an actively traded market. In the event that the market for a financial instrument is not active, a valuation technique is used. The judgement as to whether a market is active may include, but is not restricted to, the consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads. In inactive markets, obtaining assurance that the transaction price provides evidence of fair value or determining the adjustments to transaction prices that are necessary to measure the fair value of the instrument requires additional work during the valuation process.

24 Fair values of financial instruments *(continued)*

Valuation techniques incorporate assumptions about factors that other market participants would use in their valuations. A range of valuation techniques is employed, dependent upon the instrument type and available market data. Most valuation techniques are based upon discounted cash flow analysis, in which expected future cash flows are calculated and discounted to present value using a discounting curve. Prior to consideration of credit risk, the expected future cash flows may be known, as would be the case for the fixed leg of an interest rate swap, or may be uncertain and require projection, as would be the case for the floating leg of an interest rate swap. Projection utilizes market forward curves, if available. In option models, the probability of different potential future outcomes must be considered. In addition, the value of some products are dependent upon more than one market factor, and in these cases it will typically be necessary to consider how movements in one market factor may impact the other market factors. The model inputs necessary to perform such calculations include interest rate yield curves, exchange rates, volatilities, correlations, prepayment and default rates. For interest rate derivatives with collateralized counterparties and in significant currencies, HSBC uses a discounting curve that reflects the overnight interest rate.

The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them, the derivation of fair value is more judgmental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's carrying amount and/ or inception profit ('day 1 gain and loss') is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the level at which an arm's length transaction would be likely to occur. It generally does not mean that there is no market data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used). Furthermore, in some cases the majority of the fair value derived from a valuation technique with significant unobservable inputs may be attributable to the observable inputs. Consequently, the effect of uncertainty in the determining unobservable inputs will generally be restricted to uncertainty about the overall fair value of the financial instrument being measured.

In certain circumstances, primarily where debt is hedged with interest rate derivatives or structured notes issued, the bank uses fair value to measure the carrying value of its own debt in issue. The bank records its own debt in issue at fair value, based on quoted prices in an active market for the specific instrument concerned, if available. When quoted market prices are unavailable, the own debt in issue is valued using valuation techniques, the inputs for which are either based upon quoted prices in an inactive market for the instrument, or are estimated by comparison with quoted prices in an active market for similar instruments. In both cases, the fair value includes the effect of applying the credit spread which is appropriate to the bank's liabilities. For all issued debt securities, discounted cash flow modelling is used to separate the change in fair value that may be attributed to the bank's credit spread movements from movements in other market factors such as benchmark interest rates or foreign exchange rates. Specifically, the change in fair value of issued debt securities attributable to the bank's own credit spread is computed as follows: for each security at each reporting date, an externally verifiable price is obtained or a price is derived using credit spreads for similar securities for the same issuer. Then, using discounted cash flow, each security is valued using a risk-free discount curve. The difference in the valuations is attributable to the bank's own credit spread. This methodology is applied consistently across all securities.

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and are measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the bank would issue structured notes.

Gains and losses arising from changes in the credit spread of liabilities issued by the bank reverse over the contractual life of the debt, provided that the debt is not repaid early. All net positions in non-derivative financial instruments, and all derivative portfolios, are valued at bid or offer prices as appropriate. Long positions are marked at bid prices; short positions are marked at offer prices.

The fair value of a portfolio of financial instruments quoted in an active market is calculated as the product of the number of units and its quoted price and no block discounts are made.

Transaction costs are not included in the fair value calculation, nor are the future costs of administering the over the counter derivative portfolio. These, along with trade origination costs such as brokerage fees and post-trade costs, are included either in 'Fee expense' or in 'Total operating expenses'.

A detailed description of the valuation techniques applied to instruments of particular interest follows:

– *Private equity*

The bank's private equity portfolios are classified as investments in associates, held at fair value, are not traded in active markets. In the absence of an active market, an investment's fair value is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership. The exercise of judgment is required because of uncertainties inherent in estimating fair value for private equity investments.

– *Debt securities, treasury and other eligible bills, and equities*

The fair value of these instruments is based on quoted market prices from an exchange, dealer, broker, industry group or pricing service, when available. When unavailable, the fair value is determined by reference to quoted market prices for similar instruments, adjusted as appropriate for the specific circumstances of the instruments.

In the absence of quoted market prices, fair value is determined using valuation techniques based on the calculation of the present value of expected future cash flows of the assets. The inputs to these valuation techniques are derived from observable market data and, where relevant, assumptions in respect of unobservable inputs.

– *Derivatives*

Over-the-counter (i.e. non-exchange traded) derivatives are valued using valuation models. Valuation models calculate the present value of expected future cash flows, based upon 'no-arbitrage' principles. For many vanilla derivative products, such as interest rate swaps and European options, the modeling approaches used are standard across the industry. For more complex derivative products, there may be some differences in market practice. Inputs to valuation models are determined from observable market data wherever possible, including prices available from exchanges, dealers, brokers or providers of consensus pricing. Certain inputs may not be observable in the market directly, but can be determined from observable prices via model calibration procedures. Finally, some inputs are not observable, but can generally be estimated from historical data or other sources. Examples of inputs that are generally observable include foreign exchange spot and forward rates, benchmark interest rate curves and volatility surfaces for commonly traded option products. Examples of inputs that may be unobservable include volatility spreads, in whole or in part, for less commonly traded option products, and correlations between market factors such as foreign exchange rates, interest rates and equity prices.

As a result of changing practices in response to regulatory and accounting changes, as well as general market developments, the bank has previously adopted a number of methodologies for applying certain adjustments relating to the valuation of derivative instruments. Previously, this has included credit and debit valuation adjustments relating to counter-party and own credit risk in the measurement of the fair values of derivatives. Historically, the bank has valued uncollateralized derivatives by discounting expected future cash flows at a benchmark interest rate, typically Canadian Dealer Offered Rate or its equivalent. In line with evolving industry practice, HSBC changed this approach in 2014. HSBC now views the Overnight Indexed Swap ("OIS") curve as the base discounting curve for all derivatives, both collateralized and uncollateralized, and has adopted a 'funding fair value adjustment' to reflect the funding of uncollateralized derivative exposure at rates other than OIS. As at 31 December 2014, the funding fair value adjustment was $4m and the impact of initially adopting the funding fair value adjustment was a reduction in trading revenues in 2014 of the same amount. This is an area in which a full industry consensus has not yet emerged. The bank will continue to monitor industry evolution and refine the calculation methodology as necessary.

Derivative products valued using valuation techniques with significant unobservable inputs comprise certain long-dated foreign exchange options.

– *Structured notes*

The fair value of structured notes is derived from the fair value of the underlying debt security as described above, and the fair value of the embedded derivative is determined as described in the paragraph above on derivatives.

Trading liabilities valued using a valuation technique with significant unobservable inputs comprised equity-linked structured notes, which are issued by HSBC and provide the counterparty with a return that is linked to the performance of certain equity securities. The notes are classified as Level 3 due to the unobservability of parameters such as long-dated equity volatilities, correlations between equity prices and interest rates and between interest rates and foreign exchange rates.

Notes on the Consolidated Financial Statements (continued)

24 Fair values of financial instruments *(continued)*

Bases of valuing financial assets and liabilities measured at fair value

The table below provides an analysis of the various bases described above which have been deployed for valuing financial assets and financial liabilities measured at fair value in the consolidated financial statements.

	Valuation techniques			
	Level 1 Quoted market price $m	*Level 2 using observable inputs* $m	*Level 3 with significant unobservable inputs* $m	*Total* $m
At 31 December 2014				
Assets				
Trading assets	**2,680**	**6,234**	**–**	**8,914**
Derivatives	**–**	**4,042**	**40**	**4,082**
Financial investments: available-for-sale	**17,078**	**3,044**	**–**	**20,122**
Liabilities				
Trading liabilities	**3,753**	**468**	**6**	**4,227**
Financial liabilities at fair value	**–**	**425**	**–**	**425**
Derivatives	**–**	**3,845**	**40**	**3,885**
At 31 December 2013				
Assets				
Trading assets	2,754	3,974	–	6,728
Derivatives	–	2,078	34	2,112
Financial investments: available-for-sale	19,143	2,671	–	21,814
Liabilities				
Trading liabilities	3,470	917	9	4,396
Financial liabilities at fair value	–	428	–	428
Derivatives	–	1,712	34	1,746

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy

	Assets		Liabilities	
	Available-for-sale $m	*Derivatives* $m	*Held for trading* $m	*Derivatives* $m
At 1 January 2014	**–**	**34**	**9**	**34**
Total gains or losses recognized in profit or loss	**–**	**5**	**–**	**5**
Settlements	**–**	**–**	**(1)**	**–**
Transfer out	**–**	**(14)**	**(3)**	**(14)**
Transfer in	**–**	**15**	**1**	**15**
At 31 December 2014	**–**	**40**	**6**	**40**
Total gains or losses recognized in profit or loss relating to those assets and liabilities held at the end of the reporting period	**–**	**5**	**–**	**5**

24 Fair values of financial instruments *(continued)*

Bases of valuing financial assets and liabilities measured at fair value (continued)

	Assets		Liabilities	
	Available-for-sale $m	*Derivatives* $m	*Held for trading* $m	*Derivatives* $m
At 1 January 2013	9	5	49	7
Total gains or losses recognized in profit or loss	1	34	1	32
Issues	–	–	15	–
Settlements	(10)	–	(1)	–
Transfer out	–	(5)	(55)	(5)
At 31 December 2013	–	34	9	34
Total gains or losses recognized in profit or loss relating to those assets and liabilities held at the end of the reporting period	–	34	–	34

During 2014 and 2013, there were no significant transfers between Level 1 and 2.

For assets and liabilities classified as held for trading, realized and unrealized gains and losses are presented in the income statement under 'Trading income excluding net interest income'. Fair value changes on long-term debt designated at fair value and related derivatives are presented in the income statement under 'Changes in fair value of long-term debt issued and related derivatives'. The income statement line item 'Net income from financial instruments designated at fair value' captures fair value movements on all other financial instruments designated at fair value and related derivatives.

Realized gains and losses from available-for-sale securities are presented under 'Gains less losses from financial investments' in the income statement while unrealized gains and losses are presented in 'Fair value gains' taken to equity within 'Available-for-sale investments' in other comprehensive income.

Fair values of financial instruments not carried at fair value

Fair values at the balance sheet date of the assets and liabilities set out below are estimated for the purpose of disclosure at follows:

i) *Loans and advances to banks and customers*

The fair value of loans and advances is based on observable market transactions, where available. In the absence of observable market transactions, fair value is estimated using discounted cash flow models. Performing loans are grouped, as far as possible, into homogeneous pools segregated by maturity and coupon rates. In general, contractual cash flows are discounted using the bank's estimate of the discount rate that a market participant would use in valuing instruments with similar maturity, repricing and credit risk characteristics.

The fair value of a loan portfolio reflects both loan impairments at the reporting date and estimates of market participants' expectations of credit losses over the life of the loans. For impaired loans, fair value is estimated by discounting the future cash flows over the time period in which they are expected to be recovered.

ii) *Deposits by banks and customer accounts*

For the purposes of estimating fair value, deposits by banks and customer accounts are grouped by residual maturity. Fair values are estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of a deposit repayable on demand approximates its book value.

iii) *Debt securities in issue and subordinated liabilities*

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

Notes on the Consolidated Financial Statements (continued)

24 Fair values of financial instruments *(continued)*

Fair values of financial instruments not carried at fair value (continued)

The fair values in this note are stated at a specific date and may be significantly different from the amounts which will actually be paid on the maturity or settlement dates of the instruments. In many cases, it would not be possible to realize immediately the estimated fair values given the size of the portfolios measured. Accordingly, these fair values do not represent the value of these financial instruments to the bank as a going concern.

For all classes of financial instruments, fair value represents the product of the value of a single instrument, multiplied by the number of instruments held.

The following table lists financial instruments whose carrying amount is a reasonable approximation of fair value because, for example, they are short-term in nature or reprice to current market rates frequently:

Assets	*Liabilities*
Cash and balances at central bank	Items in the course of transmission to other banks
Items in the course of collection from other banks	Acceptances
Customers' liability under acceptances	Short-term payables within 'Other liabilities'
Short-term receivables within 'Other assets'	Accruals
Accrued income	

Fair values of financial instruments which are not carried at fair value on the consolidated balance sheet are as follows:

	2014					2013	
	Carrying amount **$m**	*Fair value* **$m**	*Level 1 Quoted market price* **$m**	*Level 2 using observable inputs* **$m**	*Level 3 with significant unobservable inputs* **$m**	*Carrying amount* $m	*Fair value* $m
Assets							
Loans and advances to banks	**1,264**	**1,264**	**–**	**1,264**	**–**	1,149	1,149
Loans and advances to customers	**41,219**	**41,311**	**–**	**168**	**41,143**	40,524	40,593
Reverse repurchase agreements	**6,714**	**6,714**	**–**	**6,714**	**–**	6,161	6,161
Liabilities							
Deposits by banks	**681**	**681**	**–**	**681**	**–**	635	635
Customer accounts	**50,843**	**50,882**	**–**	**37,686**	**13,196**	50,926	51,001
Repurchase agreements	**4,054**	**4,054**	**–**	**4,054**	**–**	1,487	1,487
Debt securities in issue	**10,610**	**10,765**	**–**	**10,765**	**–**	11,348	11,498
Subordinated liabilities	**239**	**247**	**–**	**247**	**–**	239	236

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

Assets charged as security for liabilities and contingent obligations

In the ordinary course of business, we pledge assets recorded on our consolidated balance sheet in relation to securitization activity, mortgages sold with recourse, securities lending and securities sold under repurchase agreements. These transactions are conducted under terms that are usual and customary to standard securitization, mortgages sold with recourse, securities lending and repurchase agreements. In addition, we also pledge assets to secure our obligations within payment and depository clearing systems.

Financial assets pledged to secure recognized liabilities on the balance sheet and obligations within payment and depository clearing systems:

	2014	2013
	$m	$m
Cash	**628**	263
Residential mortgages	**3,122**	4,418
Debt securities	**4,783**	3,246
	8,533	7,927

The bank is required to pledge assets to secure its obligations in the Large Value Transfer System ('LVTS'), which processes electronically in real-time large value and time-critical payments in Canada. In the normal course of business, pledged assets are released upon settlement of the bank's obligations at the end of each business day. Only in very rare circumstances are we required to borrow from the Bank of Canada to cover any settlement obligations. Under those circumstances, the pledged assets would be used to secure the borrowing. No amounts were outstanding under this arrangement at 31 December 2014 or 2013. Consequently, the assets pledged with respect to the bank's LVTS obligations have not been included in the table above.

Collateral accepted as security for assets

The fair value of financial assets accepted as collateral that the bank is permitted to sell or repledge in the absence of default is $7,457m (2013: $6,727m). The fair value of financial assets accepted as collateral that have been sold or repledged is $4,702m (2013: $2,651m). The bank is obliged to return equivalent assets.

These transactions are conducted under terms that are usual and customary to standard securities borrowing and reverse repurchase agreements.

Notes on the Consolidated Financial Statements (continued)

26 Share capital

Accounting policy

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

Authorized:

Preferred – Unlimited number of Class 1 preferred shares in one or more series and unlimited number of Class 2 preferred shares in one or more series. We may, from time to time, divide any unissued Class 1 preferred shares into separate series and fix the number of shares in each series along with the associated rights, privileges, restrictions and conditions.

Common – 993,677,000 shares.

Issued and fully paid:

	2014		2013	
	Number of shares	*Share capital* **$m**	*Number of shares*	*Share capital* $m
Preferred shares Class 1				
Series C[1]	**7,000,000**	**175**	7,000,000	175
Series D[2]	**7,000,000**	**175**	7,000,000	175
Series E[3]	**–**	**–**	10,000,000	250
	14,000,000	**350**	24,000,000	600
Common Shares	**498,668,000**	**1,225**	498,668,000	1,225

1 *The shares are non-voting, non-cumulative and redeemable. Each share yields 5.1%, payable quarterly, as and when declared. During 2014 and 2013, $9m in dividends were declared and paid. Subject to regulatory approval, we may redeem the shares, in whole or in part, for cash at a declining premium up to 30 June 2014, and at par thereafter. In each case, declared and unpaid dividends will also be paid thereon to the date fixed for redemption.*

We may also, at any time, but only with the prior consent of the regulator, give shareholders notice that they have the right, at their option, to convert their shares into a new series of Class 1 Preferred Shares on a share-for-share basis.

2 *The shares are non-voting, non-cumulative and redeemable. Each share yields 5%, payable quarterly, as and when declared. During 2014 and 2013, $9m in dividends were declared and paid.*

Subject to regulatory approval, we may redeem the shares, in whole or in part, for cash at a declining premium up to 31 December 2014, and at par thereafter. In each case, declared and unpaid dividends will also be paid thereon to the date fixed for redemption.

We may also, at any time but only with the prior consent of the regulator, give shareholders notice that they have the right, at their option, to convert their shares into a new series of Class 1 Preferred Shares on a share-for-share basis.

3 *The shares were non-voting, non-cumulative and redeemable shares with a par value of $25 each. Each share yields 6.6%, payable quarterly, as and when declared. During 2014 and 2013, respectively $8m and $16m, in dividends were declared and paid.*

Dividend restrictions:

We have covenanted that if the Trust fails to pay the indicated yield in full on the HSBC HaTS™, we will not declare dividends on any of our shares unless the Trust first pays the indicated yield (note 27).

27 Non-controlling interest in trust and subsidiary

Non-controlling interest in trust and subsidiary comprises:

	2014	2013
	$m	$m
HSBC Canada Asset Trust	**200**	200
	200	200

HSBC Canada Asset Trust

HSBC Canada Asset Trust ('the Trust') is a closed-end trust. The Trust was established by HSBC Trust Company (Canada), our wholly-owned subsidiary, as trustee. The Trust's objective is to hold qualifying assets which will generate net income for distribution to holders of securities issued by the Trust ('HSBC HaTS™'). The Trust assets are primarily undivided co-ownership interests in pools of Canada Mortgage and Housing Corporation and Genworth Financial Mortgage Insurance Company Canada insured first mortgages originated by the bank, and Trust deposits with the bank.

Unless we fail to declare dividends on our preferred shares, the Trust will make non-cumulative, semi-annual cash distributions to the holders of the HSBC HaTS™. We have covenanted that if the Trust fails to pay the indicated yield in full on the HSBC HaTS™, we will not declare dividends on any of our shares unless the Trust first pays the indicated yield (note 26).

	2014		2013	
	Units	**$m**	Units	$m
HaTS™ – Series 2015	**200,000**	**200**	200,000	200

Each Series 2015 unit was issued at $1,000 per unit to provide an effective annual yield of 5.149% to 30 June 2015 and the six month bankers' acceptance rate plus 1.5% thereafter. The units are not redeemable by the holders. The Trust may redeem the units from 30 June 2010 and on any distribution date thereafter, subject to payment of a premium in certain circumstances and regulatory approval.

Notes on the Consolidated Financial Statements (continued)

28 Notes on the statement of cash flows

Non-cash items included in profit before tax	**2014 $m**	2013 $m
Depreciation and amortization	**50**	48
Share-based payment expense	**12**	9
Loan impairment charges and other credit risk provisions	**107**	188
Charge for defined benefit pension plans	**20**	20
	189	265

Change in operating assets		
Change in prepayment and accrued income	**20**	(41)
Change in net trading securities and net derivatives	**(2,134)**	235
Change in loans and advances to customers	**(802)**	1,745
Change in reverse repurchase agreements – non-trading	**(142)**	(2,713)
Change in other assets	**(279)**	190
	(3,337)	(584)

Change in operating liabilities		
Change in accruals and deferred income	**(27)**	23
Change in deposits by banks	**46**	(521)
Change in customer accounts	**(83)**	4,633
Change in repurchase agreements – non-trading	**2,567**	(1,541)
Change in debt securities in issue	**(738)**	(632)
Change in financial liabilities designated at fair value	**(3)**	(8)
Change in other liabilities	**158**	(107)
	1,920	1,847

Interest		
Interest paid	**(715)**	(714)
Interest received	**1,910**	2,033

Cash and cash equivalents

Accounting policy

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 the central bank, debt securities, loans and advances to banks, items in the course of collection from or in transmission to other banks and certificates of deposit.

	2014 $m	2013 $m
Cash and balances at central bank	**73**	165
Items in the course of collection from other banks, net	**(29)**	54
Loans and advances to banks of one month or less	**1,264**	1,149
Reverse repurchase agreements with banks of one month or less	**744**	333
T-Bills and certificates of deposits – three months or less	**285**	195
	2,337	1,896

29 Contingent liabilities, contractual commitments and guarantees

Accounting policy

Contingent liabilities

Contingent liabilities are possible obligations that arise from past events whose existence will be confirmed by uncertain future events not wholly within the control of the bank; or are present obligations that have arisen from past events where it is not probable that settlement will require the outflow of economic benefits or because the amount of settlement cannot be reliably measured. Contingent liabilities are not recognized in the balance sheet but are disclosed unless the probability of settlement is remote.

Financial guarantee contracts

Liabilities under financial guarantee contracts are recorded initially at their fair value, which is generally the fee received or receivable. Subsequently, financial guarantee liabilities are measured at the higher of the initial fair value, less cumulative amortization, and the best estimate of the expenditure required to settle the obligations.

	2014	2013
	$m	$m
Guarantees and other contingent liabilities		
Guarantees and irrevocable letters of credit pledged as collateral security	**5,230**	3,940
Commitments		
Undrawn formal standby facilities, credit lines and other commitments to lend[1]	**37,239**	34,588
Documentary credits and short-term trade-related transactions	**572**	540
	37,811	35,128

1 *Based on original contractual maturity.*

The table above discloses the nominal principal amounts of commitments, guarantees and other contingent liabilities. They are mainly credit-related instruments which include both financial and non-financial guarantees and commitments to extend credit. Nominal principal amounts represent the amounts at risk should contracts be fully drawn upon and clients default. As a significant portion of guarantees and commitments is expected to expire without being drawn upon, the total of these nominal principal amounts is not representative of future liquidity requirements.

Litigation

We are subject to a number of legal proceedings arising in the normal course of our business. We do not expect the outcome of any of these proceedings, in aggregate, to have a material effect on our consolidated financial position or our result of operations.

HSBC global disclosures

In October 2010, HSBC Bank USA (‘HBUS’) entered into a consent cease and desist order with the Office of the Comptroller of the Currency (the ‘OCC’) and the indirect parent of that company, HSBC North America Holdings Inc. (‘HNAH’), entered into a consent cease and desist order with the Federal Reserve Board (the ‘Orders’). These Orders required improvements to establish an effective compliance risk management programme across HSBC’s US businesses, including risk management related to US Bank Secrecy Act (‘BSA’) and anti-money laundering (‘AML’) compliance. Steps continue to be taken to address the requirements of the Orders.

In December 2012, HSBC Holdings, HNAH and HBUS entered into agreements with US and UK government agencies regarding past inadequate compliance with the BSA, AML and sanctions laws. Among those agreements, HSBC Holdings and HBUS entered into a five-year deferred prosecution agreement with the US Department of Justice (‘DoJ’), the US Attorney’s Office for the Eastern District of New York, and the US Attorney’s Office for the Northern District of West Virginia (the ‘US DPA’); HSBC Holdings entered into a two-year deferred prosecution agreement with the New York County District Attorney (the ‘DANY DPA’); and HSBC Holdings consented to a cease and desist order and HSBC Holdings and HNAH consented to a civil money penalty order with the Federal Reserve Board. In addition, HBUS entered into a civil money penalty order with Financial Crimes Enforcement Network and a separate civil money penalty order with the OCC. HSBC Holdings also entered into an agreement with the Office of Foreign Assets Control (‘OFAC’) regarding historical transactions involving parties subject to OFAC sanctions and an undertaking with the UK Financial Conduct Authority (‘FCA’), to comply with certain forward-looking AML and sanctions-related obligations.

Notes on the Consolidated Financial Statements (continued)

29 Contingent liabilities, contractual commitments and guarantees *(continued)*

Under these agreements, HSBC Holdings and HBUS made payments totalling US$1.9bn to US authorities and are continuing to comply with ongoing obligations. In July 2013, the US District Court for the Eastern District of New York approved the US DPA and retained authority to oversee implementation of that agreement. Under the agreements with the DoJ, FCA, and the FRB, an independent monitor (who is, for FCA purposes, a 'skilled person' under Section 166 of the Financial Services and Markets Act) is evaluating and regularly assessing the effectiveness of HSBC's AML and sanctions compliance function and HSBC's progress in implementing its remedial obligations under the agreements.

HSBC Holdings fulfilled all of the requirements imposed by the DANY DPA which expired at the end of the two-year period of that agreement in December 2014. If HSBC Holdings and HBUS fulfil all of the requirements imposed by the US DPA, the DoJ charges against those entities will be dismissed at the end of the five-year period of that agreement. The DoJ may prosecute HSBC Holdings or HBUS in relation to the matters that are the subject of the US DPA if HSBC Holdings or HBUS breaches the terms of the US DPA.

HBUS entered into a separate consent order with the OCC requiring it to correct the circumstances and conditions as noted in the OCC's then most recent report of examination, and imposing certain restrictions on HBUS directly or indirectly acquiring control of, or holding an interest in, any new financial subsidiary, or commencing a new activity in its existing financial subsidiary, unless it receives prior approval from the OCC. HBUS also entered into a separate consent order with the OCC requiring it to adopt an enterprise-wide compliance programme.

The settlement with US and UK authorities has resulted in private litigation, and does not preclude further private litigation relating to HSBC's compliance with applicable AML, BSA and sanctions laws or other regulatory or law enforcement actions for AML, BSA or sanctions matters not covered by the various agreements.

In July 2014, a claim was filed in the Ontario Superior Court of Justice against HSBC Holdings and one of its former employees purportedly on behalf of a class of persons that purchased HSBC common shares and American Depositary Shares ('ADSs') between July 2006 and July 2012. The complaint, which seeks monetary damages of up to $20bn, alleges that the defendants made statutory and common law misrepresentations in documents released by HSBC Holdings and the bank relating to HSBC's compliance with AML, BSA, sanctions and other laws. This matter is at an early stage. Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of this matter, including the timing or any possible impact on HSBC.

Guarantees

The bank provides guarantees and similar undertakings on behalf of both third party customers and other entities within the bank. These guarantees are generally provided in the normal course of the bank's banking business. The principal types of guarantees provided, and the maximum potential amount of future payments which the bank could be required to make at 31 December, were as follows:

	2014	2013
Guarantees in favour of third parties	**$m**	$m
Guarantee type		
Financial guarantee contracts[1]	**2,489**	1,663
Performance bonds[2]	**2,741**	2,277
	5,230	3,940

1 *Financial guarantees contracts require the issuer to make specified payments to reimburse the holder for a loss incurred because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. The amounts in the above table are nominal principal amounts.*

2 *Performance bonds, bid bonds, standby letters of credit and other transaction-related guarantees are undertakings by which the obligation on the bank and/or the bank to make payment depends on the outcome of a future event.*

The amounts disclosed in the above table reflect the bank's maximum exposure under a large number of individual guarantee undertakings. The risks and exposures arising from guarantees are captured and managed in accordance with the bank's overall credit risk management policies and procedures. Guarantees with terms of more than one year are subject to the bank's annual credit review process.

29 Contingent liabilities, contractual commitments and guarantees *(continued)*

Credit enhancements

The bank provides partial program-wide credit enhancements to the multi-seller conduit program administered by it to protect commercial paper investors in the event that the collections on the underlying assets and any draws on the transaction specific credit enhancement and liquidity backstop facilities are insufficient to repay the maturing asset-backed commercial paper issued by such multi-seller conduit program. Each of the assets pools funded by this multi-seller conduit program is structured to achieve a high investment grade credit profile through the provision of transaction specific credit enhancement provided by the seller of each asset pool to this multi-seller conduit program. The term of this program-wide credit enhancement is 12 months.

30 Lease commitments

Accounting policy

Agreements which transfer substantially all the risks and rewards incidental to the ownership of assets, are classified as finance leases. As a lessor under finance leases, the bank presents the amounts due under the leases, after deduction of unearned charges, in 'Loans and advances to banks' or 'Loans and advances to customers'.

All other leases are classified as operating leases. As lessor, the bank presents assets subject to operating leases in 'Property, plant and equipment'. Impairment losses are recognized to the extent that carrying values are not fully recoverable. As lessee, leased assets are not recognized on the balance sheet.

Finance income or charges on the finance lease are recognized in 'Net interest income' over the lease periods so as to give a constant rate of return. Rentals payable and receivable under operating leases are spread on a straight-line basis over the lease periods and are recognized in 'General and administrative expenses' or in 'Other operating income'.

Operating lease commitments

At 31 December 2014, the bank was obligated under a number of non-cancellable operating leases for land and buildings for which the future minimum lease payments extend over a number of years, with an option to renew after that period. Base rents are increased as according to the terms stated in the lease.

	Land and buildings	
	2014	2013
	$m	$m
Future minimum lease payments under non-cancellable operating leases expiring		
No later than one year	**49**	50
Later than one year and no later than five years	**145**	143
Later than five years	**53**	71
	247	264

In 2014, $50m (2013: $52m) was charged to 'General and administrative expenses' in respect of lease and sublease agreements, all of which related to minimum lease payments.

Notes on the Consolidated Financial Statements (continued)

30 Lease commitments *(continued)*

Finance lease receivables

The bank leases a variety of assets to third parties under finance leases, including transport assets (such as aircraft), property and general plant and machinery. At the end of the lease terms, assets may be sold to third parties or leased for further terms. Lessees may participate in any sales proceeds achieved. Lease rentals arising during the lease terms will either be fixed in quantum or be varied to reflect changes in, for example, tax or interest rates. Rentals are calculated to recover the cost of assets less their residual value, and earn finance income.

	2014			2013		
	Total future minimum payment **$m**	*Unearned finance income* **$m**	*Present value* **$m**	*Total future minimum payment* $m	*Unearned finance income* $m	*Present value* $m
Less receivables:						
No later than one year	**700**	**(57)**	**643**	709	(58)	651
Later than one year and no later than five years	**1,326**	**(89)**	**1,237**	1,383	(97)	1,286
Later than five years	**80**	**(3)**	**77**	71	(3)	68
	2,106	**(149)**	**1,957**	2,163	(158)	2,005

At 31 December 2014, unguaranteed residual values of $11m (2013: $11m) had been accrued, and the accumulated allowance for uncollectible minimum lease payments is included in loan loss allowances.

During the year, no contingent rents were received (2013: $nil) and recognized in the income statement.

31 Related party transactions

The ultimate parent company of the bank is HSBC Holdings, which is incorporated in England. The bank's related parties include the parent, fellow subsidiaries, and Key Management Personnel.

a *Transactions with Key Management Personnel*

Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of the bank and includes members of the Board of HSBC Bank Canada.

Compensation of Key Management Personnel

The following represents the compensation paid to the Key Management Personnel of the bank in exchange for services rendered to the bank.

	2014	2013
	$m	$m
Short-term employee benefits	**10**	8
Post-employment benefits	**1**	1
Share-based payments	**2**	2
	13	11

Other transactions, arrangements and agreements involving Key Management Personnel

The disclosure of the year end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year. The transactions below were made in the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with persons of a similar standing or, where applicable, with other employees. The transactions did not involve more than the normal risk of repayment or present other unfavourable features.

	2014		2013	
	Highest balance during the year	*Balance at 31 December*	*Highest balance during the year*	*Balance at 31 December*
	$m	**$m**	$m	$m
Key Management Personnel[1]				
Loans	**5.5**	**2.7**	5.7	2.8
Credit cards	**0.1**	**0.1**	0.2	0.1

1 *Includes 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 member.*

Notes on the Consolidated Financial Statements (continued)

31 Related party transactions *(continued)*

b *Transactions between the bank and HSBC Holdings including fellow subsidiaries of HSBC Holdings*

Transactions detailed below include amounts due to/from the bank and HSBC Holdings including fellow subsidiaries of HSBC Holdings. The disclosure of the year end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year. The transactions below were made in the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

	2014		2013	
	Highest balance during the year **$m**	*Balance at 31 December* **$m**	*Highest balance during the year* $m	*Balance at 31 December* $m
Assets				
Trading assets	**1,729**	**1,729**	549	425
Derivatives	**2,128**	**2,128**	1,032	1,011
Loans and advances to banks	**613**	**209**	833	299
Loans and advances to customers	**155**	**155**	225	–
Other assets	**43**	**26**	45	36
Liabilities				
Deposits by banks	**1,620**	**420**	990	257
Customer accounts	**1,464**	**1,464**	3,928	716
Derivatives	**1,346**	**1,346**	884	740
Trading liabilities	**2,080**	**67**	524	118
Other liabilities	**184**	**21**	112	23
Subordinated liabilities	**–**	**–**	90	–

	2014 **$m**	2013 $m
Income Statement		
Interest income	**44**	62
Interest expense	**(9)**	(42)
Fee income	**12**	13
Fee expense	**(9)**	(5)
Other operating income	**43**	50
General and administrative expenses	**(102)**	(106)

32 Offsetting of financial assets and financial liabilities

Accounting policy

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

Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements are as follows:

				Amounts not set off in the balance sheet		
	Gross amounts of recognized financial assets **$m**	*Gross amounts set off in the balance sheet* **$m**	*Amounts presented in the balance sheet* **$m**	*Financial instruments*[1] **$m**	*Cash collateral received* **$m**	*Net amount* **$m**
At 31 December 2014						
Derivatives[2] (note 11).....	**4,082**	**–**	**4,082**	**3,375**	**6**	**701**
Reverse repurchase, securities borrowing and similar agreements:						
– Loan and advances to banks at amortized cost.......	**1,316**	**(572)**	**744**	**744**	**–**	**–**
– Loan and advances to customers at amortized cost.......	**6,118**	**(148)**	**5,970**	**5,970**	**–**	**–**
Loans and advances excluding reverse repos						
– to customers at amortized cost.......	**1,720**	**(1,174)**	**546**	**–**	**–**	**546**
	13,236	**(1,894)**	**11,342**	**10,089**	**6**	**1,247**

1 *Including non-cash collateral.*

2 *Includes amounts that are both subject to and not subject to enforceable master netting agreements and similar agreements.*

Notes on the Consolidated Financial Statements (continued)

32 Offsetting of financial assets and financial liabilities *(continued)*

				Amounts not set off in the balance sheet		
	Gross amounts of recognized financial assets $m	*Gross amounts set off in the balance sheet* $m	*Amounts presented in the balance sheet* $m	*Financial instruments*[1] $m	*Cash collateral received* $m	*Net amount* $m
At 31 December 2013						
Derivatives[2] (note 11).....	2,112	–	2,112	1,282	13	817
Reverse repurchase, securities borrowing and similar agreements:						
– Loan and advances to banks at amortized cost.......	596	(263)	333	333	–	–
– Loan and advances to customers at amortized cost.......	6,151	(323)	5,828	5,828	–	–
Loans and advances excluding reverse repos						
– to customers at amortized cost.......	1,699	(1,124)	575	–	–	575
	10,558	(1,710)	8,848	7,443	13	1,392

1 *Including non-cash collateral.*

2 *Includes amounts that are both subject to and not subject to enforceable master netting agreements and similar agreements.*

32 Offsetting of financial assets and financial liabilities *(continued)*

Financial liabilities subject to offsetting, enforceable master netting arrangements and similar agreements are as follows:

	Gross amounts of recognized financial liabilities $m	Gross amounts set off in the balance sheet $m	Amounts presented in the balance sheet $m	Amounts not set off in the balance sheet: Financial instruments[1] $m	Amounts not set off in the balance sheet: Cash collateral pledged $m	Net amount $m
At 31 December 2014						
Derivatives[2] (note 11)	**3,885**	**–**	**3,885**	**2,791**	**659**	**435**
Repurchase, securities lending and similar agreements						
– Deposits by banks at amortized cost	**1,337**	**(572)**	**765**	**765**	**–**	**–**
– Customer accounts at amortized cost	**3,437**	**(148)**	**3,289**	**3,289**	**–**	**–**
Customer accounts excluding repos at amortized cost	**2,245**	**(1,174)**	**1,071**	**–**	**–**	**1,071**
	10,904	**(1,894)**	**9,010**	**6,845**	**659**	**1,506**
At 31 December 2013						
Derivatives[2] (note 11)	1,746	–	1,746	1,282	93	371
Repurchase, securities lending and similar agreements						
– Deposits by banks at amortized cost	832	(263)	569	569	–	–
– Customer accounts at amortized cost	1,241	(323)	918	918	–	–
Customer accounts excluding repos at amortized cost	2,006	(1,124)	882	–	–	882
	5,825	(1,710)	4,115	2,769	93	1,253

1 *Including non-cash collateral.*

2 *Includes amounts that are both subject to and not subject to enforceable master netting agreements and similar agreements.*

33 Events after the reporting period

Except as noted above, there have been no other material events after the reporting period which would require disclosure or adjustment to the 31 December 2014 consolidated financial statements.

These accounts were approved by the Board of Directors on 20 February 2015 and authorized for issue.

HSBC Group International Network*

Services are provided by over 6,100 offices in 73 countries and territories:

Europe	Offices
Armenia	10
Austria	1
Belgium	2
Channel Islands	25
Czech Republic	2
France	361
Germany	18
Greece	17
Ireland	3
Isle of Man	2
Italy	3
Luxembourg	6
Malta	35
Monaco	3
Netherlands	1
Poland	5
Russia	2
Spain	3
Sweden	2
Switzerland	15
Turkey	300
United Kingdom	1,087

Asia-Pacific	Offices
Australia	38
Bangladesh	14
Brunei Darussalam	11
China	258
Cook Islands	1
Hong Kong Special Administrative Region	255
India	71
Indonesia	144
Japan	4
Korea, Republic of	3
Macau Special Administrative Region	6
Malaysia	75
Maldives	1
New Zealand	8
Philippines	16
Singapore	17
Sri Lanka	15
Taiwan	50
Thailand	1
Vietnam	19

Americas	Offices
Argentina	162
Bahamas	1
Bermuda	10
Brazil	1,343
British Virgin Islands	2
Canada	159
Cayman Islands	3
Chile	1
Colombia	1
Mexico	988
Peru	1
United States of America	247
Uruguay	11

Middle East and Africa	Offices
Algeria	3
Angola	1
Bahrain	5
Egypt	71
Israel	1
Kenya	1
Kuwait	1
Lebanon	4
Libya	1
Mauritius	12
Nigeria	1
Oman	84
Pakistan	3
Palestinian Autonomous Area	1
Qatar	3
Saudi Arabia	102
South Africa	4
United Arab Emirates	16

Associated companies are included in the network of offices.

HSBC Bank Canada Subsidiaries*

HSBC Global Asset Management (Canada) Limited
1 (888) 390-3333
www.hsbc.ca

HSBC Investment Funds (Canada) Inc.
1 (800) 830-8888
www.hsbc.ca/funds

HSBC Private Wealth Services (Canada) Inc.
1 (844) 756-7783
www.hsbc.ca

HSBC Securities (Canada) Inc.
1 (800) 760-1180
www.hsbc.ca

HSBC Trust Company (Canada)
1 (888) 887-3388
www.hsbc.ca/trust

For more information, or to find the HSBC Bank Canada branch nearest you, call 1 (888) 310-4722 or visit our website at www.hsbc.ca

* *As of March 2015*

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Vancouver

Darren Boyer
Senior Vice President and Chief Auditor
Vancouver

Jacques Fleurant
Chief Financial Officer
Vancouver

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HSBC Holdings plc

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Chief Operating Officer
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* *As of March 2015*

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www.hsbc.ca

HSBC BANK CANADA SECURITIES ARE LISTED ON THE TORONTO STOCK EXCHANGE:

HSBC Bank Canada
Class 1 Preferred Shares – Series C
(HSB.PR.C)
Class 1 Preferred Shares – Series D
(HSB.PR.D)

SHAREHOLDER CONTACT:

For change of address, shareholders are requested to contact their brokers.

For general information please write to the bank's transfer agent, Computershare Investor Services Inc., at their mailing address or by e-mail to service@computershare.com.

Other shareholder inquiries may be directed to Shareholder Relations by writing to:

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8th Floor, 100 University Avenue
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Tel: 1 (800) 564-6253

DIVIDEND DATES:

Dividend record and payable dates for the bank's preferred shares, subject to approval by the Board, are:

Record Date	*Payable Date*
13 March	31 March
15 June	30 June
15 September	30 September
15 December	31 December

Distribution dates on our HSBC HaTS™ are 30 June and 31 December.

Designation of eligible dividends:
For the purposes of the *Income Tax Act* (Canada), and any similar provincial legislation, HSBC Bank Canada advises that all of its dividends paid to Canadian residents in 2006 and subsequent years are eligible dividends unless indicated otherwise.

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