# 2014

# HSBC BANK BERMUDA LIMITED

## Consolidated Financial Statements

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**HSBC BANK BERMUDA LIMITED**

**Consolidated Financial Statements and Audit Report for the year ended 31 December 2014**

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# Independent Auditors' Report

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

We have audited the accompanying consolidated financial statements of HSBC Bank Bermuda Limited and its subsidiaries (the 'Group'), which comprise the consolidated balance sheet as at 31 December 2014, and the consolidated income statement, and consolidated statements of comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

***Management's Responsibility for the Financial Statements***

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

***Auditors' Responsibility***

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

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

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

***Opinion***

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Group as at 31 December 2014, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards.

KPMG Audit Limited

Chartered Professional Accountants
Hamilton, Bermuda
13 February 2015

## Consolidated Income Statement
**for the year ended 31 December 2014**

| | Notes | **2014 US$000** | 2013 US$000 |
|---|---|---|---|
| Interest income | | 198,678 | 224,012 |
| Interest expense | | (5,565) | (7,863) |
| Net interest income | 3 | 193,113 | 216,149 |
| Fee income | | 107,655 | 119,376 |
| Fee expense | | (21,908) | (21,830) |
| Net fee income | 3 | 85,747 | 97,546 |
| Dealing profits | | 31,389 | 32,606 |
| Gains less losses from financial investments | 10 | 14,614 | 20,508 |
| Dividend income | | 655 | 540 |
| **Total operating income before loan impairment charges** | | 325,518 | 367,349 |
| Loan impairment charges | 9 | (64,367) | (125,615) |
| **Net operating income** | | 261,151 | 241,734 |
| Employee compensation and benefits | 4,5 | (110,825) | (118,178) |
| General and administrative expenses | | (60,593) | (55,639) |
| Depreciation of property, plant and equipment | 12 | (12,981) | (13,406) |
| Impairment of goodwill | 13,17 | (9,078) | (13,321) |
| **Total operating expenses** | | (193,477) | (200,544) |
| **Operating profit** | | 67,674 | 41,190 |
| (Losses) gains on disposal of subsidiary investments | 16 | (14,221) | 9,118 |
| Losses on disposal and impairment of assets held for sale | 15 | (5,346) | (5,205) |
| Share of profit in associates | 14 | 215 | 300 |
| **Profit before tax** | | 48,322 | 45,403 |
| Tax expense | 6 | - | (148) |
| **Profit for the year** | | 48,322 | 45,255 |
| Add/deduct: Loss (Profit) from discontinued operations (net of income tax) | 17 | 22,584 | (3,714) |
| **Profit for the year from continuing operations** | | 70,906 | 41,541 |

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

## Consolidated Statement of Comprehensive Income

**for the year ended 31 December 2014**

| | *Notes* | **2014** **US$000** | 2013 US$000 |
|---|---|---|---|
| **Profit for the year** | | 48,322 | 45,255 |
| | | | |
| **Other comprehensive income (expense)** | | | |
| Available-for-sale investments | | 11,830 | (23,006) |
| -fair value gains (losses) | | 19,877 | (5,222) |
| -amounts reclassified to the income statement on disposal | | (8,047) | (17,784) |
| Actuarial (losses) gains on defined benefit plans | *4* | (5,895) | 21,070 |
| Foreign exchange gains reclassified to income statement on disposal of a foreign operation | | - | (647) |
| Other movements | | (152) | (1,622) |
| **Other comprehensive income (expense) for the year** | | 5,783 | (4,205) |
| **Total comprehensive income for the year** | | 54,105 | 41,050 |

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

## Consolidated Balance Sheet
**at 31 December 2014**

| | Notes | 2014 US$000 | 2013 US$000 |
|---|---|---|---|
| **ASSETS** | | | |
| Cash and balances at central banks | | 29,859 | 39,293 |
| Items in the course of collection from other banks | | 1 | 560 |
| Derivatives | 7,11 | 54,909 | 18,046 |
| Loans and advances to banks | 8 | 2,905,596 | 4,405,978 |
| Loans and advances to customers | 9 | 2,944,144 | 3,088,064 |
| Financial investments | 10,11 | 5,266,909 | 6,303,029 |
| Assets held for sale | 17 | 8,868 | 29,827 |
| Prepayments and accrued income | | 64,374 | 71,502 |
| Other assets | | 15,461 | 23,430 |
| Interest in associate | 14 | 1,778 | 1,563 |
| Property, plant and equipment | 12 | 167,040 | 182,015 |
| Goodwill | 13 | - | 9,078 |
| **Total assets** | | 11,458,939 | 14,172,385 |
| **LIABILITIES AND EQUITY** | | | |
| **Liabilities** | | | |
| Deposits by banks | | 68,183 | 53,887 |
| Customer accounts | | 10,119,108 | 12,881,684 |
| Items in the course of transmission to other banks | | 2,973 | 4,025 |
| Derivatives | 7,11 | 23,861 | 23,725 |
| Accruals and deferred income | | 50,343 | 46,343 |
| Provisions | 18 | 298 | 280 |
| Other liabilities | | 51,103 | 27,734 |
| Retirement benefit liabilities | 4 | 80,420 | 70,837 |
| **Total liabilities** | | 10,396,289 | 13,108,515 |
| **Equity** | | | |
| Called up share capital | 27 | 30,027 | 30,027 |
| Share premium | 27 | 388,652 | 388,652 |
| Other reserves | | 38,582 | 26,077 |
| Retained earnings | | 605,389 | 619,114 |
| **Total equity** | | 1,062,650 | 1,063,870 |
| **Total liabilities and equity** | | 11,458,939 | 14,172,385 |

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

**Philip M. Butterfield**
**Director**

**Richard J. Moseley**
**Director**

## Consolidated Statement of Cash Flows
**for the year ended 31 December 2014**

| | 2014 US$000 | 2013 US$000 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Profit for the year | 48,322 | 45,255 |
| Adjustments for: | | |
| Net interest income | (193,113) | (216,149) |
| Tax expense | - | 148 |
| Dividends income | (655) | (540) |
| Non-cash items in profit for the year | 297,598 | 33,003 |
| Change in loans and advances to customers | (70,357) | 453,132 |
| Change in other operating assets | 18,167 | 19,260 |
| Change in deposits by banks | 14,296 | (1,916) |
| Change in customer accounts | (2,294,314) | 1,520,077 |
| Change in other operating liabilities | (5,603) | (18,381) |
| Net gain from investing activities | (14,614) | (20,508) |
| Tax paid | - | (1,427) |
| Interest received | 204,687 | 212,846 |
| Interest paid | (6,609) | (9,669) |
| Net cash flows (used in) from operating activities | (2,002,195) | 2,015,131 |
| **Cash flows from investing activities** | | |
| Dividends received | 655 | 540 |
| Purchase of financial investments | (12,741,478) | (13,315,085) |
| Proceeds from the sale and maturity of financial investments | 13,569,094 | 11,736,294 |
| Purchase of property, plant and equipment | (2,452) | (6,006) |
| Proceeds from the sale of assets held for sale | 15,613 | 437 |
| Proceeds (used in) from disposal of subsidiary investments | (313,052) | 12,500 |
| Net cash flows from (used in) investing activities | 528,380 | (1,571,320) |
| **Cash flows from financing activities** | | |
| Dividends paid | (56,000) | (594,000) |
| Net cash flows used in financing activities | (56,000) | (594,000) |
| **Net decrease in cash and cash equivalents** | (1,529,815) | (150,189) |
| Cash and cash equivalents at the beginning of the year | 4,441,806 | 4,585,668 |
| Effect of exchange rate changes on cash and cash equivalents | 20,492 | 6,327 |
| **Cash and cash equivalents at the end of the year** | 2,932,483 | 4,441,806 |
| **Cash and cash equivalents comprise** | | |
| Cash and balances at central banks | 29,859 | 39,293 |
| Items in the course of collection from other banks | 1 | 560 |
| Loans and advances to banks | 2,905,596 | 4,405,978 |
| Items in the course of transmission to other banks | (2,973) | (4,025) |
| **Total cash and cash equivalents** | 2,932,483 | 4,441,806 |

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

## Consolidated Statement of Changes in Equity
**for the year ended 31 December 2014**
*(In US dollar thousands)*

| | | | Other reserves | | | | |
|---|---|---|---|---|---|---|---|
| | **Called up share capital** | **Share premium** | **Available-for-sale fair value reserve** | **Foreign exchange reserve** | **Share-based payment reserve** | **Retained earnings** | **Total equity** |
| **At 1 January 2013** | **30,027** | **388,652** | **46,065** | **647** | **2,161** | **1,148,411** | **1,615,963** |
| **Total Comprehensive income for the year** | | | | | | | |
| Profit for the year | - | - | - | - | - | 45,255 | 45,255 |
| Available-for-sale valuation movement | - | - | (23,006) | - | - | - | (23,006) |
| Liquidation of subsidiary | - | - | - | (647) | - | - | (647) |
| Actuarial gains on defined benefit plans | - | - | - | - | - | 21,070 | 21,070 |
| Other movements | - | - | - | - | - | (1,622) | (1,622) |
| Total comprehensive income for the year | - | - | (23,006) | (647) | - | 64,703 | 41,050 |
| **Transactions with the shareholder recorded directly in equity** | | | | | | | |
| Dividends | - | - | - | - | - | (594,000) | (594,000) |
| Share-based plan movements | - | - | - | - | 857 | - | 857 |
| Total transactions with the shareholder recorded directly in equity | - | - | - | - | 857 | (594,000) | (593,143) |
| **At 31 December 2013** | **30,027** | **388,652** | **23,059** | **-** | **3,018** | **619,114** | **1,063,870** |
| **Total Comprehensive income for the year** | | | | | | | |
| Profit for the year | - | - | - | - | - | 48,322 | 48,322 |
| Available-for-sale valuation movement | - | - | 11,830 | - | - | - | 11,830 |
| Actuarial losses on defined benefit plans | - | - | - | - | - | (5,895) | (5,895) |
| Other movements | - | - | - | - | - | (152) | (152) |
| Total comprehensive income for the year | - | - | 11,830 | - | - | 42,275 | 54,105 |
| **Transactions with the shareholder recorded directly in equity** | | | | | | | |
| Dividends | - | - | - | - | - | (56,000) | (56,000) |
| Share-based plan movements | - | - | - | - | 675 | - | 675 |
| Total transactions with the shareholder recorded directly in equity | - | - | - | - | 675 | (56,000) | (55,325) |
| **At 31 December 2014** | **30,027** | **388,652** | **34,889** | **-** | **3,693** | **605,389** | **1,062,650** |

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

## 1 Basis of preparation

### (a) General

HSBC Bank Bermuda Limited (the 'Bank') was established in 1889 and incorporated in 1891. The address of its registered office is 6 Front Street, Hamilton HM11, Bermuda. The consolidated financial statements of the Bank for the year ended 31 December 2014 comprise the Bank and its subsidiaries (together referred to as the 'group') and the group's interests in associates. The Bank is domiciled in Bermuda and provides retail and corporate banking, investment, trust, custody and fund administration services to international and local clients. The immediate parent company of the Bank is HSBC Asia Holdings BV. The ultimate parent company is HSBC Holdings plc ('HSBC'). Copies of the financial statements of HSBC may be obtained from its registered office at 8 Canada Square, London, England, E14 5HQ, or from the HSBC website, www.hsbc.com.

These consolidated financial statements were authorised for issue by the Board of Directors on 13 February 2015.

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

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

Certain reclassifications have been made to the 2013 comparative financial information in order to conform to the current year presentation.

These consolidated financial statements are presented in accordance with IAS 1 'Presentation of Financial Statements'. In the opinion of management, all normal and recurring adjustments considered necessary for a fair presentation of the group's net income, financial position and cash flows for the years ended 31 December 2014 and 31 December 2013 have been made. In accordance with IFRS 8 'Operating Segments', no segment information has been presented as the shares of the group are not publicly traded.

**Standards adopted during the year ended 31 December 2014**

There were no new standards adopted during the year ended 31 December 2014.

On 1 January 2014, the group 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 these consolidated financial statements.

During 2013, the group adopted a number of interpretations and amendments to standards which had an insignificant effect on these consolidated financial statements.

### (b) Basis of consolidation

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. The Bank is considered to have power over an entity when it has existing rights that give it the current ability to direct the relevant activities. For the Bank to have power over an entity, it must have the practical ability to exercise those rights. In the rare situations where potential voting rights exist, these are taken into account if the Bank has the practical ability to exercise those rights.

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

that the fair value of net assets acquired is in excess of the aggregation of the consideration transferred, the amount of non-controlling interest and the fair value of the previously held equity interest, the difference is recognised immediately in the consolidated income statement.

Entities that are controlled by the Bank are consolidated. Subsidiaries are consolidated from the date the group gains control, until the date that control ceases. The Bank performs a re-assessment of consolidation whenever there is a change in the facts and circumstances of determining the control of all entities.

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

**(c) Use of estimates and assumptions**

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

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

**(d) Future accounting developments**

At 31 December 2014, a number of standards and amendments to standards had been issued by the IASB, which are not effective for these consolidated financial statements. In addition to the projects to complete financial instrument accounting project, discussed below, the IASB is continuing to work on projects on insurance and lease accounting which could represent significant changes to accounting requirements in the future.

**Amendments issued by the IASB**

**(i) IFRS 15 'Revenue from Contracts with Customers'**

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 recognising revenue for obligations as they are satisfied. The standard should be applied retrospectively, with certain practical expedients available. The group is currently assessing the impact of this standard.

**(ii) IFRS 9 '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 amortised cost, Fair Value through Other Comprehensive Income ('FVOCI') 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, since IFRS 9 does not apply embedded derivative accounting to financial assets and equity securities will be measured at fair value through profit or loss or, in limited circumstances, at FVOCI. 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 amortised 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 other comprehensive income.

*Impairment*

The impairment requirements apply to financial assets measured at amortised cost and FVOCI, and lease receivables and 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 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 group intends to revise the presentation of fair value gains and losses relating to the entity's own credit risk on certain liabilities.

HSBC is currently assessing the impact that IFRS 9 will have on the financial statements through a 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.

## 2 Significant accounting policies

### (a) Interest income and expense

Interest income and expense for all financial instruments are recognised in 'Interest income' and 'Interest expense' in the consolidated income statement using the effective interest rate method. The effective interest rate method is a way of calculating the amortised cost of a financial asset or a financial liability (or groups of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

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

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

### (b) Non-interest income

*(i) Fee income*

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

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

*(ii) Dealing profits*

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

*(iii) Dividend income*

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

### (c) Cash and cash equivalents

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

### (d) Loans and advances to banks and customers

Loans and advances to banks and customers include loans and advances originated by the group which are not classified as held for trading or designated at fair value. They are recognised when cash is advanced to a borrower and are derecognised 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 amortised cost using the effective interest rate method, less impairment allowance.

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

**(e) Impairment of loans and advances**

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

*(i) Individually assessed loans and advances*

The factors considered in determining that a loan is individually significant for the purposes of assessing impairment include the size of the loan, the number of loans in the portfolio 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 a collective assessment.

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

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

- known cash flow difficulties experienced by the borrower;
- contractual payments of either principal or interest being past due for more than 90 days;
- breach of loan covenants or conditions;
- the probability that the borrower will enter bankruptcy or other financial realisation;
- 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 significant;
- there has been deterioration in the financial condition or outlook of the borrower such that its ability to repay is considered doubtful; and
- a significant downgrading in credit rating by an external credit rating agency.

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

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

The realisable 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.

*(ii) 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.

*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 the purpose of calculating an estimated collective impairment. These credit risk characteristics may include country of origination, type of business involved, type of products offered, security obtained or other relevant factors. This assessment captures impairment losses that the group has incurred as a result of events occurring before the balance sheet date, which the group is not able to identify on an individual loan basis, and that can be reliably estimated. 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 loss is determined after taking into account:

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

The period between a loss occurring and its identification is estimated by local management for each identified portfolio 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 impairment losses for homogeneous groups of loans that are 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 group utilises 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 group 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. In certain highly developed markets, sophisticated models also take into account behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.
- When the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll rate methodology, the group adopts a basic formulaic approach based on historical loss rate experience, or a discounted cash flow model. Where a basic formulaic approach is undertaken, management estimates that typically it takes twelve months between a loss occurring and its identification.

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

*(iii) Write-off of loans and advances*

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

*(iv) Reversals of impairment*

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

*(v) Assets acquired in exchange for loans*

Non-financial assets acquired in exchange for loans as part of an orderly realisation are recorded as assets '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 provided in respect of assets held for sale. Impairments and reversal of previous impairments are recognised in the consolidated income statement, in 'Losses on disposal and impairments of assets held for sale', together with any realised gains or losses on disposal.

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

*(vi) Renegotiated loans*

Loans subject to collective impairment assessment whose terms have been renegotiated are no longer considered past due, but are treated as current 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 derecognised 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.

**(f) Financial investments**

Treasury bills, debt securities and equity securities intended to be held on a continuing basis are classified as 'available-for-sale' securities. They are recognised on the trade date when the group enters into contractual arrangements to purchase those securities, and are normally derecognised 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 remeasured at fair value, and changes therein are recognised in other comprehensive income in 'Available-for-sale investments – fair value gains (losses)' until the financial assets are either sold or become impaired. When available-for-sale financial assets are sold, cumulative gains or losses previously recognised in other comprehensive income are recognised in the consolidated income statement as 'Gains less losses from financial investments'.

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

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

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

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.

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

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

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

**(g) Valuation of financial instruments**

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

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

- *Level 1 valuation technique using quoted market price:* financial instruments with quoted prices for identical instruments in active markets.
- *Level 2 - valuation technique using observable inputs:* financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.
- *Level 3 - valuation technique with significant unobservable inputs*: financial instruments valued using valuation techniques where one or more significant inputs are unobservable. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. It generally does not mean that there is no data available at all upon which to base a determination of fair value.

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. The bid/offer spread represents the difference in prices at which a market participant would be willing to buy compared with the price at which they would be willing to sell. 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.

**(h) Assets held for sale**

Assets and liabilities of disposal groups and non-current assets are classified as held for sale ('HFS') when their carrying amounts will be recovered principally through sale rather than through continuing use. HFS assets are generally measured at the lower of their carrying amount and fair value less cost to sell.

Immediately before the initial classification as held for sale, the carrying amounts of the relevant assets and liabilities are measured in accordance with applicable IFRSs. On subsequent remeasurement of a disposal group, fair value less costs to sell of the disposal group is determined after each HFS asset is individually measured under applicable IFRSs.

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

**(i) Sale and repurchase agreements**

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

Securities lending and borrowing transactions are generally secured against cash or non-cash collateral. Securities lent or borrowed do not normally result in derecognition or recognition on the consolidated balance sheet. Cash collateral advanced or received is recorded as an asset or a liability respectively.

**(j) Derivatives and hedge accounting**

Derivatives are initially recognised, and are subsequently remeasured, at fair value. Fair values of derivatives are obtained from either quoted market prices or using valuation techniques. Derivative assets and liabilities arising from different transactions are only offset for accounting purposes when there is a legally enforceable right to offset the recongised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are bifurcated from the last contract 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 recognised in the consolidated income statement.

Derivatives are classified as assets when their fair value is positive, or as liabilities when their fair value is negative.

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 'Dealing profits' 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. When derivatives are designated as hedges, the group classifies them as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedges'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedges'); or (iii) a hedge of a net investment in a foreign operation ('net investment hedges').

**Hedge accounting**

At the inception of a hedging relationship, the group documents the relationship between the hedging instruments and the hedged items, its risk management objective and its strategy for undertaking the hedge. The group requires 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 of the hedged items. Interest on designated qualifying hedges is included in 'Net interest income'.

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

*Fair value hedge*

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the consolidated income statement, along with changes in the fair value of the hedged assets, liabilities or group 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 amortised to the consolidated income statement on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognised, in which case, it is released to the consolidated income statement immediately.

*Cash flow hedge*

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

The accumulated gains and losses recognised in other comprehensive income are reclassified to the consolidated 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 recognised in other comprehensive income are included in the initial measurement of the asset or liability.

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

**Hedge effectiveness testing**

To qualify for hedge accounting, the group requires that at the inception of the hedge and throughout its life each hedge must be expected to be highly effective 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 recognised in the consolidated income statement in 'Dealing profits'.

**Derivatives that do not qualify for hedge accounting**

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

**(k) Derecognition of financial assets and financial liabilities**

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

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

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

**(l) Offsetting financial assets and financial liabilities**

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

**(m) Subsidiaries and associates**

The group classifies investments in entities which it controls as subsidiaries. The group classifies investments in entities over which it has significant influence, and that are neither subsidiaries nor joint ventures, as associates.

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

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

**(n) Property, plant and equipment**

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

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

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

**(o) Goodwill**

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

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

**(p) Impairment of assets other than financial instruments**

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

Impairment losses are recognised in the consolidated income statement.

**(q) Finance and operating leases**

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

All other leases are classified as operating leases. As lessor, the group presents assets subject to operating leases in 'Property, plant and equipment'. Impairment losses are recognised to the extent that carrying values are not fully recoverable and the carrying value of the assets are thereby impaired. As a lessee, leased assets are not recognised on the consolidated balance sheet. Rentals payable and

receivable under operating leases are accounted for on a straight-line basis over the lease periods and are included in 'General and administrative expenses' and 'Other operating income', respectively.

**(r) Income tax**

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

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

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

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

**(s) Pension and other post-employment benefits**

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

*(i) Defined contribution pension plans*

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

*(ii) Defined benefit pension plans*

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

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

*(iii) Post-employment healthcare benefits plan*

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

**(t) Share-based payments**

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

Fair value is determined using appropriate valuation models, taking into account the terms and conditions 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 date of grant, so that an award is treated as vesting irrespective of whether these conditions are satisfied, provided all other vesting conditions are satisfied.

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

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

**(u) Foreign currencies**

*(i) Transactions and balances*

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

*(ii) Group entities*

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

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

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

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

**(v) Deposits by banks and customer accounts**

Financial liabilities are recognised when the group enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and initially measured at fair value, which is normally the 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 amortised cost, using the effective interest rate method.

**(w) Provisions**

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

**(x) Fiduciary activities**

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

**(y) Contingent liabilities, contractual commitments and financial guarantee contracts**

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

Contractual commitments include loan commitments to provide credit under pre-specified term and conditions.

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

**(z) Trading assets and liabilities**

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

## 3 Net interest income and net fee income

### (a) Analysis of net interest income

| | **2014** | 2013 |
|---|---|---|
| **Interest income** | | |
| Financial investments | 38,140 | 42,479 |
| Loans and advances to banks | 6,181 | 7,575 |
| Loans and advances to customers | 154,357 | 173,958 |
| | 198,678 | 224,012 |
| **Interest expense** | | |
| Customer accounts | (5,565) | (7,863) |
| | (5,565) | (7,863) |
| **Net interest income** | 193,113 | 216,149 |

### (b) Analysis of net fee income

| | **2014** | 2013 |
|---|---|---|
| **Fee Income** | | |
| Custody and fund administration | 10,293 | 16,102 |
| Trust | 16,194 | 16,831 |
| Banking | 40,845 | 42,134 |
| Management | 30,133 | 31,464 |
| Other | 10,190 | 12,845 |
| **Fee income** | 107,655 | 119,376 |
| **Fee expense** | (21,908) | (21,830) |
| **Net fee income** | 85,747 | 97,546 |

## 4 Employee compensation and benefits

**Post-employment benefit plans**

*Income statement charge*

| | **2014** | 2013 |
|---|---|---|
| Defined contribution pension plans | 6,050 | 4,979 |
| Defined benefit pension plans | 63 | 165 |
| Post-employment healthcare benefits plan | 4,946 | 6,007 |
| **Total post-employment benefit income statement charge** | 11,059 | 11,151 |

*Balance sheet*

| | **2014** | 2013 |
|---|---|---|
| Defined benefit pension plans | (1,043) | 705 |
| Post-employment healthcare benefits plan | (79,377) | (71,542) |
| **Total post-employment benefit plan (deficit)** | (80,420) | (70,837) |

### (a) Defined contribution pension plans

The group provides defined contribution pension plans to its employees in Bermuda and Cayman. Employees are able to make additional voluntary payments to the defined contribution pension plans.

The group's expense for the defined contribution pension plans in 2014 was $6,050 (2013: $4,979), of which $4,118 (2013: $4,665) relates to the Bermuda-based plan.

**(b) Defined benefit pension plans**

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

The group continues to assume responsibility for the entire Plan B which consists of fourteen individuals (2013: fourteen) as well as the plan comprising thirty three individuals (2013: thirty three) previously employed by the Bank of Bermuda (Isle of Man) Limited. The net deficit at 31 December 2014 and surplus 31 December 2013 relates only to the components of the plan over which the group maintains current and future legal responsibility.

The group also has an interest in a funded defined benefit plan relating to ten individuals (2013: ten) in Bermuda and the Cayman Islands.

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

These defined benefit plans expose the group to actuarial risks, such as longevity risk, and to currency risk, interest rate risk and market (investment) risk.

***Summary***

| | **2014** | 2013 |
|---|---|---|
| Defined benefit obligations | (23,349) | (22,446) |
| Fair value of plan assets | 22,306 | 23,151 |
| Net (deficit) surplus | (1,043) | 705 |

Actuarial valuation of the assets and liabilities of the group's defined benefit pension plans are carried out annually to determine their financial position and to ensure that benefit obligations are adequately funded. The group's pension expense for the defined benefit pension plans was $63 (2013: $165).

An actuarial loss of $1,740 (2013: gain of $2,496) was included in the consolidated statement of comprehensive income for the defined benefit pension plans. The cumulative amount of actuarial losses recognised in the consolidated statement of comprehensive income is $4,289 (2013: $2,549).

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

| **Year** | **Rate of increase for pensions in payment and deferred pensions** | **Inflation assumption** | **Discount Rate** |
|---|---|---|---|
| | **%** | **%** | **%** |
| **2014** | 3.5 | 3.8 | 3.8 |
| 2013 | 3.6 | 4.2 | 4.4 |

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

| | **2014** | 2013 |
|---|---|---|
| Equities | 8,995 | 10,262 |
| Bonds | 10,527 | 10,875 |
| Property and other | 2,784 | 2,014 |
| Fair value of plan assets | 22,306 | 23,151 |
| Present value of defined benefit obligations | (23,349) | (22,446) |
| Net (deficit) surplus | (1,043) | 705 |

The changes in the present value of the defined benefit obligation in respect of the group's pension plan are presented below:

| | **2014** | 2013 |
|---|---|---|
| At 1 January | 22,446 | 22,246 |
| Current service cost | 14 | 15 |
| Interest cost | 869 | 895 |
| Actuarial losses (gains) | 1,016 | (939) |
| Benefits paid | (637) | (592) |
| Exchange and other movements | (359) | 821 |
| At 31 December | 23,349 | 22,446 |

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

| | **2014** | 2013 |
|---|---|---|
| At 1 January | 23,151 | 20,465 |
| Return on plan assets excluding interest income | 348 | 1,025 |
| Interest income | 560 | 508 |
| Contributions by the group | 149 | 140 |
| Actuarial gains | 65 | 1,158 |
| Benefits paid | (637) | (592) |
| Exchange and other movements | (1,330) | 447 |
| At 31 December | 22,306 | 23,151 |

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

| | **2014** | 2013 |
|---|---|---|
| Current service cost | (14) | (15) |
| Interest cost | (309) | (387) |
| Administrative costs and other movements | 260 | 237 |
| Total net expense | (63) | (165) |

**(c) Post-employment healthcare benefits plan**

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

The latest actuarial assessment was carried out in October 2014 in accordance with IAS 19 'Employee Benefits'. At 31 December 2014, the estimated present value of the post-employment healthcare benefit obligation was $79,377 (2013: $71,542). The main financial assumptions used to estimate the obligation at 31 December 2014 are current and ultimate healthcare claims trend rate of 7.50% and 4.75% per annum respectively (2013: 8.50% and 4.75%) and a discount rate of 4.00% (2013: 5.00%) per annum.

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

| | **2014** | 2013 |
|---|---|---|
| At 1 January | 71,542 | 85,270 |
| Current service cost | 2,027 | 2,962 |
| Interest cost | 2,920 | 3,045 |
| Contributions by employees | 1,570 | 1,558 |
| Actuarial losses (gains) | 4,155 | (18,574) |
| Benefits paid | (2,837) | (2,719) |
| At 31 December | 79,377 | 71,542 |

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

| | **2014** | 2013 |
|---|---|---|
| Current service cost | (2,027) | (2,962) |
| Interest cost | (2,920) | (3,045) |
| Total net expense | (4,947) | (6,007) |

Total net actuarial results recognised in the consolidated statement of comprehensive income in 2014 in respect of the post-employment healthcare benefits plan are a loss of $4,155 (2013: gain of $18,574). The total cumulative net actuarial loss to date, which has been recognised in the consolidated statement of comprehensive income, is $12,890 (2013: $8,735).

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

| | **2014** | 2013 |
|---|---|---|
| Net obligation | 79,377 | 71,542 |
| Experience adjustments on plan liabilities expressed as an amount | (4,155) | 18,574 |
| Experience adjustments on plan liabilities expressed as a percentage | (5%) | 26% |

The actuarial assumptions related to the healthcare cost trend rates may have a significant effect on the amounts recognised. A one-percentage point change in assumed healthcare cost trend rates would have the following effects on amounts recognised in 2014:

| | **1% increase** | **1% decrease** |
|---|---|---|
| Effect on the aggregate of the current service cost and interest cost | 1,405 | (1,024) |
| Effect on present value of the benefit obligation | 20,259 | (15,055) |

## 5 Share-based payments

During 2014, $1,457 was charged to the consolidated income statement in respect of share-based payment transactions relating to deferred share awards (2013: $724). This expense, which was computed from the fair values of the share-based payments on transaction dates, arose under employee share awards made in accordance with the group's reward structures. All share plans are based on ordinary $0.50 par value shares in the ultimate parent company HSBC Holdings plc. All exercise prices and fair values of shares and options presented below are exact amounts (not rounded or shown to the nearest thousand).

**HSBC Holdings Savings-related share option plans - calculation of fair values**

The fair values of share options at the date of grant of the option are calculated using a Black-Scholes model.

The fair value of a share award is based on the share price at the date of the grant. The fair value of a share option is inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

There were no share options granted this year or 2013.

The significant weighted average assumptions used to estimate the fair value of the options granted in 2012 were as follows:

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

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

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

Expected dividends are incorporated into the valuation model for share options and awards, where applicable. The expected US dollar denominated dividend yield was determined to be 4.5%, in line with consensus analyst forecast (2013: 4.5%).

**The HSBC share plan**

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

*Restricted share awards*

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

| | **2014 Number of awards (000s)** | 2013 Number of awards (000s) |
|---|---|---|
| Outstanding at 1 January | 323 | 439 |
| Additions in the year[1] | 105 | 140 |
| Released in the year | (240) | (232) |
| Forfeited in the year | (30) | (24) |
| Outstanding at 31 December | 158 | 323 |

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

The weighted average fair value of shares originally awarded by the group for restricted share awards in 2014 was $10.22 (2013: $10.77).

*Savings-related share option plans*

During 2013 the savings-related share option plans were temporarily suspended. Prior to 2013 eligible employees were invited to enter into savings contracts to save up to three hundred and fifty dollars per month, with the option to use the savings to acquire shares. The aim of the plans is to align the interests of all employees with the creation of shareholder value. The options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or fifth anniversaries of the commencement of three-year or five-year savings contracts, respectively. The exercise price is set at a 20% discount to the average market value immediately preceding the date of invitation.

| | **2014** | | 2013 | |
|---|---|---|---|---|
| | **Number of options (000s)** | **Weighted average exercise price** | Number of options (000s) | Weighted average exercise price |
| Outstanding at 1 January | 221 | 5.25 | 391 | 6.41 |
| Transferred in from group companies | 8 | 7.99 | 12 | 5.50 |
| Exercised in the year | (62) | 5.65 | (74) | 6.30 |
| Forfeited in the year | (44) | 7.35 | (108) | 8.76 |
| Outstanding at 31 December | 123 | 4.47 | 221 | 5.25 |

The weighted average fair value of options granted during the year was $NIL (2013: $NIL).

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

| | **2014** | 2013 |
|---|---|---|
| Exercise price range from lowest to highest price ($) | 4.89–8.21 | 4.89–11.88 |
| Weighted average remaining contractual life (years) | 1.0 | 1.4 |
| Number of options exercisable at year end (in thousands) | 30 | 10 |
| Weighted average exercise price of options exercisable at year end ($) | 6.09 | 10.00 |

## 6 Tax expense

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

**Tax charged to the consolidated income statement**

| | **2014** | 2013 |
|---|---|---|
| Current tax - current overseas tax charge | - | 148 |
| Deferred tax | - | - |
| Tax expense | - | 148 |

**Tax reconciliation**

| | **2014** | **%** | 2013 | % |
|---|---|---|---|---|
| Taxation at Bermuda corporation tax rate of 0% | - | - | - | - |
| Impact of differently taxed overseas profits | - | - | 148 | 0.27% |
| Adjustments in respect of prior years | - | - | - | - |
| Other items | - | - | - | - |
| Tax expense | - | - | 148 | 0.27% |

**Movement of deferred tax assets**

There was no deferred tax in 2014 and 2013.

## 7 Derivatives

**Fair values of derivatives by product type**

| | **2014** | | 2013 | |
|---|---|---|---|---|
| | **Fair value** | | Fair value | |
| | **Assets** | **Liabilities** | Assets | Liabilities |
| Foreign exchange | 17,724 | 15,300 | 13,655 | 12,352 |
| Interest rate | 187 | 68 | 334 | 160 |
| **Trading derivatives** | 17,911 | 15,368 | 13,989 | 12,512 |
| Fair value hedges | 2,140 | 8,480 | 4,057 | 11,213 |
| Cash flow hedges | 34,858 | 13 | - | - |
| **Total derivatives** | 54,909 | 23,861 | 18,046 | 23,725 |

The notional contract amounts of derivatives held for trading purposes indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

**Notional contract amounts of derivatives by product type**

| | **2014** | 2013 |
|---|---|---|
| Foreign exchange | 1,808,542 | 2,172,788 |
| Interest rate | 26,154 | 81,674 |
| **Trading derivatives** | 1,834,696 | 2,254,462 |
| Fair value hedges | 1,283,837 | 1,264,000 |
| Cash flow hedges | 393,877 | - |
| **Total derivatives** | 3,512,410 | 3,518,462 |

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

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

**Use of derivatives**

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

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

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

**(a) Trading derivatives**

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

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

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

A three level fair value hierarchy, which reflects the availability of observable market inputs, is used when estimating fair values. All derivatives are considered Level 2 as they are based upon observable market inputs. Total exposure to HSBC Group counterparties at 31 December 2014 amounted to an unrealised loss of $2,878 (2013: $1,537) and cash collateral was $15,400 (2013: $15,600). Where the group receives collateral from customers related to outstanding derivative contracts, these comprise cash and cash equivalents, securities and mortgage interests over property. Credit concentrations with large counterparties are controlled though counterparty limits. Credit exposures, incorporating derivative exposures, to single names are capped and monitored by senior management as detailed in Note 24.

**(b) Hedging accounting derivatives**

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

*Fair value hedges*

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

**Gains or (losses) arising from fair value hedges**

| | **2014** | 2013 |
|---|---|---|
| Gains (losses) | | |
| - on hedging instruments | 3,313 | 19,494 |
| - on hedged items attributable to the hedged risk | (3,424) | (19,351) |
| Net (loss) gain | (111) | 143 |

*Cash flow hedges*

The group's cash flow hedges consist primarily of interest rate swaps and currency forwards 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.

The principle balance that has been hedged is $359,863 (2013: $NIL) and which matures in less than 3 months.

The gains and losses on ineffective portions of derivatives designated as cash flow hedges are recognised immediately in 'Dealing profits'. During the year to 31 December 2014 a gain of $2 (2013: $NIL) was recognised due to hedge ineffectiveness.

## 8 Loans and advances to banks

**Maturity analysis**

| | 2014 | | 2013 | |
|---|---|---|---|---|
| | **Amortised cost** | **Fair value** | Amortised cost | Fair value |
| One year or less | 2,905,596 | 2,905,596 | 4,362,978 | 4,362,978 |
| More than one year | - | - | 43,000 | 43,000 |
| | 2,905,596 | 2,905,596 | 4,405,978 | 4,405,978 |

There are no impairment losses included in loans and advances to banks (2013: $NIL) and there are no netting agreements or collateral held in respect of loans and advances to banks (2013: $NIL).

**Loans and advances to banks by country and credit rating**

| | 2014 | | | | | |
|---|---|---|---|---|---|---|
| **Country** | **AAA** | **AA+ AA AA-** | **A+ A A-** | **BBB+ BBB BBB-** | **Not rated** | **Total** |
| Australia | - | 20,792 | 81 | - | 2,110 | 22,983 |
| Bahrain | - | - | - | - | 64 | 64 |
| Belgium | - | 5,249 | - | - | - | 5,249 |
| Bermuda | 3,986 | - | 14,349 | 4,282 | 820 | 23,437 |
| Brazil | - | - | 30,000 | - | - | 30,000 |
| Canada | - | 31,278 | 145,000 | - | - | 176,278 |
| Cayman Islands | - | - | - | - | 12,482 | 12,482 |
| Czech Republic | - | - | 73 | - | - | 73 |
| Denmark | - | - | 1,241 | - | - | 1,241 |
| France | - | 20,025 | 20,000 | - | - | 40,025 |
| Germany | - | - | 68,569 | - | - | 68,569 |
| Hong Kong | - | 22,788 | - | - | 228 | 23,016 |
| Hungary | - | - | 17 | - | - | 17 |
| Israel | - | - | 8 | - | - | 8 |
| Japan | - | - | 570,000 | - | 34,358 | 604,358 |
| Mexico | - | | - | 6,158 | - | 6,158 |
| Netherlands | - | - | - | - | 58 | 58 |
| New Zealand | - | - | - | - | 1,393 | 1,393 |
| Norway | - | - | 128,368 | - | - | 128,368 |
| Poland | - | - | 174 | - | - | 174 |
| Republic of Ireland | - | - | - | - | 29 | 29 |
| Republic of Korea | - | - | - | - | 35 | 35 |
| Singapore | - | 19,948 | - | - | 26 | 19,974 |
| South Africa | - | - | - | 179 | - | 179 |
| Sweden | - | - | 2,158 | - | - | 2,158 |
| Switzerland | - | - | 22,201 | - | 14,390 | 36,591 |
| Turkey | - | - | - | - | 99 | 99 |
| United Arab Emirates | - | 447 | - | - | - | 447 |
| United Kingdom | - | 444,313 | - | - | - | 444,313 |
| United States | - | 995,388 | 262,432 | - | - | 1,257,820 |
| | 3,986 | 1,560,228 | 1,264,671 | 10,619 | 66,092 | 2,905,596 |

**Loans and advances to banks by country and credit rating**

| | 2013 | | | | | |
|---|---|---|---|---|---|---|
| **Country** | AAA | AA+<br>AA<br>AA- | A+<br>A<br>A- | BBB+<br>BBB<br>BBB- | Not<br>rated | Total |
| Australia | - | - | 215,435 | - | - | 215,435 |
| Belgium | - | 2,074 | - | - | - | 2,074 |
| Bermuda | 4,037 | - | 1,750 | 4,221 | 1,701 | 11,709 |
| Brazil | - | - | 30,000 | 40,000 | - | 70,000 |
| Canada | - | 9,297 | 170,000 | - | - | 179,297 |
| Czech Republic | - | - | - | 52 | - | 52 |
| Denmark | - | - | 1,556 | - | - | 1,556 |
| France | - | 200,000 | 345,000 | - | - | 545,000 |
| Germany | - | 275,640 | 115,728 | - | - | 391,368 |
| Hong Kong | - | 82,623 | - | - | - | 82,623 |
| Israel | - | - | - | 52 | - | 52 |
| Japan | - | 17,870 | 55,000 | - | 29,578 | 102,448 |
| Mexico | - | | - | 1,258 | - | 1,258 |
| Netherlands | - | - | 17 | - | - | 17 |
| New Zealand | - | - | - | - | 28,673 | 28,673 |
| Norway | - | - | 50,142 | - | - | 50,142 |
| Panama | - | - | - | 1 | - | 1 |
| Poland | - | - | 246 | - | - | 246 |
| Singapore | - | 11,523 | - | - | - | 11,523 |
| South Africa | - | - | 616 | 74 | - | 690 |
| Sweden | - | - | 2,619 | - | - | 2,619 |
| Switzerland | - | - | 4,917 | - | 16,577 | 21,494 |
| Turkey | - | - | - | - | 148 | 148 |
| United Kingdom | - | 879,605 | - | - | - | 879,605 |
| United States | - | 1,488,928 | 319,020 | - | - | 1,807,948 |
| | 4,037 | 2,967,560 | 1,312,046 | 45,658 | 76,677 | 4,405,978 |

Loans and advances to banks are rated using a hierarchy of rating agencies. The Standard & Poor's ('S&P') ratings are used where available, followed by Fitch then Moody's. If no rating is provided by S&P, Fitch or Moody's, the balance is classified as not rated.

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

## 9 Loans and advances to customers

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

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

| | **2014** | 2013 |
|---|---|---|
| Personal | | |
| Residential mortgages | 1,403,880 | 1,602,227 |
| Other personal | 253,077 | 361,730 |
| Total loans to individuals | 1,656,957 | 1,963,957 |
| Corporate | | |
| Commercial, industrial and international trade | 233,114 | 245,905 |
| Commercial real estate | 355,397 | 512,045 |
| Government | - | 20,000 |
| Other commercial | 580,430 | 521,592 |
| Total commercial | 1,168,941 | 1,299,542 |
| Non-bank financial institutions | 235,641 | 65,560 |
| Total corporate | 1,404,582 | 1,365,102 |
| **Gross loans and advances to customers** | 3,061,539 | 3,329,059 |
| Allowance for losses on loans and advances | (117,395) | (240,995) |
| **Loans and advances to customers** | 2,944,144 | 3,088,064 |

Gross loans with variable rates are $3,050,274 (2013: $3,324,829) and fixed rates are $11,265 (2013: $4,230).

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

| | **2014** | | 2013 | |
|---|---|---|---|---|
| **Maturity analysis** | **Amortised cost** | **Fair value** | Amortised cost | Fair value |
| One year or less | 549,147 | 548,801 | 534,716 | 534,369 |
| More than one year | 2,394,997 | 2,329,040 | 2,553,348 | 2,483,874 |
| | 2,944,144 | 2,877,841 | 3,088,064 | 3,018,243 |

The loan fair values disclosed above are based on weighted average estimated remaining maturities and are determined using a valuation technique supported by market interest rates and estimated future cash flows. As there is no secondary liquid market, they are classified as Level 3. Additional information about the interest rate risk exposure pertaining to loans and advances to customers is presented in Note 24.

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

| | **2014** | | | 2013 | | |
|---|---|---|---|---|---|---|
| **Loans and advances to customers** | **Gross** | **Allowance** | **Net** | Gross | Allowance | Net |
| Not past due or impaired | 2,423,581 | (33,236) | 2,390,345 | 2,510,851 | (29,777) | 2,481,074 |
| Past due less than 30 days | 86,849 | (832) | 86,017 | 102,131 | (1,116) | 101,015 |
| Past due between 30 and 60 days | 15,062 | (55) | 15,007 | 18,521 | (216) | 18,305 |
| Past due between 60 and 90 days | 1,929 | (18) | 1,911 | 8,574 | (100) | 8,474 |
| Impaired | 534,118 | (83,254) | 450,864 | 688,982 | (209,786) | 479,196 |
| Total | 3,061,539 | (117,395) | 2,944,144 | 3,329,059 | (240,995) | 3,088,064 |

| Allowances for loans and advances to customers | 2014 Specifically provided | 2014 Collectively provided | 2014 Total allowance | 2013 Specifically provided | 2013 Collectively provided | 2013 Total allowance |
|---|---|---|---|---|---|---|
| Not past due or impaired | - | (33,236) | (33,236) | - | (29,777) | (29,777) |
| Past due less than 30 days | - | (832) | (832) | - | (1,116) | (1,116) |
| Past due between 30 and 60 days | - | (55) | (55) | - | (216) | (216) |
| Past due between 60 and 90 days | - | (18) | (18) | - | (100) | (100) |
| Impaired | (81,399) | (1,855) | (83,254) | (206,842) | (2,944) | (209,786) |
| Total | (81,399) | (35,996) | (117,395) | (206,842) | (34,153) | (240,995) |

| Gross loans and advances to customers by type of collateral | 2014 Mortgage interest | 2014 Assets other than mortgage interest | 2014 Unsecured | 2013 Mortgage interest | 2013 Assets other than mortgage interest | 2013 Unsecured |
|---|---|---|---|---|---|---|
| Not past due or impaired | 1,312,963 | 391,043 | 719,575 | 1,609,076 | 258,416 | 643,359 |
| Past due less than 30 days | 54,883 | 26,193 | 5,773 | 93,623 | 748 | 7,760 |
| Past due between 30 and 60 days | 2,577 | 10,729 | 1,756 | 16,878 | - | 1,643 |
| Past due between 60 and 90 days | 1,185 | 262 | 482 | 7,825 | - | 749 |
| Impaired | 497,844 | 15,792 | 20,482 | 641,808 | 24,297 | 22,877 |
| Total | 1,869,452 | 444,019 | 748,068 | 2,369,210 | 283,461 | 676,388 |

The group holds collateral against loans and advances to customers in the form of mortgage interests over property, other charges over real and financial assets, and guarantees. Estimates of fair value are based on the value of collateral assessed at the time of borrowing, and updated at a minimum of every three years for performing facilities but more frequently where the market is subject to significant changes in condition. In the case of performing retail mortgages the value of collateral is adjusted annually to reflect overall movements in the market. Where a loan is showing signs of potential impairment, or where the loan is individually assessed as impaired, collateral values are updated annually.

Collateral held is shown in the table below (unaudited):

| 2014 | Uncollateralised | Fully collateralised | Partially collateralised Loan value | Partially collateralised *Collateral value* | Total Loans |
|---|---|---|---|---|---|
| Personal | | | | | |
| Residential mortgages | 4,239 | 949,236 | 450,405 | *377,894* | 1,403,880 |
| Other personal | 108,298 | 123,367 | 21,412 | *18,918* | 253,077 |
| Total loans to individuals | 112,537 | 1,072,603 | 471,817 | *396,812* | 1,656,957 |
| Corporate | | | | | |
| Commercial, industrial and international trade | 48,055 | 172,372 | 12,687 | *9,304* | 233,114 |
| Commercial real estate | 95,452 | 237,395 | 22,550 | *16,859* | 355,397 |
| Government | - | - | - | - | - |
| Other commercial | 363,621 | 106,938 | 109,871 | *106,059* | 580,430 |
| Total commercial | 507,128 | 516,705 | 145,108 | *132,222* | 1,168,941 |
| Non-bank financial institutions | 128,403 | 103,991 | 3,247 | *2,823* | 235,641 |
| Total corporate | 635,531 | 620,696 | 148,355 | *135,045* | 1,404,582 |
| **Gross loans and advances to customers** | 748,068 | 1,693,299 | 620,172 | *531,857* | 3,061,539 |

| | 2013 | | | | |
|---|---|---|---|---|---|
| | | | Partially collateralised | | |
| | Uncollateralised | Fully collateralised | Loan value | *Collateral value* | Total Loans |
| Personal | | | | | |
| Residential mortgages | 3,391 | 1,185,137 | 413,699 | *354,179* | 1,602,227 |
| Other personal | 121,661 | 219,483 | 20,586 | *18,636* | 361,730 |
| Total loans to individuals | 125,052 | 1,404,620 | 434,285 | *372,815* | 1,963,957 |
| Corporate | | | | | |
| Commercial, industrial and international trade | 53,616 | 95,374 | 96,915 | *60,843* | 245,905 |
| Commercial real estate | 78,372 | 265,594 | 168,079 | *70,421* | 512,045 |
| Government | - | 20,000 | - | - | 20,000 |
| Other commercial | 390,339 | 10,837 | 120,416 | *2,511* | 521,592 |
| Total commercial | 522,327 | 391,805 | 385,410 | *133,775* | 1,299,542 |
| Non-bank financial institutions | 29,009 | 34,897 | 1,654 | *1,606* | 65,560 |
| Total corporate | 551,336 | 426,702 | 387,064 | *135,381* | 1,365,102 |
| **Gross loans and advances to customers** | 676,388 | 1,831,322 | 821,349 | *508,196* | 3,329,059 |

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

The group regularly reviews loans and advances to customers and allocates a risk rating against each loan or advance based on performance criteria. The breakdown of loans and advances to customers by risk category at 31 December 2014 is 80.6% (2013: 76.3%) performing, 1.4% (2013: 3.0%) substandard and 18.0% (2013: 20.7%) non-performing.

Interest receivable on non-performing facilities at 31 December 2014 amounted to $28,299 (2013: $29,228).

At 31 December 2014, the group held $NIL (2013: $12,600) of non-financial assets acquired in exchange for loans which are recorded as 'Assets held for sale' (see Note 17). In addition, at 31 December 2014, the group repossessed collateral relating to impaired loans with carrying value of $8,580 (2013: $4,600).

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

| | **Individually assessed loans** | **Collectively assessed loans** | **Total** |
|---|---|---|---|
| **Opening balance at 1 January 2013** | 125,306 | 27,399 | 152,705 |
| Uncollectible amounts written off during the year | (34,013) | (4,810) | (38,823) |
| Recoveries | 3 | 1,495 | 1,498 |
| Impairment charges during the year | 115,546 | 10,069 | 125,615 |
| **Balance at 31 December 2013** | 206,842 | 34,153 | 240,995 |
| Uncollectible amounts written off during the year | (185,564) | (3,622) | (189,186) |
| Recoveries | 165 | 1,054 | 1,219 |
| Impairment charges during the year | 59,956 | 4,411 | 64,367 |
| **Balance at 31 December 2014** | 81,399 | 35,996 | 117,395 |

Renegotiated loans that would otherwise have been past due or considered impaired totalled $32,914 at 31 December 2014 (2013: $39,340).

Renegotiated loans and advances to customers are shown in the table below:

| | **2014** | | | |
|---|---|---|---|---|
| | **Neither past due nor impaired** | **Past due but not impaired** | **Impaired** | **Total** |
| Personal | | | | |
| Residential mortgages | 30,559 | 1,293 | 158,273 | 190,125 |
| Other personal | 1,879 | 64 | 3,766 | 5,709 |
| Total loans to individuals | 32,438 | 1,357 | 162,039 | 195,834 |
| Corporate | | | | |
| Commercial, industrial and international trade | 131 | 12 | 54,006 | 54,149 |
| Commercial real estate | 27 | - | 68,333 | 68,360 |
| Other commercial | 228 | - | 484 | 712 |
| Total commercial | 386 | 12 | 122,823 | 123,221 |
| Non-bank financial institutions | 90 | - | - | 90 |
| Total corporate | 476 | 12 | 122,823 | 123,311 |
| **Total renegotiated loans and advances to customers** | 32,914 | 1,369 | 284,862 | 319,145 |

| | 2013 | | | |
|---|---|---|---|---|
| | Neither past due nor impaired | Past due but not impaired | Impaired | Total |
| Personal | | | | |
| Residential mortgages | 34,792 | 5,340 | 121,933 | 162,065 |
| Other personal | 1,999 | 200 | 1,921 | 4,120 |
| Total loans to individuals | 36,791 | 5,540 | 123,854 | 166,185 |
| Corporate | | | | |
| Commercial, industrial and international trade | 1,271 | 171 | 2,869 | 4,311 |
| Commercial real estate | 683 | - | 135,857 | 136,540 |
| Other commercial | 595 | - | 13,889 | 14,484 |
| Total commercial | 2,549 | 171 | 152,615 | 155,335 |
| Non-bank financial institutions | - | - | - | - |
| Total corporate | 2,549 | 171 | 152,615 | 155,335 |
| **Total renegotiated loans and advances to customers** | 39,340 | 5,711 | 276,469 | 321,520 |

Of the total renegotiated loans and advances $NIL (2013: $NIL) relates to loans that were derecognised for accounting purposes and a new asset recognised following renegotiation. On derecognition, an impairment charge of the difference between the previous carrying value of the derecognised loan and the new loan recorded at fair value would be recognised.

## 10 Financial investments

The following tables provide an analysis of the group's financial investments, all classified as available-for-sale securities with the exception of $130,592 (2013: $131,721) classified as trading assets related to structured certificates of deposit.

| | **2014** | | 2013 | |
|---|---|---|---|---|
| | **Amortised cost** | **Fair value** | Amortised cost | Fair value |
| Treasury and other eligible bills | 853,626 | 853,919 | 1,440,800 | 1,440,690 |
| Debt securities – fixed rate | 3,922,793 | 3,931,743 | 4,278,713 | 4,274,937 |
| Debt securities – floating rate | 448,897 | 449,363 | 553,425 | 552,977 |
| Total debt securities | 5,225,316 | 5,235,025 | 6,272,938 | 6,268,604 |
| Equity securities | 195 | 31,884 | 2,330 | 34,425 |
| **Total financial investments** | 5,225,511 | 5,266,909 | 6,275,268 | 6,303,029 |

| **Maturity analysis of debt securities** | **2014** | 2013 |
|---|---|---|
| One year or less | 1,540,907 | 2,471,077 |
| More than one year | 3,694,118 | 3,797,527 |
| | 5,235,025 | 6,268,604 |

| **Credit rating analysis of debt securities** | **2014** | 2013 |
|---|---|---|
| AAA | 2,661,902 | 3,091,097 |
| AA+ | 1,601,150 | 1,775,274 |
| AA | - | 98,044 |
| AA- | 421,164 | 677,416 |
| A+ | 550,809 | 572,327 |
| A- | - | 54,446 |
| | 5,235,025 | 6,268,604 |

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

Debt securities are rated using a hierarchy of rating agencies. The Standard & Poor's ('S&P') ratings are used where available, followed by Fitch then Moody's. All securities guaranteed by the U.S. Government are assigned the U.S. Government's sovereign rating.

**Financial investments by country and sector**

| | 2014 | | | | | |
|---|---|---|---|---|---|---|
| **Country** | **Sovereign** | **Bank** | **Corporate** | **Asset backed** | **Equities** | **Total** |
| Australia | - | - | - | - | - | - |
| Belgium | - | - | - | - | 31 | 31 |
| Bermuda | 27,471 | - | - | - | 444 | 27,915 |
| Canada | - | 866,440 | - | - | - | 866,440 |
| Cayman Islands | - | - | - | - | 8,436 | 8,436 |
| France | - | - | - | - | - | - |
| Germany | 208,439 | 195,938 | - | - | - | 404,377 |
| Japan | 655,129 | 96,214 | - | - | - | 751,343 |
| Netherlands | - | - | - | - | - | - |
| New Zealand | - | - | - | - | - | - |
| Norway | - | 30,313 | - | - | - | 30,313 |
| Supranational | - | 1,168,605 | - | - | - | 1,168,605 |
| Sweden | - | 50,002 | - | - | - | 50,002 |
| United Kingdom | 323,927 | 229,380 | - | - | 22,973 | 576,280 |
| United States | 1,254,303 | 107,417 | - | 21,447 | - | 1,383,167 |
| | 2,469,269 | 2,744,309 | - | 21,447 | 31,884 | 5,266,909 |

**Financial investments by country and sector**

| | 2013 | | | | | |
|---|---|---|---|---|---|---|
| **Country** | Sovereign | Bank | Corporate | Asset backed | Equities | Total |
| Australia | 107,856 | 25,043 | - | - | - | 132,899 |
| Belgium | - | - | - | - | 35 | 35 |
| Bermuda | 57,203 | - | - | - | 1,354 | 58,557 |
| Canada | - | 1,048,186 | - | - | - | 1,048,186 |
| Cayman Islands | - | - | - | - | 12,958 | 12,958 |
| France | - | 80,074 | - | - | - | 80,074 |
| Germany | 388,722 | 296,455 | - | - | - | 685,177 |
| Japan | 683,089 | 71,351 | - | - | - | 754,440 |
| Netherlands | - | 125,267 | - | - | - | 125,267 |
| New Zealand | 68,005 | - | - | - | - | 68,005 |
| Norway | - | 51,090 | - | - | - | 51,090 |
| Supranational | - | 1,288,350 | - | - | - | 1,288,350 |
| Sweden | - | 50,000 | - | - | - | 50,000 |
| United Kingdom | 885,060 | 229,132 | - | - | 20,063 | 1,134,255 |
| United States | 607,764 | 162,618 | - | 43,339 | 15 | 813,736 |
| | 2,797,699 | 3,427,566 | - | 43,339 | 34,425 | 6,303,029 |

Supranational entities, reflected in the above tables, are formed by two or more central governments to promote economic development for the member countries.

No debt securities (2013: $NIL) have been pledged to third parties as collateral in the normal course of business and debt securities amounting to $901,913 (2013: $450,169) have been transferred to third parties under securities lending agreements.

The group is carrying all financial investments at fair value. During the year the group received proceeds of $13,569,094 (2013: $11,736,294) from the sale or maturity of financial investments and realised a net gain of $14,614 (2013: $20,508). The group monitors interest rate sensitivity under varying interest rate scenarios as summarised in Note 24.

## 11 Fair values of financial investments carried at fair value

The fair value of financial instruments is generally measured on the basis of the individual financial instrument. A three level fair value hierarchy, which reflects the significance of observable market inputs, is used when estimating fair values and is summarised below:

| | **2014** | | | |
|---|---|---|---|---|
| **Financial Investments fair value hierarchy summary by sector** | **Quoted market price Level 1** | **Using observable inputs Level 2** | **With significant unobservable inputs Level 3** | **Total** |
| Sovereign | 1,254,303 | 1,214,966 | - | 2,469,269 |
| Bank | - | 2,651,395 | 92,914 | 2,744,309 |
| Asset backed | - | 21,447 | - | 21,447 |
| Equities | 99 | - | 31,785 | 31,884 |
| **Total Financial Investments** | 1,254,402 | 3,887,808 | 124,699 | 5,266,909 |
| **Derivatives** | | | | |
| Assets | - | 54,909 | - | 54,909 |
| Liabilities | - | 23,861 | - | 23,861 |

| | 2013 | | | |
|---|---|---|---|---|
| **Financial Investments fair value hierarchy summary by sector** | Quoted market price Level 1 | Using observable inputs Level 2 | With significant unobservable inputs Level 3 | Total |
| Sovereign | 607,764 | 2,189,935 | - | 2,797,699 |
| Bank | - | 3,333,915 | 93,651 | 3,427,566 |
| Asset backed | - | 43,339 | - | 43,339 |
| Equities | 113 | - | 34,312 | 34,425 |
| **Total Financial Investments** | 607,877 | 5,567,189 | 127,963 | 6,303,029 |
| **Derivatives** | | | | |
| Assets | - | 18,046 | - | 18,046 |
| Liabilities | - | 23,725 | - | 23,725 |

The fair values of these securities have been measured using quoted market prices for identical instruments in active markets.

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

| | **2014** | 2013 |
|---|---|---|
| At 1 January | 127,963 | 123,883 |
| Purchases | - | 3,802 |
| Sales | (5,038) | (4,717) |
| Total gains or losses: | | |
| in profit or loss | (4,752) | (5,996) |
| in other comprehensive income | 6,526 | 10,991 |
| At 31 December | 124,699 | 127,963 |

Level 3 securities comprise equity and equity-linked securities. 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.

## 12 Property, plant and equipment

| | Land and buildings | Equipment, fixtures and fittings | Total |
|---|---|---|---|
| **Cost** | | | |
| Cost at 1 January 2014 | 186,654 | 94,571 | 281,225 |
| Additions at cost | - | 2,452 | 2,452 |
| Disposals and write-offs | - | - | - |
| **Cost at 31 December 2014** | 186,654 | 97,023 | 283,677 |
| **Accumulated depreciation** | | | |
| Accumulated depreciation at 1 January 2014 | 36,489 | 62,721 | 99,210 |
| Depreciation charge for the year | 4,011 | 8,970 | 12,981 |
| Impairment losses | - | 4,446 | 4,446 |
| Disposals and write-offs | - | - | - |
| **Accumulated depreciation at 31 December 2014** | 40,500 | 76,137 | 116,637 |
| **Net book value at 31 December 2014** | 146,154 | 20,886 | 167,040 |

| | Land and buildings | Equipment, fixtures and fittings | Total |
|---|---|---|---|
| **Cost** | | | |
| Cost at 1 January 2013 | 186,630 | 88,875 | 275,505 |
| Additions at cost | 24 | 5,982 | 6,006 |
| Disposals and write-offs | - | (286) | (286) |
| **Cost at 31 December 2013** | 186,654 | 94,571 | 281,225 |
| **Accumulated depreciation** | | | |
| Accumulated depreciation at 1 January 2013 | 32,477 | 53,613 | 86,090 |
| Depreciation charge for the year | 4,012 | 9,394 | 13,406 |
| Disposals and write-offs | - | (286) | (286) |
| **Accumulated depreciation at 31 December 2013** | 36,489 | 62,721 | 99,210 |
| **Net book value at 31 December 2013** | 150,165 | 31,850 | 182,015 |

During 2014 there was a partial sale of the Cayman operations which resulted in an impairment of equipment, fixtures and fittings in the amount of $4,446. Note 17 presents information about subsidiary undertakings disposed of during the year ended 31 December 2014 and 2013. The impairment has been included in the consolidated income statement as part of ‘(Losses) gains on disposal of subsidiary investments’.

## 13 Goodwill

| Cost | **2014** | 2013 |
|---|---|---|
| At 1 January | 9,078 | 22,399 |
| Impairment | (9,078) | (13,321) |
| At 31 December | - | 9,078 |

There were no additions to or disposals of goodwill during the year ended 31 December 2014 (2013: $NIL).

During 2014 there was a partial sale of the Cayman operations. Note 16 presents information about subsidiary undertakings disposed of during the year ended 31 December 2014. Based on an analysis of the proceeds of the partial sale of the Cayman operations and estimated future cash inflows related to its residual assets, all remaining goodwill in the amount of $9,078 was written off.

Goodwill is reviewed for impairment at least annually. Goodwill was found to be impaired at 31 December 2013 due to anticipated declines in cash flows based on annual operating plans and impairment of $13,321 was recognised.

As part of the annual review of operations, management reviews the recoverable amount of the investment in subsidiaries that gives rise to goodwill. During 2013 the recoverable amount of goodwill was calculated based on the value in use determined by discounting the future cash flows expected to be generated from continuing operation of the subsidiaries. Key assumptions used in the calculation of value in use were the following:

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

## 14 Group entities

### (a) Principal subsidiaries

The Bank has a 100% interest in the legal entities listed below:

| Legal Entity | Country of incorporation or registration | Activity |
|---|---|---|
| Bermuda International Securities Limited | Bermuda | Agent for investment transactions |
| Bermuda Trust Company Limited | Bermuda | Trust administration |
| HSBC Global Asset Management (Bermuda) Limited | Bermuda | Investment management |
| HSBC Institutional Trust Services (Bermuda) Limited | Bermuda | Custodial and other fiduciary services |
| HSBC Securities Services (Bermuda) Limited | Bermuda | Fund administration |
| HSBC Cayman Services Limited | Cayman | Fund and Trust administration |

All of the above entities prepare their financial statements up to 31 December. Please refer to Note 16 for details of acquisitions and disposals during 2014.

During the year ended 31 December 2014 HSBC Bank (Cayman) Limited relinquished its Banking Licence and on 18 December 2014 the Board of Directors resolved to change its name to HSBC Cayman Services Limited. This change was effected 7 January 2015.

During the year ended 31 December 2013 Bermuda International (Guernsey) Limited was placed into liquidation and dissolved in 2014.

**(b) Principal associate**

**Movement in investment in associate**

| | **2014** | 2013 |
|---|---|---|
| At 1 January | 1,563 | 1,263 |
| Share of profit | 215 | 300 |
| At 31 December | 1,778 | 1,563 |

**Summarised aggregate financial information on associate at 31 December**

| | **2014** | 2013 |
|---|---|---|
| Assets | 4,458 | 4,091 |
| Liabilities | 881 | 960 |
| Operating income | 5,151 | 5,555 |
| Profit for the year | 430 | 600 |

The associate investment is accounted for using the equity method.

## 15 Impairment of assets other than financial instruments

During 2014, the group obtained an independent market valuation for each major building owned and compared the carrying cost to the appraisal value and the asset's value in use, where appropriate. As a result, an impairment loss on two buildings, classified as 'assets held for sale', was recognised in the amount of $5,346 (2013: $5,205).

Note 13 presents detailed information about the impairment of goodwill.

## 16 Investments

**(a) Acquisitions**

The group did not purchase any subsidiary undertakings in 2014 or 2013.

***(b)* Disposals**

*(i) During the year ended 31 December 2014*

Following a strategic review, HSBC Bank (Cayman) Limited, an indirect wholly owned subsidiary of the Bank, entered into an agreement, to sell parts of its corporate and retail banking business in the Cayman Islands to Butterfield Bank (Cayman) Limited ("Butterfield"). Branch operations ceased on 7 November 2014 with customer balances transferring to Butterfield on 11 November 2014. Post-transaction with Butterfield, HSBC Bank (Cayman) Limited relinquished its Cayman Islands Banking Licence and changed its legal name to HSBC Cayman Services Limited.

The partial disposal resulted in a loss of $14,221, before impairment of goodwill. This loss has been included in '(Losses) gains on disposal of subsidiary investments' in the group's consolidated income statement. Note 17 (b) presents further details on the discontinued operations of the subsidiary. Note 13 presents additional information in connection with the impairment of goodwill related to this transaction.

*(ii) During the year ended 31 December 2013*

During the year ended 31 December 2013 the group disposed of Bermuda Asia Pacific Holdings Limited to an HSBC affiliated entity for net cash proceeds of $12,500. The attributable gain of $7,944 has been included in '(Losses) gains on disposal of subsidiary investments' in the group's consolidated income statement.

## 17 Assets held for sale and discontinued operations

### (a) Assets held for sale

At 31 December 2014, assets held for sale is comprised of two office buildings and one condominium. During the year the group sold assets consisting of one office building, one condominium and land. The assets were recorded at the lower of net book value and fair value less costs to sell, which amounted to $8,868 (2013: $29,827).

During the year ended December 31 2013, the group disposed of its wholly owned subsidiary Bermuda Asia Pacific Holdings Limited as described in part (b) (ii) below.

| | Property, plant and equipment | Discontinued operations of subsidiary | Total |
|---|---|---|---|
| **Assets** | | | |
| At 1 January 2013 | 35,496 | 4,866 | 40,362 |
| Reduction in value through impairment (Note 15) | (5,205) | - | (5,205) |
| Disposals | (464) | (4,866) | (5,330) |
| **Assets held for sale 31 December 2013** | 29,827 | - | 29,827 |
| Reduction in value through impairment (Note 15) | (5,346) | - | (5,346) |
| Disposals | (15,613) | - | (15,613) |
| **Assets held for sale 31 December 2014** | 8,868 | - | 8,868 |
| **Liabilities** | | | |
| At 1 January 2013 | - | 893 | 893 |
| Disposals | - | (893) | (893) |
| **Liabilities held for sale at 31 December 2013** | - | - | - |
| **Liabilities held for sale at 31 December 2014** | - | - | - |

### (b) Discontinued operations of subsidiaries

| | **2014** | 2013 |
|---|---|---|
| **Results from discontinued operations** | | |
| Operations discontinued during the year end December 31 2014 | (22,584) | 3,131 |
| Operations discontinued during the year end December 31 2013 | - | 583 |
| **(Loss) profit from discontinued operations** | (22,584) | 3,714 |

*(i) During the year ended 31 December 2014*

Following a strategic review, HSBC Bank (Cayman) Limited, an indirect wholly owned subsidiary of the Bank, entered into an agreement to sell parts of its corporate and retail banking business in the Cayman Islands to Butterfield Bank (Cayman) Limited ("Butterfield"). The transaction completed on 11 November 2014 with customer balances transferring at that date. The net proceeds paid to Butterfield in respect of the net liabilities transferred were $313,052. The $14,221 loss on disposal of discontinued operations before goodwill impairment includes an impairment of equipment, fixtures and fittings in the amount of $4,446 as disclosed in Note 12.

The consolidated income statement has been presented to show the discontinued operations separately from continuing operations. The results and impact of the discontinued operations of the subsidiary are summarised below:

| | **2014** | 2013 |
|---|---|---|
| **Results from discontinued operations** | | |
| Net operating income | 11,747 | 15,925 |
| Loan impairment charges | (268) | (595) |
| Total operating expenses | (10,764) | (12,199) |
| Operating profit | 715 | 3,131 |
| Loss on disposal of discontinued operations before goodwill impairment | (14,221) | - |
| Impairment of goodwill | (9,078) | - |
| (Loss) profit before tax | (22,584) | 3,131 |
| Tax expense | - | - |
| **(Loss) profit from discontinued operations** | (22,584) | 3,131 |

| | 2014 |
|---|---|
| **Cash flows used in discontinued operations** | |
| Net cash flows used in operating activities | (1,473,321) |
| Net cash flows used in investing activities | (313,052) |
| Net cash flows from financing activities | - |
| **Net decrease in cash and cash equivalents** | (1,786,373) |

*(ii) During the year ended 31 December 2013*

Effective 1 July 2013, the group disposed of Bermuda Asia Pacific Holdings Limited and its subsidiaries to an HSBC affiliated entity for total cash proceeds of $12,500 which is the estimated fair value of the business at sale date. The disposal of this subsidiary resulted in a gain of $7,944.

The consolidated income statement has been presented to show the discontinued operations separately from continuing operations. The results and impact of the discontinued operations of the subsidiary are summarised below:

| | 2013 |
|---|---|
| **Results from discontinued operations** | |
| Net operating income | 1,411 |
| Total operating expenses | (669) |
| Profit before tax | 742 |
| Tax expense | (159) |
| **Profit from discontinued operations (net of income tax)** | 583 |
| | |
| **Cash flows from (used in) discontinued operations** | |
| Net cash flows from operating activities | 365 |
| Net cash flows (used in) investing activities | - |
| Net cash flows (used in) financing activities | (3,883) |
| **Net decrease in cash and cash equivalents** | (3,518) |
| | |
| **Proceeds on sale of subsidiary** | |
| Assets held for sale in subsidiary at 1 January 2013 | 4,866 |
| Liabilities held for sale in subsidiary at 1 January 2013 | (893) |
| Profit from discontinued operations to date of sale | 583 |
| Net assets of subsidiary at 1 July 2013 | 4,556 |
| Gain on disposal of subsidiary | 7,944 |
| **Fair value of subsidiary at 1 July 2013** | 12,500 |

## 18 Provisions

| | **2014** | 2013 |
|---|---|---|
| At 1 January | 280 | 400 |
| Increases in provisions | 168 | 280 |
| Provisions utilised | (140) | (345) |
| Amounts reversed | (10) | (55) |
| **At 31 December** | 298 | 280 |

‘Provisions’ for 2014 and 2013 are comprised entirely of legal provisions related to ongoing legal proceedings, which are undertaken in the normal course of business.

## 19 Contingent liabilities, contractual commitments and guarantees

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

| | **2014** | 2013 |
|---|---|---|
| **Guarantees and contingent liabilities in favour of third parties** | | |
| Guarantees in the form of irrevocable letters of credit | 162,527 | 184,215 |
| Financial and other guarantees | 28,500 | 28,500 |
| Other contingent liabilities | 1,147 | 1,236 |
| **At 31 December** | 192,174 | 213,951 |
| | | |
| **Commitments** | | |
| Documentary credits and short-term trade-related transactions | 3,336 | 3,816 |
| Undrawn revolving underwriting facilities | 255,232 | 274,074 |
| Undrawn formal standby facilities, credit lines and other commitments to lend | | |
| – remaining contractual maturity one year or less | 294,814 | 285,833 |
| – remaining contractual maturity more than one year | 176,060 | 311,238 |
| **At 31 December** | 729,442 | 874,961 |

At 31 December 2014 approximately 85% (2013: 87%) of the above guarantees have an original contractual term of less than one year. Guarantees with a term of more than one year are subject to the group's annual credit review process. When the group has given a guarantee on behalf of a customer, it will have the right to recover from that customer any amounts paid under the guarantee. At 31 December 2014, the group holds collateral amounting to $73,633 (2013: $125,811), which could be used to recover amounts paid under the above guarantees.

## 20 Lease commitments

At 31 December 2014, the group was obligated under a number of non-cancellable operating leases for properties, plant and equipment, for which the future minimum lease payments extend over a number of years as follows:

| | **2014** | | 2013 | |
|---|---|---|---|---|
| **Future minimum lease payments under non-cancellable operating leases** | **Land and buildings** | **Equipment** | Land and buildings | Equipment |
| No later than one year | 1,777 | 22 | 1,815 | 92 |
| Later than one year and not later than five years | 6,957 | - | 6,777 | 18 |
| Later than five years | 6,652 | - | 8,552 | - |
| | 15,386 | 22 | 17,144 | 110 |

During the year $2,251 (2013: $2,164) was recognised within 'General and administrative expenses' in respect of lease agreements.

## 21 Maturity analysis of financial assets and financial liabilities

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

| 31 December 2014 | Due not more than 1 month | Due over 1 month but not more than 3 months | Due over 3 months but not more than 6 months | Due over 6 months but not more than 9 months | Due over 9 months but not more than 1 year | Due over 1 year but not more than 2 years | Due over 2 years but not more than 5 years | Due over 5 years | Total |
|---|---|---|---|---|---|---|---|---|---|
| Cash and balances at central banks | 29,859 | - | - | - | - | - | - | - | 29,859 |
| Items in the course of collection from other banks | 1 | - | - | - | - | - | - | - | 1 |
| Derivatives | 11,526 | 42,378 | 929 | 19 | 19 | 38 | - | - | 54,909 |
| Loans and advances to banks | 2,875,596 | - | 30,000 | - | - | - | - | - | 2,905,596 |
| Loans and advances to customers | 194,320 | 2,475 | 119,097 | 55,511 | 177,744 | 273,167 | 373,656 | 1,748,174 | 2,944,144 |
| *Of which:* | | | | | | | | | |
| *- Personal* | 49,207 | 508 | 686 | 3,197 | 3,233 | 13,889 | 92,444 | 1,417,570 | 1,580,734 |
| *- Corporate and commercial* | 124,698 | 1,967 | 118,411 | 52,314 | 172,922 | 213,432 | 276,324 | 299,731 | 1,259,799 |
| *- Financial and other* | 20,415 | - | - | - | 1,589 | 45,846 | 4,888 | 30,873 | 103,611 |
| Financial investments | 171,041 | 782,977 | 327,182 | 170,198 | 89,608 | 1,457,210 | 2,187,990 | 80,703 | 5,266,909 |
| **Total financial assets** | 3,282,343 | 827,830 | 477,208 | 225,728 | 267,371 | 1,730,415 | 2,561,646 | 1,828,877 | 11,201,418 |
| Other assets | 64,374 | - | - | - | - | - | - | 193,147 | 257,521 |
| **Total assets** | 3,346,717 | 827,830 | 477,208 | 225,728 | 267,371 | 1,730,415 | 2,561,646 | 2,022,024 | 11,458,939 |
| Deposits by banks | 68,183 | - | - | - | - | - | - | - | 68,183 |
| Customer accounts | 9,655,156 | 186,419 | 161,278 | 71,317 | 23,489 | 7,157 | 14,292 | - | 10,119,108 |
| *Of which:* | | | | | | | | | |
| *- Personal* | 2,807,695 | 92,644 | 115,701 | 35,451 | 17,109 | 7,101 | 13,721 | - | 3,089,422 |
| *- Corporate and commercial* | 2,415,611 | 22,724 | 2,277 | 489 | 804 | 56 | 571 | - | 2,442,532 |
| *- Financial and other* | 4,431,850 | 71,051 | 43,300 | 35,377 | 5,576 | - | - | - | 4,587,154 |
| Items in course of transmission to other banks | 2,973 | - | - | - | - | - | - | - | 2,973 |
| Derivatives | 15,241 | 7,489 | 1,055 | 19 | 19 | 38 | - | - | 23,861 |
| **Total financial liabilities** | 9,741,553 | 193,908 | 162,333 | 71,336 | 23,508 | 7,195 | 14,292 | - | 10,214,125 |
| Other liabilities | 50,769 | - | - | - | - | - | - | 131,395 | 182,164 |
| **Total liabilities** | 9,792,322 | 193,908 | 162,333 | 71,336 | 23,508 | 7,195 | 14,292 | 131,395 | 10,396,289 |
| **Off balance sheet commitments given** | | | | | | | | | |
| Loans and other credit-related commitments | 510,658 | 58,227 | 65,682 | 71,045 | 9,436 | 24,297 | 177,014 | 5,257 | 921,616 |
| *Of which:* | | | | | | | | | |
| *- Personal* | 157,646 | - | 1 | - | 41 | 45 | 628 | 4,580 | 162,941 |
| *- Corporate and commercial* | 281,251 | 17,780 | 2,136 | 16,194 | 1,775 | 24,177 | 52,332 | 677 | 396,322 |
| *- Financial and other* | 71,761 | 40,447 | 63,545 | 54,851 | 7,620 | 75 | 124,054 | - | 362,353 |

'Other assets' and 'Other liabilities' comprise other financial assets such as 'Prepayments and accrued income', 'Interest in associate' 'Goodwill', 'Property, plant and equipment', 'Other liabilities' and 'Retirement benefit liabilities'.

| 31 December 2013 | Due not more than 1 month | Due over 1 month but not more than 3 months | Due over 3 months but not more than 6 months | Due over 6 months but not more than 9 months | Due over 9 months but not more than 1 year | Due over 1 year but not more than 2 years | Due over 2 years but not more than 5 years | Due over 5 years | Total |
|---|---|---|---|---|---|---|---|---|---|
| Cash and balances at central banks | 39,293 | - | - | - | - | - | - | - | 39,293 |
| Items in the course of collection from other banks | 560 | - | - | - | - | - | - | - | 560 |
| Derivatives | 12,118 | 1,288 | 16 | 105 | 132 | 58 | 4,329 | - | 18,046 |
| Loans and advances to banks | 4,135,978 | 227,000 | - | - | - | - | 13,000 | 30,000 | 4,405,978 |
| Loans and advances to customers | 114,807 | 150,975 | 36,023 | 201,296 | 31,615 | 304,784 | 364,603 | 1,883,961 | 3,088,064 |
| *Of which:* | | | | | | | | | |
| *- Personal* | 72,846 | 10,362 | 18,197 | 16,143 | 17,255 | 68,933 | 222,470 | 1,488,622 | 1,914,828 |
| *- Corporate and commercial* | 31,171 | 140,117 | 17,071 | 184,388 | 13,543 | 232,625 | 99,811 | 390,031 | 1,108,757 |
| *- Financial and other* | 10,790 | 496 | 755 | 765 | 817 | 3,226 | 42,322 | 5,308 | 64,479 |
| Financial investments | 1,085,510 | 989,720 | 65,450 | 286,329 | 44,068 | 832,245 | 2,862,032 | 137,675 | 6,303,029 |
| **Total financial assets** | 5,388,266 | 1,368,983 | 101,489 | 487,730 | 75,815 | 1,137,087 | 3,243,964 | 2,051,636 | 13,854,970 |
| Other assets | 94,933 | - | - | - | - | - | - | 222,482 | 317,415 |
| **Total assets** | 5,483,199 | 1,368,983 | 101,489 | 487,730 | 75,815 | 1,137,087 | 3,243,964 | 2,274,118 | 14,172,385 |
| Deposits by banks | 53,887 | - | - | - | - | - | - | - | 53,887 |
| Customer accounts | 11,636,843 | 989,844 | 99,549 | 85,999 | 37,095 | 19,262 | 13,086 | 6 | 12,881,684 |
| *Of which:* | | | | | | | | | |
| *- Personal* | 2,922,134 | 755,950 | 50,904 | 46,038 | 23,245 | 7,169 | 11,720 | 6 | 3,817,166 |
| *- Corporate and commercial* | 6,857,908 | 142,751 | 48,645 | 39,961 | 13,850 | 12,093 | 1,366 | - | 7,116,574 |
| *- Financial and other* | 1,856,801 | 91,143 | - | - | - | - | - | - | 1,947,944 |
| Items in course of transmission to other banks | 4,025 | - | - | - | - | - | - | - | 4,025 |
| Derivatives | 10,856 | 1,253 | 15 | 330 | 130 | 1,330 | 9,811 | - | 23,725 |
| **Total financial liabilities** | 11,705,611 | 991,097 | 99,564 | 86,329 | 37,225 | 20,592 | 22,897 | 6 | 12,963,321 |
| Other liabilities | 27,344 | 46,617 | 407 | 403 | 399 | 1,672 | 5,245 | 63,107 | 145,194 |
| **Total liabilities** | 11,732,955 | 1,037,714 | 99,971 | 86,732 | 37,624 | 22,264 | 28,142 | 63,113 | 13,108,515 |
| **Off balance sheet commitments given** | | | | | | | | | |
| Loans and other credit-related commitments | 569,347 | 41,569 | 75,687 | 47,047 | 11,883 | 67,403 | 191,319 | 84,657 | 1,088,912 |
| *Of which:* | | | | | | | | | |
| *- Personal* | 164,113 | 47 | 3 | 3 | 2 | 50 | 860 | 10,509 | 175,587 |
| *- Corporate and commercial* | 332,279 | 1,600 | 1,501 | 1,192 | 3,825 | 16,148 | 79,987 | 73,758 | 510,290 |
| *- Financial and other* | 72,955 | 39,922 | 74,183 | 45,852 | 8,056 | 51,205 | 110,472 | 390 | 403,035 |

'Other assets' and 'Other liabilities' comprise other financial assets such as 'Prepayments and accrued income', 'Interest in associate' 'Goodwill', 'Property, plant and equipment', 'Other liabilities' and 'Retirement benefit liabilities'.

## 22 Interest rate analysis of financial instruments

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

| 31 December 2014 | Due not more than 3 months | Due over 3 months and not more than 6 months | Due over 6 months and not more than 1 year | Due over 1 year and not more than 5 years | Due over 5 years and not more than 10 years | Non-interest bearing | Total | Range of weighted average effective interest rates |
|---|---|---|---|---|---|---|---|---|
| **Financial assets** | | | | | | | | |
| Cash and balances at central banks | - | - | - | - | - | 29,859 | 29,859 | |
| Items in the course of collection from other banks | - | - | - | - | - | 1 | 1 | |
| Derivatives | - | - | - | - | - | 54,909 | 54,909 | |
| Loans and advances to banks | 2,875,596 | 30,000 | - | - | - | - | 2,905,596 | 0.16-0.28% |
| Loans and advances to customers | 2,932,879 | - | - | - | 11,265 | - | 2,944,144 | 4.58-4.91% |
| Financial investments | 2,682,532 | 187,065 | 199,201 | 2,138,757 | 27,471 | 31,883 | 5,266,909 | 1.38-2.05% |
| **Total at 31 December 2014** | 8,491,007 | 217,065 | 199,201 | 2,138,757 | 38,736 | 116,652 | 11,201,418 | |
| | | | | | | | | |
| **Financial liabilities** | | | | | | | | |
| Deposits by banks | 65,518 | - | - | - | - | 2,665 | 68,183 | 0.00-0.21% |
| Customer accounts | 9,809,294 | 178,011 | 104,896 | 26,906 | 1 | - | 10,119,108 | 0.05-0.08% |
| Items in course of transmission to other banks | - | - | - | - | - | 2,973 | 2,973 | |
| Derivatives | - | - | - | - | - | 23,861 | 23,861 | |
| **Total at 31 December 2014** | 9,874,812 | 178,011 | 104,896 | 26,906 | 1 | 29,499 | 10,214,125 | |
| | | | | | | | | |
| Interest rate sensitivity gap | (1,383,805) | 39,054 | 94,305 | 2,111,851 | 38,735 | | | |
| Cumulative interest rate sensitivity gap | (1,383,805) | (1,344,751) | (1,250,446) | 861,405 | 900,140 | | | |

Financial instruments included within ‘Prepayments and accrued income’, ‘Other assets’, ‘Accruals and deferred income’, ‘Provisions’, ‘Other liabilities’ and ‘Retirement benefit liabilities’ have not been included in the analysis above and are all considered non-interest bearing. The interest rate sensitivity gap on non-interest bearing assets and liabilities is considered to be $NIL.

| 31 December 2013 | Due not more than 3 months | Due over 3 months and not more than 6 months | Due over 6 months and not more than 1 year | Due over 1 year and not more than 5 years | Due over 5 years and not more than 10 years | Non-interest bearing | Total | Range of weighted average effective interest rates |
|---|---|---|---|---|---|---|---|---|
| **Financial assets** | | | | | | | | |
| Cash and balances at central banks | - | - | - | - | - | 39,293 | 39,293 | |
| Items in the course of collection from other banks | - | - | - | - | - | 560 | 560 | |
| Derivatives | - | - | - | - | - | 18,046 | 18,046 | |
| Loans and advances to banks | 4,405,978 | - | - | - | - | - | 4,405,978 | 0.14-0.36% |
| Loans and advances to customers | 3,053,366 | 34,698 | - | - | - | - | 3,088,064 | 4.71-4.94% |
| Financial investments | 3,849,198 | 45,417 | 201,487 | 1,983,578 | 188,924 | 34,425 | 6,303,029 | 1.45-2.75% |
| **Total at 31 December 2013** | 11,308,542 | 80,115 | 201,487 | 1,983,578 | 188,924 | 92,324 | 13,854,970 | |
| | | | | | | | | |
| **Financial liabilities** | | | | | | | | |
| Deposits by banks | 53,887 | - | - | - | - | - | 53,887 | 0.16-0.25% |
| Customer accounts | 12,626,687 | 99,549 | 123,094 | 32,348 | 6 | - | 12,881,684 | 0.06-0.10% |
| Items in course of transmission to other banks | - | - | - | - | - | 4,025 | 4,025 | |
| Derivatives | - | - | - | - | - | 23,725 | 23,725 | |
| **Total at 31 December 2013** | 12,680,574 | 99,549 | 123,094 | 32,348 | 6 | 27,750 | 12,963,321 | |
| | | | | | | | | |
| Interest rate sensitivity gap | (1,372,032) | (19,434) | 78,393 | 1,951,230 | 188,918 | | | |
| Cumulative interest rate sensitivity gap | (1,372,032) | (1,391,466) | (1,313,073) | 638,157 | 827,075 | | | |

Financial instruments included within ‘Prepayments and accrued income’, ‘Other assets’, ‘Accruals and deferred income’, ‘Provisions’, ‘Other liabilities’ and ‘Retirement benefit liabilities’ have not been included in the analysis above and are all considered non-interest bearing. The interest rate sensitivity gap on non-interest bearing assets and liabilities is considered to be $NIL.

## 23 Foreign currency exposures

### (a) Balance sheet denominated in foreign currency

The group recognises that changes in foreign exchange rates can result in changes to profit and loss and other comprehensive income. In order to mitigate this risk, the group matches assets and liabilities by currency to the greatest extent possible including using forward foreign exchange contracts to reduce potential mismatches. The table below shows the extent of foreign currency mismatch including the impact of the forward foreign exchange contracts.

| **31 December 2014** | **Assets** | **Liabilities and Equity** | **Net foreign exchange exposure** |
|---|---|---|---|
| Euro | 441,048 | 436,425 | 4,623 |
| Pound sterling | 701,066 | 699,968 | 1,098 |
| Japanese yen | 330,139 | 329,808 | 331 |
| Canadian dollars | 223,778 | 222,712 | 1,066 |
| Australian dollars | 129,901 | 129,261 | 640 |
| New Zealand dollars | 80,456 | 80,554 | (98) |
| Swiss franc | 130,596 | 130,560 | 36 |
| Other currencies | 182,203 | 181,201 | 1,002 |
| Total foreign currency | 2,219,187 | 2,210,489 | 8,698 |
| US and Bermuda dollars | 9,239,752 | 9,248,450 | (8,698) |
| Total | 11,458,939 | 11,458,939 | - |

| 31 December 2013 | Assets | Liabilities and Equity | Net foreign exchange exposure |
|---|---|---|---|
| Euro | 786,818 | 787,017 | (199) |
| Pound sterling | 885,321 | 886,512 | (1,191) |
| Japanese yen | 369,021 | 368,896 | 125 |
| Canadian dollars | 270,896 | 269,259 | 1,637 |
| Australian dollars | 180,804 | 180,906 | (102) |
| New Zealand dollars | 114,764 | 115,051 | (287) |
| Swiss franc | 134,110 | 134,152 | (42) |
| Other currencies | 100,696 | 100,236 | 460 |
| Total foreign currency | 2,842,430 | 2,842,029 | 401 |
| US and Bermuda dollars | 11,329,955 | 11,330,356 | (401) |
| Total | 14,172,385 | 14,172,385 | - |

Considering the foreign exchange exposures as at 31 December 2014 and 31 December 2013, shareholders' equity would decrease by US$339 (2013: US$12) if Pound sterling, Euro and Canadian dollar foreign currency exchange rates all weakened by 5% relative to the US dollar. The group therefore considers that the overall risk of changes in foreign exchange rates to profit and loss and equity is not significant.

### (b) Structural currency exposures

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

## 24 Risk management

**Introduction**

All our activities involve, to varying degrees, the measurement, evaluation, acceptance and management of risk or combinations of risks. As a provider of banking and financial services, we actively manage risk as a core part of our day-to-day activities. We employ a risk management framework at all levels of the organisation, underpinned by a strong risk culture and reinforced by HSBC Values and HSBC Global Standards. It ensures that our risk profile remains conservative and aligned to our risk appetite, which describes the type and quantum of risk we are willing to accept in achieving our strategic objectives.

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

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

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

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

*(i) Risk governance*

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

Primary responsibility for managing risk at the group's operating entity levels lies with the relevant Chief Executive Officer, as custodian of the relevant balance sheets. In turn, the Chief Risk Officer and the group's Operational Risk Function have functional responsibility for the primary financial risk types, namely: credit, market, operational and security / fraud risks. Internal Controls co-ordinates the development of the risk appetite statement. Finance (including asset and liability management) is primarily responsible for the economic capital and stress-testing frameworks.

*(ii) Risk management framework and risk appetite*

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

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

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

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

Quantitative and qualitative metrics are assigned to ten key categories: returns, capital, liquidity and funding, securitisations, cost of risk, intra-Group lending, strategic investments, risk categories such as credit, market and operational risk, risk diversification and concentration, and financial crime compliance.

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

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

**(a) Market risk management**

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

The group is not required to report under market risk methodologies as its trading book does not exceed the De Minimis threshold, resulting in an exemption as defined in the Bermuda Monetary Authority ('BMA') Framework. Exposure to market risk relates to non-trading portfolios which comprise positions that primarily arise from the interest rate management of our retail and commercial banking assets and liabilities, financial investments designated as available for sale and fair value hedges.

Market risk is:

- **measured** in terms of value at risk, which is used to estimate potential losses 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 augmented with stress testing to evaluate the potential impact on portfolio values of more extreme, though plausible, events or movements in a set of financial variables;
- **monitored** using measures including sensitivity of net interest income and the sensitivity of structural foreign exchange which are applied to market risk positions within each risk type; and
- **managed** using approved risk limits applied to our businesses.

The objectives of the group's market risk management are to manage and control market risk exposures in order to optimise return within the group's risk appetite.

The management of market risk is undertaken mainly in Global Markets using risk limits approved by the HSBC Group Management Board. Limits are set for portfolios, products and risk types with market liquidity being a primary factor in determining the level of limits set. Final approval of limits resides with local entity Boards.

Global Risk is responsible for our market risk management policies and measurement techniques. The group has an independent market risk management and control function which is responsible for measuring market risk exposures in accordance with the policies defined by Global Risk, and for monitoring and reporting exposures against the prescribed limits on a daily basis in accordance with our risk appetite. Interest rate risk in the banking book ('IRRBB') is defined as the exposure of our non-trading products to interest rates. This risk arises in such portfolios principally from mismatches between the future yield on assets and their funding costs, as a result of interest rate changes. Analysis of this risk is complicated by behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts.

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

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

A principal part of the group's management of market risk is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). The group aims to mitigate the effect of prospective interest rate movements, which could reduce future net interest income, while balancing the cost of such hedging activities on the current net operating income stream. The models measure the effect on net interest income due to parallel and ramp movements of plus or minus 100 basis points in all yield curves. The results represent the effect of the pro-forma movements in net interest income based on the projected yield curve scenarios and the group's current interest rate risk profile.

| **Change in 2014 projected net interest income arising from 100 basis points movement in yield curves *(unaudited)*** | **At 31 December 2014 increase (decrease)** | At 31 December 2013 increase (decrease) |
|---|---|---|
| +100 basis points parallel | 23,939 | 54,052 |
| +100 basis points ramp | 4,643 | 30,779 |
| | | |
| -100 basis points parallel | (7,644) | (19,099) |
| -100 basis points ramp | (4,031) | (14,048) |

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

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

**(b) Liquidity and funding risk management**

Liquidity and funding risk is the risk that we do not have sufficient financial resources to meet our obligations as they fall due or that we can only do so at excessive cost. Liquidity risk arises from mismatches in the timing of cash flows. Funding risk arises when the liquidity needed to fund illiquid asset positions cannot be obtained at the expected terms and when required.

Liquidity and funding risk is:

- **measured** using internal metrics including stressed operational cash flow projections, coverage ratios and advances to core funding ratios;
- **monitored** against the group's liquidity and funding risk framework and overseen by ALCO and the Risk Management Committee (RMC); and
- **managed** on a stand-alone basis with no reliance on any HSBC Group entity (unless pre-committed) or central bank or government body unless this represents routine established business as usual market practice.

There were no material changes to our policies and practices for the management of liquidity and funding risks in 2014.

The group manages its liquidity and funding risk by:

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

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

The management of liquidity and funding is subject to the groups' liquidity and funding risk management framework which includes limits, policies and practices. Limits vary according to the depth and liquidity of markets in which the group operates. A key element of our internal framework is the classification of customer deposits into core and non-core based on our expectation of their behaviour

during periods of liquidity stress. This characterisation takes into account the inherent liquidity risk categorisation of the operating entity originating the deposit, the nature of the customer and the size and pricing of the deposit. No deposit is considered to be core in its entirety unless it is contractually collateralising a loan. The core deposit base is considered to be a long-term source of funding and therefore is assumed not to be withdrawn in the liquidity stress scenario that we use to calculate our principal liquidity risk metrics. Core deposits form a significant part of the group's overall funding. Considerable importance is attached to this core deposit base which, over the years, has been stable and predictable. Additional information regarding liquidity and funding risk is found in Note 21.

The primary responsibility for managing liquidity and funding within the group's framework and risk appetite resides with the ALCO. The terms of reference of all ALCOs include the monitoring and control of liquidity and funding.

**(c) Operational risk management**

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events; including legal risks (along with accounting tax, security and fraud, people, systems, projects, operations and organisational change risk). Operational risk arises from day to day operations or external events, and is relevant to every aspect of our business. Compliance risk (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 fiduciary risk (the risk of breaching our fiduciary duties) form part of operational risk. Compliance risk arises from rules, regulations, other standards and HSBC policies, including those related to anti-money laundering, anti-bribery and corruption, counter-terrorist and proliferation financing, sanctions compliance, conduct of business and market conduct. Fiduciary risk arises from our business activities where we act in a fiduciary capacity ('designated businesses') as Trustee, Investment Manager or as mandated by law or regulation.

Operational risk is:

- **measured** using both the top risk analysis process and the risk and control assessment ('RCA') process, which assess the level of risk and effectiveness of controls;
  - compliance risk more specifically is measured by reference to identified metrics, incident assessments, regulatory feedback and the judgement and assessment of the managers of our businesses and functions;
  - fiduciary risk more specifically is measured by each designated business monitoring against their own risk appetites and by the operational RCA process, which assesses the level of risk and the effectiveness of key controls;
- **monitored** using key indicators and other internal control activities;
  - compliance risk is more specifically monitored against our compliance risk assessments and metrics, the results of monitoring and control activities of the second line of defence functions and the results of internal and external audits and regulatory inspections;
  - fiduciary risk is more specifically monitored through a combination of testing key indicators and other metrics such as client and regulatory feedback;
- **managed** primarily by the business and functional managers. They identify and assess risks, implement controls to manage them and monitor effectiveness of these controls utilising the operational risk management framework. Operational Risk is responsible for the framework and for overseeing the management of operational risks within business and functions;
  - compliance risk is more specifically managed by establishing and communicating appropriate policies and procedures, training employees in them, and monitoring activity to assure their observance. Proactive risk control and/or remediation work is undertaken where required;
  - fiduciary risk is more specifically managed within the designated business via established governance frameworks, and comprehensive policies, procedures and training programmes.

The objective of our operational risk management is to manage and control operational risk in a cost effective manner within targeted levels consistent with our risk appetite.

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

Operational risk is organised as a specific risk discipline within Risk, and a formal governance structure provides oversight over its management. The Operational Risk function reports to the Chief Risk Officer and supports the Operational Risk Working Group. It is responsible for establishing and maintaining the operational risk management framework ('ORMF'), monitoring the level of operational losses and the effectiveness of the control environment. It is also responsible for operational risk reporting, including the preparation of reports for consideration by the Risk Management Meeting and Risk Committee. The Operational Risk Committee meets monthly, to discuss key risk issues and review the effective implementation of the ORMF.

The ORMF defines minimum standards and processes and the governance structure for the management of operational risk and internal control in our geographical regions, global businesses and global functions. 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 giving guidance on mitigating action to be taken when weaknesses are identified.

Business managers throughout the Group are 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 loss data.

The Operational Risk function and the ORMF direct business management in discharging their responsibilities. The ORMF defines minimum standards and processes, and the governance structure for operational risk and internal control across the group. To implement the ORMF a 'three lines of defence' model is used for the management of risks as described below:

| | |
|---|---|
| **First line of defence** | **Every employee at HSBC is responsible for the risks that are a part of their day to day jobs. This ensures that all key risks within operations are identified, mitigated and monitored by appropriate internal controls within an overall control environment.** |
| **Second line of defence** | **Functions such as Risk, Finance and Human Resources, form the second line of defence. They are responsible for providing assurance, challenge and oversight of the activities conducted by the first line.** |
| **Third line of defence** | **Internal Audit forms the third line of defence, providing independent assurance to senior management and the Board over the implementation of the first and second lines of defence.** |

Articulating our risk appetite for material operational risks helps the organisation understand the level of risk the group is willing to accept. A group Operational Risk appetite statement is approved annually by the Board under advice from the Operational Risk Management Committee. Monitoring operational risk exposure against risk appetite on a regular basis and implementing our risk acceptance process drives risk awareness in a forward-looking manner. It assists management in determining whether further action is required. Operational risk and control assessments are performed by individual business units and functions. The RCA 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. RCAs are reviewed and updated at least annually.

For regulatory reporting, the group has adopted the Standardised approach to determine its operational risk capital which is a method of calculating the operational capital requirement by the application of a BMA defined percentage charge to the gross income of eight specified business lines. It continues to enhance its ORMF including the use of the RCA process.

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

### (d) Credit risk management

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. Credit risk arises principally from direct lending, trade finance and also from certain other products such as guarantees and derivatives.

Credit risk is:

- **measured** as the amount that could be lost if a customer or counterparty fails to make repayments;
- **monitored** within limits, approved by individuals within a framework of delegated authorities. These limits represent the peak exposure or loss to which the group could be subjected should the customer or counterparty fail to perform its contractual obligations; and
- **managed** through a robust risk control framework which outlines clear and consistent policies, principles and guidance for risk managers.

The group has in place standards, policies and procedures for the control and monitoring of all such risks. Additional credit-related information is presented in Note 7 'Derivatives', Note 8 'Loans and advances to banks', Note 9 'Loans and advances to customers' and Note 10 'Financial investments'.

The principal objectives of our credit risk management are:

- to maintain across the group a strong culture of responsible lending and a robust risk policy and control framework;
- to both partner and challenge our businesses in defining, 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.

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

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

The role of an independent credit control unit is fulfilled by the Risk function. Credit approval authorities are delegated by the Board to certain executive officers of the group. The Chief Risk Officer reports to the Chief Executive Officer on credit-related issues, while maintaining a direct functional reporting line to the HSBC Chief Risk Officer in Global Risk.

### (e) Capital management

*(i) Regulatory capital*

The group's lead regulator, the BMA, sets and monitors capital requirements for the group as a whole under the Banks and Deposit Companies Act 1999. Individual banking operations of the group are directly supervised by their local regulators.

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

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

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

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

The group's policy is to maintain a strong capital base and our approach to managing group capital is designed to ensure that we exceed current regulatory requirements and are well placed to meet those expected in the future so as to maintain creditor and market confidence and to sustain future development of the business. We monitor capital adequacy by the use of capital ratios, which measure capital relative to a regulatory assessment of risks taken, and by the leverage ratio, which measures capital relative to exposure. The group and its individual regulated operations have complied with all external imposed capital requirements throughout the period. There have been no material changes in the group's management of capital during the year.

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

**Composition of regulatory capital**

| | *Notes* | **2014** | 2013 |
|---|---|---|---|
| **Tier 1 capital** | | | |
| Called up share capital | *27* | 30,027 | 30,027 |
| Share premium | | 388,652 | 388,652 |
| Retained earnings | | 608,635 | 622,576 |
| Less goodwill | *13* | - | (9,078) |
| Total Tier 1 capital | | 1,027,314 | 1,032,177 |
| **Tier 2 capital** | | | |
| Collective impairment allowances | *9* | 35,996 | 34,153 |
| **Capital deductions** | | | |
| Investments in capital of other banks | | (57) | (57) |
| Investment in associate | *14* | (1,778) | (1,563) |
| **Total regulatory capital** | | 1,061,475 | 1,064,710 |

**Pillar 1**

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

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

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

**Pillar 2**

The second pillar of Basel II, supervisory assessment process, involves both the group and the Authority to assess and agree the appropriate capital necessary to mitigate the impact of risks not fully captured by the credit risk measures ('Pillar 1'). The annual Supervisory Assessment Process ('SAP'), undertaken by the Authority, aims to assess the group's risk profile and self-assessment as documented in the Capital Assessment and Risk Profile ('CARP'). The completion of the SAP formed the basis for the final agreements on new statutory minimum capital requirements for the group going forward. The group has complied with all minimum capital requirements prescribed by the Authority in 2014 and 2013.

**Pillar 3**

The third pillar of Basel II, market discipline, complements the minimum capital requirements and the supervisory review process. Its aim is to develop disclosures by banks which allow market participants to assess the scope of application of Basel II, capital, particular risk exposures and risk assessment processes, and hence the capital adequacy of the institution. Under the Pillar 3 framework all material risks must be disclosed, enabling a comprehensive view of the institution's risk profile. Disclosures consist of both quantitative and qualitative information and are provided at the consolidated level. The most recent disclosure of the group, 'Capital and Risk Management Interim Pillar 3 Disclosures at 30 June 2014', is published in the group's internet website in the 'About us' section.

*(ii) Capital allocation*

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

**Basel 3**

On 31 December 2014 the Authority published the 'Basel III for Bermuda Banks – Final Rule' which became effective on 1 January 2015. All banks will be expected to report in a Basel III consistent manner commencing with the reporting for the first quarter of 2015. The Basel III requirements complement the requirements outlined above relating to Pillar 1, 2 and 3. The revised capital framework adopts the Common Equity Tier 1 Capital ('CET1') as the main form of regulatory capital. For the group this is similar to Tier 1 capital outlined above. Minimum Basel III capital ratios will be CET1 at least 4.5% of Risk Weighted Assets ('RWAs'), Tier 1 Capital at least 6.0% of RWAs and Total Capital at least 8.0% of RWAs. Through Pillar 2 capital ratio add-ons, which form part of the Authority's Prudential Supervision, the Authority has prescribed a total minimum capital ratio in excess of the minimum Basel III requirements. The group has at all times maintained a capital ratio in excess of the minimum regulatory requirement and it is well placed to continue to exceed regulatory requirements in the future.

In addition to the minimum capital ratios and Pillar 2 related add-ons prescribed by the Authority the new Basel III rules will also contemplate the following capital requirements:

- Capital Conservation Buffer: Ultimately set at 2.5% of RWAs and is composed of CET1 eligible capital. The ratio will be phased in over five years starting at 0.0% in 2015 and increasing to 2.5% by 2019.

- Countercyclical Buffer: To be comprised of CET1 eligible capital. The Authority will assess the need for a buffer of up to 2.5% of RWAs during periods of excessive credit or periods exhibiting other macroeconomic pressures.

- Capital Surcharge for Domestic Systemically Important Banks ('D-SIB'): Can range from 0.5% to 3.0% and is related to factors such as size, interconnectedness, substitutability and complexity. The D-SIB buffer will be determined by the Authority in conjunction with the CARP process scheduled for the second quarter of 2015.

The new Basel III rules also address the areas of Leverage and Liquidity. The Authority has adopted a 5% leverage ratio calculated as the ratio of T1 Capital to Total Exposure. The group is currently in excess of this requirement. The Authority has adopted a Liquidity Coverage Ratio ('LCR') with an implementation timetable consistent with that published by the Basel Committee. The minimum requirement is 60% starting on 1 January 2015 rising in equal annual incremental steps of 10% to reach 100% on 1 January 2019. The LCR is designed to ensure that banks have a sufficient stock of unencumbered high-quality liquid assets ('HQLA') to survive a significant liquidity stress scenario lasting 30 days. The LCR is calculated as HQLA divided by total net cash outflows over the period of the next 30 days. Total net cash outflows are calculated in accordance with rules prescribed by the regulator. Based on its adherence to HSBC standards implemented during 2014 the group is compliant with LCR requirements and is well positioned to continue to be compliant during the ramp up to a 100% ratio.

## 25 Litigation

In the ordinary course of business, the Company is routinely defendant in, or party to, a number of pending and threatened legal actions and proceedings. Apart from the matters described below, the Company considers that none of these matters is material, either individually or in the aggregate. The Company recognises a provision for a liability in relation to these matters when it is probable that an outflow of economic benefits will be required to settle an obligation which has arisen as a result of past events, and for which a reliable estimate can be made of the amount of the obligation. While the outcome of these matters is inherently uncertain, management believes that, based on the information available to it, appropriate provisions have been made in respect of legal proceedings as at 31 December 2014 (see Note 18).

### Bernard L. Madoff Investment Securities LLC

Bernard L. Madoff ('Madoff') was arrested in December 2008, and ultimately pleaded guilty to running a Ponzi scheme. He has acknowledged, in essence, that while purporting to invest his customers' money in securities, he in fact never invested in securities and used other customers' money to fulfil requests to return investments. His firm, Bernard L. Madoff Investment Securities LLC ('Madoff Securities'), is being liquidated by a trustee (the 'Trustee').

Various non-US HSBC companies provided custodial, administration and similar services to a number of funds incorporated outside the US whose assets were invested with Madoff Securities. Based on information provided by Madoff Securities, as at 30 November 2008, the purported aggregate value of these funds was US$8.4bn, an amount that includes fictitious profits reported by Madoff. Based on information available to HSBC, we have estimated that the funds' actual transfers to Madoff Securities minus their actual withdrawals from Madoff Securities during the time that HSBC serviced the funds totalled approximately US$4bn. Various HSBC companies have been named as defendants in lawsuits arising out of Madoff Securities' fraud.

US/UK Litigation: The Trustee has brought suits against various HSBC companies in the US Bankruptcy Court and in the English High Court. The Trustee's US actions included common law claims, alleging that HSBC aided and abetted Madoff's fraud and breach of fiduciary duty. Those claims were dismissed on grounds of lack of standing. The Trustee's remaining US claims seek recovery of prepetition transfers pursuant to US bankruptcy law. The amount of these remaining claims has not been pleaded or determined as against HSBC.

Alpha Prime Fund Ltd ('Alpha Prime') and Senator Fund SPC, co-defendants in the Trustee's US actions, have brought cross-claims against HSBC.

The Trustee's English action seeks recovery of unspecified transfers from Madoff Securities to or through HSBC. HSBC has not yet been served with the Trustee's English action. The Trustee's deadline for serving the claim has been extended through the third quarter of 2015.

Fairfield Sentry Limited, Fairfield Sigma Limited and Fairfield Lambda Limited (collectively, 'Fairfield'), funds whose assets were invested with Madoff Securities, commenced multiple suits in the US and the British Virgin Islands (the 'BVI') against fund shareholders, including various HSBC companies that acted as nominees for HSBC clients, seeking restitution of payments made in connection with share redemptions. The US actions brought by Fairfield are stayed pending the outcome of the Fairfield cases in the BVI (discussed below).

In September 2013, the US Court of Appeals for the Second Circuit affirmed the dismissal of purported class action claims against HSBC and others brought by investors in three Madoff-invested funds on grounds of forum non conveniens. The plaintiffs' petitions for certiorari to the US Supreme Court were filed in December 2014. Any objections by the defendants are due in February 2015. The Supreme Court's decision on whether to grant certiorari review is expected in the first half of 2015.

In December 2014, three new Madoff-related actions were filed. The first is a purported class action brought by direct investors in Madoff Securities who were holding their investments as of December 2008, asserting various common law claims and seeking to recover damages lost to Madoff Securities' fraud on account of HSBC's purported knowledge and alleged furtherance of the fraud. The other two actions were filed by SPV Optimal SUS Ltd ('SPV Optimal'), the purported assignee of the Madoff Securities-invested company, Optimal Strategic US Equity Ltd. One of these actions was filed in New York state court and the other in US federal district court. In January 2015, SPV Optimal dismissed its federal lawsuit against HSBC. The state court action against HSBC remains pending. No defendant has yet been served with the complaint.

BVI Litigation: Beginning in October 2009, the Fairfield funds, whose assets were directly or indirectly invested with Madoff Securities, commenced multiple suits in the BVI against numerous fund shareholders, including various HSBC companies that acted as nominees for clients of HSBC's private banking business and other clients who invested in the Fairfield funds. The Fairfield funds are

seeking restitution of redemption payments made by the funds to defendants on the grounds that they were mistakenly based on inflated net asset values. In April 2014, the UK Privy Council issued a ruling on two preliminary issues in favour of other defendants in the BVI actions, and issued its order in October 2014. There is also a pending motion brought by other defendants before the BVI court challenging the Fairfield liquidator's authorisation to pursue its claims in the US. The BVI court has adjourned the hearing on that pending motion until March 2015.

Bermuda Litigation: In January 2009, Kingate Global Fund Limited and Kingate Euro Fund Limited (collectively, 'Kingate'), funds whose assets were directly or indirectly invested with Madoff Securities, commenced an action in Bermuda against HSBC Bank Bermuda Limited for recovery of funds held in Kingate's accounts, fees and dividends. This action is currently pending, but is not expected to move forward until there is a resolution as to the Trustee's separate US actions against Kingate and HSBC Bank Bermuda Limited.
Thema Fund Limited ('Thema') and Hermes International Fund Limited ('Hermes'), funds invested with Madoff Securities, each also brought three actions in Bermuda in 2009. The first set of actions were brought against HSBC Institutional Trust Services (Bermuda) Limited and seek recovery of funds in frozen accounts held at HSBC. The second set of actions asserts liability against HSBC Institutional Trust Services (Bermuda) Limited in relation to claims for mistake, recovery of fees and damages for breach of contract. The third set of actions seeks return of fees from HSBC Bank Bermuda Limited and HSBC Securities Services (Bermuda). There has been little progress in these actions for several years, although in January 2015, Thema and Hermes served notice of intent to proceed in respect of the second set of actions referred to above.

Cayman Islands Litigation: In February 2013, Primeo Fund, a Cayman Islands-based fund invested in Madoff Securities, brought an action against the fund administrator, Bank of Bermuda (Cayman), and the fund custodian, HSBC Securities Services (Luxembourg) ('HSSL'), alleging breaches of contract. Primeo Fund claims damages from defendants to compensate it for alleged losses, including loss of profit and any liability to the Trustee. Trial has been postponed to January 2016.

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

## 26 Related party transactions

Related parties of the group include subsidiaries, associates, post-employment benefit plans for group employees, Key Management Personnel, close family members of Key Management Personnel and entities which are controlled or jointly controlled by Key Management Personnel or their close family members.

Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of the group. The group classifies the Directors of the Bank, members of the Executive Management Committee and senior executives as the Key Management Personnel of the group.

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

| | **Loans and mortgages** | **Deposits** |
|---|---|---|
| **Balance at 1 January 2013** | 6,748 | 25,025 |
| Advances and transfers in during the year | 1,926 | 12,834 |
| Repayments and transfers out during the year | (2,200) | (31,985) |
| **Balance at 31 December 2013** | 6,474 | 5,874 |
| Advances and transfers in during the year | 717 | 37,180 |
| Repayments and transfers out during the year | (500) | (534) |
| **Balance at 31 December 2014** | 6,691 | 42,520 |

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

***Compensation of Key Management Personnel***

| | **2014** | 2013 |
|---|---|---|
| Short-term employee benefits | 8,082 | 8,199 |
| Post-employment benefits | 201 | 248 |
| Other long-term employee benefits | 59 | 111 |
| Termination benefits | - | 209 |
| Share-based payments | 306 | 321 |
| | 8,648 | 9,088 |

***Amounts included in balance sheet due from HSBC and affiliated companies***

| | **2014** | 2013 |
|---|---|---|
| Loans and advances to banks | 1,583,356 | 2,827,388 |
| Financial investments | 130,592 | 131,721 |
| Derivatives | 2,455 | 11,458 |
| Other assets | 45,302 | 11,502 |

***Amounts included in balance sheet due to HSBC and affiliated companies***

| | **2014** | 2013 |
|---|---|---|
| Deposits by banks | 55,932 | 40,821 |
| Derivatives | 13,064 | 20,149 |
| Other liabilities | 4,197 | 4,088 |

***Amounts in income statement received from HSBC and affiliated companies***

| | **2014** | 2013 |
|---|---|---|
| Interest income | 2,194 | 4,536 |
| Fee income | 7,210 | 6,756 |
| Other operating income | 841 | 13,262 |

***Amounts in income statement paid to HSBC and affiliated companies***

| | **2014** | 2013 |
|---|---|---|
| Fee expense | 220 | 1,276 |
| General and administration expenses | 20,442 | 15,520 |

There are no individually assessed loan impairment allowances in respect of outstanding balances in 2014 (2013:$NIL). No impairment charges were recognised during the year in respect of loans to related parties (2013: $NIL).

## 27 Equity

### (a) Called up share capital and share premium

The total number of authorised ordinary shares at 31 December 2014 was 140,000,000 (2013: 140,000,000) with a par value of $1 per share (2013: $1 per share). The total number of shares issued and fully paid at 31 December 2014 was 30,026,671 (2013: 30,026,671). These figures and amounts are exact (not rounded or shown to the nearest thousand). Share premium comprises additional paid in capital in excess of the par value. Share premium is not ordinarily available for distribution. The holders of ordinary shares are entitled to receive dividends as declared from time to time, and are entitled to one vote per share at meetings of the Bank.

### (b) Dividends

A final dividend of $7,500,000 ($0.25 per ordinary share), was declared by the Board of Directors on 24 February 2014 in respect of the 2013 financial year.

Interim dividends were declared by the Board of Directors on 28 May 2014 in respect of the period 1 January 2014 to 31 March 2014, for $20,500,000 ($0.68 per ordinary share), on 29 July 2014 in respect of the period 1 April 2014 to 30 June 2014, for $10,500,000 ($0.35 per ordinary share) and on 26 November 2014 in respect of the period 1 July 2014 to 30 September 2014, for $17,500,000 ($0.58 per ordinary share). These figures and amounts are exact (not rounded or shown to the nearest thousand).

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