
**UNITED STATES SECURITIES AND
EXCHANGE COMMISSION**

Washington, D.C. 20549

FORM 10-Q

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012

OR

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 1-7436

HSBC USA INC.

(Exact name of registrant as specified in its charter)

Maryland

(State of Incorporation)

452 Fifth Avenue, New York

(Address of principal executive offices)

13-2764867

(I.R.S. Employer Identification No.)

10018

(Zip Code)

(212) 525-5000

Registrant's telephone number, including area code

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of November 2, 2012, there were 712 shares of the registrant's common stock outstanding, all of which are owned by HSBC North America Inc.

HSBC USA Inc.

FORM 10-Q

TABLE OF CONTENTS

<u>Part/Item No.</u>		<u>Page</u>
Part I.		
Item 1.	Financial Statements (Unaudited):	
	Consolidated Statement of Income (Loss)	3
	Consolidated Statement of Comprehensive Income (Loss)	4
	Consolidated Balance Sheet	5
	Consolidated Statement of Changes in Shareholders' Equity	7
	Consolidated Statement of Cash Flows	8
	Notes to Consolidated Financial Statements	10
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	
	Forward-Looking Statements	103
	Executive Overview	103
	Basis of Reporting	112
	Balance Sheet Review	115
	Residential Real Estate Owned	121
	Results of Operations	122
	Segment Results — IFRSs Basis	134
	Credit Quality	143
	Liquidity and Capital Resources	153
	Off-Balance Sheet Arrangements	156
	Fair Value	159
	Risk Management	163
	Average Balances and Interest Rates	172
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	174
Item 4.	Controls and Procedures	174
Part II		
Item 1.	Legal Proceedings	174
Item 1A.	Risk Factors	174
Item 6.	Exhibits	175
Index		176
Signature		178

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED STATEMENT OF INCOME (LOSS) (UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Interest income:				
Loans	\$ 472	\$ 456	\$ 1,391	\$1,346
Securities	252	306	837	929
Trading assets	27	52	86	156
Short-term investments	23	35	82	104
Other	11	10	32	32
Total interest income	785	859	2,428	2,567
Interest expense:				
Deposits	82	64	243	196
Short-term borrowings	9	11	24	32
Long-term debt	170	151	502	449
Other	14	12	27	96
Total interest expense	275	238	796	773
Net interest income	510	621	1,632	1,794
Provision for credit losses	84	78	173	171
Net interest income after provision for credit losses	426	543	1,459	1,623
Other revenues:				
Credit card fees	18	31	70	95
Other fees and commissions	167	222	530	605
Trust income	22	26	72	83
Trading revenue	113	(107)	395	243
Other securities gains, net	50	49	145	105
Servicing and other fees from HSBC affiliates	63	49	165	151
Residential mortgage banking revenue	4	34	31	48
Gain (loss) on instruments designated at fair value and related derivatives	(187)	379	(258)	440
Gain on sale of branches	103	-	433	-
Other income (loss)	44	(16)	44	20
Total other revenues	397	667	1,627	1,790
Operating expenses:				
Salaries and employee benefits	207	266	733	852
Support services from HSBC affiliates	362	412	1,100	1,092
Occupancy expense, net	60	73	176	209
Expense accrual related to certain regulatory matters (Note 21)	800	-	1,500	-
Other expenses	188	170	515	589
Total operating expenses	1,617	921	4,024	2,742
Income (loss) from continuing operations before income tax expense	(794)	289	(938)	671
Income tax expense (benefit)	(12)	117	357	238
Income (loss) from continuing operations	(782)	172	(1,295)	433
Discontinued Operations (Note 2):				
Income from discontinued operations before income tax expense	-	218	315	682
Income tax expense	-	78	112	242
Income from discontinued operations	-	140	203	440
Net income (loss)	\$ (782)	\$ 312	\$(1,092)	\$ 873

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME (LOSS) (UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Net income (loss)	\$(782)	\$ 312	\$(1,092)	\$ 873
Net change in unrealized gains (losses), net of tax as applicable on:				
Securities available-for-sale, not other-than-temporarily impaired	97	655	218	797
Other-than-temporary impaired debt securities available-for-sale ⁽¹⁾	-	-	-	1
Other-than-temporary impaired debt securities held-to-maturity ⁽¹⁾	-	-	-	11
Adjustment to reverse other-than-temporary impairment on securities held-to-maturity due to deconsolidation of a variable interest entity	-	-	-	142
Derivatives designated as cash flow hedges	11	(124)	11	(141)
Unrecognized actuarial gains, transition obligation and prior service costs relating to pension and postretirement benefits, net of tax	-	-	1	2
Other comprehensive income, net of tax	108	531	230	812
Comprehensive income(loss)	\$(674)	\$ 843	\$(862)	\$1,685

⁽¹⁾ During the three and nine months ended September 30, 2012 and 2011, there were no other-than-temporary impairment (“OTTI”) losses on securities recognized in other revenues and no OTTI losses in the non-credit component on securities were recognized in accumulated other comprehensive income.

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED BALANCE SHEET (UNAUDITED)

	September 30, 2012	December 31, 2011
	(in millions, except share data)	
Assets⁽¹⁾		
Cash and due from banks	\$ 1,385	\$ 1,616
Interest bearing deposits with banks	15,313	25,454
Federal funds sold and securities purchased under agreements to resell	11,678	3,109
Trading assets	38,322	38,800
Securities available-for-sale	62,532	53,281
Securities held-to-maturity (fair value of \$2.0 billion and \$2.3 billion at September 30, 2012 and December 31, 2011, respectively)	1,741	2,035
Loans	61,452	51,867
Less – allowance for credit losses	637	743
Loans, net	<u>60,815</u>	<u>51,124</u>
Loans held for sale (includes \$424 million and \$377 million designated under fair value option at September 30, 2012 and December 31, 2011, respectively)	1,056	3,670
Properties and equipment, net	281	458
Intangible assets, net	253	242
Goodwill	2,228	2,228
Other assets	7,528	6,369
Other branch related assets held for sale	-	440
Assets of discontinued operations	-	21,454
Total assets	<u>\$203,132</u>	<u>\$210,280</u>
Liabilities⁽¹⁾		
Debt:		
Deposits in domestic offices:		
Noninterest bearing	\$ 31,532	\$ 20,592
Interest bearing (includes \$9.4 billion and \$9.8 billion designated under fair value option at September 30, 2012 and December 31, 2011, respectively)	61,741	73,474
Deposits in foreign offices:		
Noninterest bearing	1,782	1,912
Interest bearing	26,280	28,607
Deposits held for sale	-	15,144
Total deposits	<u>121,335</u>	<u>139,729</u>
Short-term borrowings	14,113	16,009
Long-term debt (includes \$7.7 billion and \$5.0 billion designated under fair value option at September 30, 2012 and December 31, 2011, respectively)	20,963	16,709
Total debt	<u>156,411</u>	<u>172,447</u>
Trading liabilities	20,875	14,186
Interest, taxes and other liabilities	8,277	4,223
Other branch related liabilities held for sale	-	11
Liabilities of discontinued operations	-	911
Total liabilities	<u>185,563</u>	<u>191,778</u>
Shareholders' equity		
Preferred stock	1,565	1,565
Common shareholder's equity:		
Common stock (\$5 par; 150,000,000 shares authorized; 712 shares issued and outstanding at September 30, 2012 and December 31, 2011)	-	-
Additional paid-in capital	13,798	13,814
Retained earnings	1,334	2,481
Accumulated other comprehensive income	872	642
Total common shareholder's equity	<u>16,004</u>	<u>16,937</u>
Total shareholders' equity	<u>17,569</u>	<u>18,502</u>
Total liabilities and shareholders' equity	<u>\$203,132</u>	<u>\$210,280</u>

⁽¹⁾ The following table summarizes assets and liabilities related to variable interest entities ("VIEs") as of September 30, 2012 and December 31, 2011 which are consolidated on our balance sheet. Assets and liabilities exclude intercompany balances that eliminate in consolidation.

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED BALANCE SHEET (UNAUDITED) (Continued)

	September 30, 2012	December 31, 2011
	(in millions)	
<i>Assets</i>		
Interest bearing deposits with banks	\$ 83	\$108
Other assets	<u>566</u>	<u>520</u>
Total assets	<u>\$649</u>	<u>\$628</u>
<i>Liabilities</i>		
Long-term debt	\$ 55	\$ 55
Interest, taxes and other liabilities	181	166
Liabilities of discontinued operations	-	<u>541</u>
Total liabilities	<u>\$236</u>	<u>\$762</u>

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (UNAUDITED)

Nine Months Ended September 30,	2012	2011
	(in millions)	
<i>Preferred stock</i>		
Balance at beginning and end of period	<u>\$ 1,565</u>	<u>\$ 1,565</u>
<i>Common stock</i>		
Balance at beginning and end of period	<u>-</u>	<u>-</u>
<i>Additional paid-in capital</i>		
Balance at beginning of period	13,814	13,785
Capital contributions from parent	-	21
Employee benefit plans and other	<u>(16)</u>	<u>18</u>
Balance at end of period	<u>13,798</u>	<u>13,824</u>
<i>Retained earnings</i>		
Balance at beginning of period	2,481	1,536
Net income (loss)	<u>(1,092)</u>	<u>873</u>
Cash dividends declared on preferred stock	<u>(55)</u>	<u>(55)</u>
Balance at end of period	<u>1,334</u>	<u>2,354</u>
<i>Accumulated other comprehensive income (loss)</i>		
Balance at beginning of period	642	(153)
Other comprehensive income, net of tax	<u>230</u>	<u>812</u>
Balance at end of period	<u>872</u>	<u>659</u>
<i>Total common shareholders' equity</i>	<u>16,004</u>	<u>16,837</u>
<i>Total shareholders' equity</i>	<u>\$17,569</u>	<u>\$18,402</u>

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

Nine Months Ended September 30,	2012	2011
	(in millions)	
<i>Cash flows from operating activities</i>		
Net income (loss)	\$ (1,092)	\$ 873
Income from discontinued operations	203	440
Income (loss) from continuing operations	(1,295)	433
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	243	220
Gain on sale of branches	(433)	-
Expense accrual related to certain regulatory matters	1,500	-
Impairment of internally developed software	-	94
Provision for credit losses	173	171
Realized gains on securities available-for-sale	(145)	(105)
Net change in other assets and liabilities	2,313	(1,975)
Change in loans held for sale:		
Originations of loans	(2,678)	(2,280)
Sales and collection of loans held for sale	2,795	3,106
Net change in trading assets and liabilities	7,576	(5,446)
Lower of amortized cost or fair value adjustments on loans held for sale	32	44
Mark-to-market (gains) losses on financial instruments designated at fair value and related derivatives	258	(440)
Cash provided by (used in) operating activities – continuing operations	10,339	(6,178)
Cash provided by operating activities – discontinued operations	34	1,818
Net cash provided by (used in) operating activities	10,373	(4,360)
<i>Cash flows from investing activities</i>		
Net change in interest bearing deposits with banks	10,141	(13,089)
Net change in federal funds sold and securities purchased under agreements to resell	(8,569)	3,141
Securities available-for-sale:		
Purchases of securities available-for-sale	(29,177)	(23,820)
Proceeds from sales of securities available-for-sale	10,183	17,423
Proceeds from maturities of securities available-for-sale	9,601	2,475
Securities held-to-maturity:		
Proceeds from maturities of securities held-to-maturity	301	470
Change in loans:		
Originations, net of collections	(9,509)	(4,308)
Loans sold to third parties	49	304
Net cash used for acquisitions of properties and equipment	(6)	(18)
Net outflows related to the sale of branches	(10,137)	-
Other, net	(107)	75
Cash used in investing activities – continuing operations	(27,230)	(17,347)
Cash provided by investing activities – discontinued operations	20,746	1,215
Net cash used in investing activities	(6,484)	(16,132)

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED) (Continued)

Nine Months Ended September 30,	2012	2011
	(in millions)	
<i>Cash flows from financing activities</i>		
Net change in deposits	(5,536)	11,966
Debt:		
Net change in short-term borrowings	(1,896)	6,571
Issuance of long-term debt	5,354	5,152
Repayment of long-term debt	(1,928)	(3,099)
Repayment of debt issued related to the sale and leaseback of 452 Fifth Avenue property	(8)	(21)
Other decreases in capital surplus	(16)	18
Dividends paid	(55)	(55)
Cash provided by (used in) financing activities – continuing operations	(4,085)	20,532
Cash used in financing activities – discontinued operations	(35)	(148)
Net cash provided by (used in) financing activities	(4,120)	20,384
Net change in cash and due from banks	(231)	(108)
Cash and due from banks at beginning of period ⁽¹⁾	1,616	1,693
<i>Cash and due from banks at end of period</i>	<u>\$ 1,385</u>	<u>\$ 1,585</u>
<i>Supplemental disclosure of non-cash flow investing activities</i>		
Trading securities pending settlement	\$ 20	\$ 99

⁽¹⁾ Cash at beginning of period includes \$117 million for discontinued operations as of January 1, 2011.

The accompanying notes are an integral part of the consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note	Page	Note	Page
1	Organization and Basis of Presentation	13	Income Taxes
	10	14	Accumulated Other Comprehensive Income
2	Discontinued Operations		51
3	Branch Assets and Liabilities Held for Sale	15	Pension and Other Postretirement Benefits
	12		53
4	Trading Assets and Liabilities	16	Related Party Transactions
	13	17	Regulatory Capital
5	Securities	18	Business Segments
	14	19	Variable Interest Entities
6	Loans	20	Guarantee Arrangements and Pledged Assets
	22		70
7	Allowance for Credit Losses	21	Litigation and Regulatory Matters
	33	22	Fair Value Measurements
8	Loans Held for Sale	23	New Accounting Pronouncements
	36		101
9	Intangible Assets		
	37		
10	Goodwill		
	38		
11	Derivative Financial Instruments		
	39		
12	Fair Value Option		
	46		

1. Organization and Basis of Presentation

HSBC USA Inc. is an indirect wholly owned subsidiary of HSBC North America Holdings Inc. (“HSBC North America”), which is an indirect wholly owned subsidiary of HSBC Holdings plc (“HSBC”). The accompanying unaudited interim consolidated financial statements of HSBC USA Inc. and its subsidiaries (collectively “HUSI”) have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X, as well as in accordance with predominant practices within the banking industry. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all normal and recurring adjustments considered necessary for a fair presentation of financial position, results of operations and cash flows for the interim periods have been made. HUSI may also be referred to in this Form 10-Q as “we,” “us” or “our.” These unaudited interim consolidated financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2011 (the “2011 Form 10-K”). Certain reclassifications have been made to prior period amounts to conform to the current period presentation.

The preparation of financial statements in conformity with U.S. GAAP requires the use of estimates and assumptions that affect reported amounts and disclosures. Actual results could differ from those estimates. Unless otherwise noted, information included in these notes to the consolidated financial statements relates to continuing operations for all periods presented. See Note 2, “Discontinued Operations” for further details. Interim results should not be considered indicative of results in future periods.

2. Discontinued Operations

Sale of Certain Credit Card Operations to Capital One On August 10, 2011, HSBC, through its wholly-owned subsidiaries HSBC Finance Corporation (“HSBC Finance”), HSBC USA Inc. and other wholly-owned affiliates entered into an agreement to sell its Card and Retail Services business to Capital One Financial Corporation (“Capital One”). This transaction was completed on May 1, 2012. The sale included our General Motors (“GM”) and Union Plus (“UP”) credit card receivables as well as our private label credit card and closed-end receivables, all of which were purchased from HSBC Finance. Prior to completing the transaction, we recorded cumulative lower of amortized cost or fair value adjustments on these receivables which were classified as held for sale on our balance sheet as a component of assets of discontinued operations totaling \$1.0 billion, of which \$440 million was recorded in the nine months ended September 30, 2012 and \$159 million was recorded in the three

and nine months ended September 30, 2011 and is reflected in net interest income and other revenues in the table below. These fair value adjustments were largely offset by held for sale accounting adjustments in which loan impairment charges and premium amortization are no longer recorded. The total final cash consideration allocated to us was approximately \$19.2 billion, which did not result in the recognition of a gain or loss upon completion of the sale as the receivables were recorded at fair value.

The sale to Capital One did not include credit card receivables associated with HSBC Bank USA's legacy credit card program and, therefore, are excluded from the table below. However a portion of these receivables were included as part of the sale to First Niagara Bank, N.A. and HSBC Bank USA will continue to offer credit cards to HSBC Bank USA's customers. No significant one-time closure costs have been incurred as a result of exiting these portfolios. In connection with the sale of our credit card portfolio to Capital One, we have entered into an outsourcing arrangement with Capital One with respect to the servicing of our remaining credit card portfolio.

Because the credit card and private label receivables sold were classified as held for sale prior to disposition and the operations and cash flows from these receivables will be eliminated from our ongoing operations post-disposition without any significant continuing involvement, we have determined we have met the requirements to report the results of these credit card and private label card receivables being sold as discontinued operations and have included these receivables in Assets of discontinued operations on our balance sheet for all periods presented.

The following summarizes the results of operations of our discontinued credit card operations for the periods presented.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Net interest income and other revenues ⁽¹⁾⁽²⁾	\$-	\$492	\$541	\$1,598
Income from discontinued operations before income tax	-	218	315	683

- ⁽¹⁾ Interest expense was allocated to discontinued operations in accordance with our existing internal transfer pricing policy. This policy uses match funding based on the expected lives of the assets and liabilities of the business at the time of origination, subject to periodic review, as demonstrated by the expected cash flows and re-pricing characteristics of the underlying assets.
- ⁽²⁾ Included in other revenues for the nine months ended September 30, 2012 was a \$440 million lower of amortized cost or fair value adjustment. Included in other revenues for the three and nine months ended September 30, 2011 was a \$159 million lower of amortized cost or fair value adjustment.

The following summarizes the assets and liabilities of our discontinued credit card operations at September 30, 2012 and December 31, 2011 which are reported as a component of Assets of discontinued operations and Liabilities of discontinued operations in our consolidated balance sheet.

	September 30, 2012	December 31, 2011
	(in millions)	
Loans, net ⁽¹⁾	\$ -	\$21,185
Other assets	-	269
Assets of discontinued operations	\$ -	\$21,454
Deposits in domestic offices – noninterest bearing	\$ -	\$ 35
Other liabilities	-	876
Liabilities of discontinued operations	\$ -	\$ 911

⁽¹⁾ At December 31, 2011, the receivables are carried at the lower of amortized cost or fair value.

Banknotes Business In June 2010, we decided that the wholesale banknotes business (“Banknotes Business”) within our Global Banking and Markets segment did not fit with our core strategy in the U.S. and, therefore, made the decision to exit this business. This business, which was managed out of the United States with operations in key locations worldwide, arranged for the physical distribution of banknotes globally to central banks, large commercial banks and currency exchanges. As a result of this decision, we recorded closure costs of \$14 million during 2010, primarily relating to termination and other employee benefits.

As part of the decision to exit the Banknotes Business, in October 2010 we sold the assets of our Asian banknotes operations (“Asian Banknotes Operations”) to an unaffiliated third party for total consideration of approximately \$11 million in cash. As a result, during the third quarter of 2010 we classified the assets of the Asian Banknotes Operations of \$23 million, including an allocation of goodwill of \$21 million, as held for sale. Because the carrying amount of the assets being sold exceeded the agreed-upon sales price, we recorded a lower of amortized cost or fair value adjustment of \$12 million in the third quarter of 2010. As the exit of our Banknotes Business, including the sale of our Asian Banknotes Operations, was substantially completed in the fourth quarter of 2010, we began to report the results of our Banknotes Business as discontinued operations at that time.

The exit of our Banknotes Business was completed in the second quarter of 2011 with the sale of our European Banknotes Business to HSBC Bank plc. The table below summarizes the operating results of our Banknotes Business for the periods presented.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Net interest income and other revenues	\$-	\$-	\$-	\$19
Income (loss) from discontinued operations before income tax (benefit) expense	-	-	-	(1)

At September 30, 2012 and December 31, 2011 there were no remaining assets and liabilities of our Banknotes Business reported as assets of discontinued operations and liabilities of discontinued operations in our consolidated balance sheet.

3. Branch Assets and Liabilities Held for Sale

On July 31, 2011, we announced that we had reached an agreement with First Niagara Bank, N.A. (“First Niagara”) to sell 195 non-strategic retail branches, including certain loans, deposits and related branch premises primarily located in upstate New York. The agreement included the transfer of certain deposits and loans, as well as related branch premises, for a premium of 6.67 percent of the deposits, subject to certain agreed-upon adjustments. In May 2012, we completed the sale of 138 branches to First Niagara and recognized an after-tax gain, net of allocated non-deductible goodwill, of \$71 million. Since the premium received of \$886 million was calculated based on the total amount of outstanding deposit balances for all branches being sold, a pro-rata portion of the premium related to the deposit balances associated with the branches that were not sold in the amount of \$209 million was deferred as unearned revenue and was recognized in the third quarter when the remaining branches and related deposit amounts were sold. In the third quarter of 2012, we completed the sale of the remaining 57 branches and recognized an after-tax gain, net of allocated non-deductible goodwill, of \$23 million. Included in the sale of the 195 non-strategic retail branches were approximately \$13.2 billion in deposits and \$2.1 billion in loans. Branch premises were sold for fair value and loans and other transferred assets were sold at their carrying values.

The following summarizes the assets and liabilities classified as held for sale at September 30, 2012 and December 31, 2011 in our consolidated balance sheet related to the agreement to sell certain retail branches.

	September 30, 2012	December 31, 2011
	(in millions)	
Loans held for sale ⁽¹⁾	\$ -	\$ 2,495
Other branch assets held for sale:		
Properties and equipment, net	-	42
Goodwill allocated to retail branch disposal group	-	398
Total other branch assets held for sale	-	440
Total branch assets held for sale	<u>\$ -</u>	<u>\$ 2,935</u>
Deposits held for sale	\$ -	\$15,144
Other branch liabilities held for sale	-	11
Total branch liabilities held for sale	<u>\$ -</u>	<u>\$15,155</u>

⁽¹⁾ Loans held for sale includes \$521 million of commercial loans, \$1.4 billion of residential mortgages, \$416 million of credit card loans and \$161 million in other consumer loans at December 31, 2011.

4. Trading Assets and Liabilities

Trading assets and liabilities are summarized in the following table.

	September 30, 2012	December 31, 2011
	(in millions)	
Trading assets:		
U.S. Treasury	\$ 2,283	\$ 259
U.S. Government agency issued or guaranteed	292	14
U.S. Government sponsored enterprises ⁽¹⁾	231	24
Asset-backed securities	987	1,032
Corporate and foreign bonds ⁽²⁾	9,636	11,577
Other securities	37	40
Precious metals	15,777	17,082
Fair value of derivatives, net	9,079	8,772
	<u>\$38,322</u>	<u>\$38,800</u>
Trading liabilities:		
Securities sold, not yet purchased	\$ 361	\$ 343
Payables for precious metals	6,853	6,999
Fair value of derivatives, net	13,661	6,844
	<u>\$20,875</u>	<u>\$14,186</u>

⁽¹⁾ Includes mortgage-backed securities of \$13 million and \$10 million issued or guaranteed by the Federal National Mortgage Association (“FNMA”) at September 30, 2012 and December 31, 2011, respectively, and \$218 million and \$14 million issued or guaranteed by the Federal Home Loan Mortgage Corporation (“FHLMC”) at September 30, 2012 and December 31, 2011, respectively.

⁽²⁾ We did not hold any foreign bonds issued by the governments of Greece, Ireland, Italy, Portugal or Spain at either September 30, 2012 or December 31, 2011.

At September 30, 2012 and December 31, 2011, the fair value of derivatives included in trading assets has been reduced by \$5.9 billion and \$4.8 billion, respectively, relating to amounts recognized for the obligation to return cash collateral received under master netting agreements with derivative counterparties.

At September 30, 2012 and December 31, 2011, the fair value of derivatives included in trading liabilities has been reduced by \$2.3 billion and \$6.3 billion, respectively, relating to amounts recognized for the right to reclaim cash collateral paid under master netting agreements with derivative counterparties.

5. Securities

The amortized cost and fair value of the securities available-for-sale and securities held-to-maturity are summarized in the following tables.

September 30, 2012	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available-for-sale:				
U.S. Treasury	\$30,612	\$ 557	\$ (30)	\$31,139
U.S. Government sponsored enterprises: ⁽¹⁾				
Mortgage-backed securities	168	2	-	170
Direct agency obligations	3,568	376	(2)	3,942
U.S. Government agency issued or guaranteed:				
Mortgage-backed securities	15,289	871	(4)	16,156
Collateralized mortgage obligations	3,875	175	-	4,050
Direct agency obligations	1	-	-	1
Obligations of U.S. states and political subdivisions	775	40	-	815
Asset backed securities collateralized by:				
Residential mortgages	2	-	-	2
Commercial mortgages	257	7	-	264
Home equity	322	-	(80)	242
Other	102	-	(17)	85
Corporate and other domestic debt securities ⁽²⁾	40	3	-	43
Foreign debt securities ⁽³⁾⁽⁶⁾	5,488	17	(57)	5,448
Equity securities	167	8	-	175
Total available-for-sale securities	<u>\$60,666</u>	<u>\$2,056</u>	<u>\$(190)</u>	<u>\$62,532</u>
Securities held-to-maturity:				
U.S. Government sponsored enterprises: ⁽⁵⁾				
Mortgage-backed securities	\$ 1,212	\$ 167	\$ -	\$ 1,379
U.S. Government agency issued or guaranteed:				
Mortgage-backed securities	68	13	-	81
Collateralized mortgage obligations	289	46	-	335
Obligations of U.S. states and political subdivisions	44	3	-	47
Asset backed securities collateralized by residential mortgages	128	7	-	135
Total held-to-maturity securities	<u>\$ 1,741</u>	<u>\$ 236</u>	<u>\$ -</u>	<u>\$ 1,977</u>

December 31, 2011	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Securities available-for-sale:				
U.S. Treasury	\$18,199	\$ 498	\$(121)	\$18,576
U.S. Government sponsored enterprises: ⁽¹⁾				
Mortgage-backed securities	40	1	-	41
Direct agency obligations	2,501	352	-	2,853
U.S. Government agency issued or guaranteed:				
Mortgage-backed securities	15,357	728	(3)	16,082
Collateralized mortgage obligations	6,881	177	(3)	7,055
Direct agency obligations	2	-	-	2
Obligations of U.S. states and political subdivisions	566	35	(1)	600
Asset backed securities collateralized by:				
Residential mortgages	6	-	(1)	5
Commercial mortgages	444	9	(2)	451
Home equity	369	-	(99)	270
Student loans	13	-	(1)	12
Other	102	-	(22)	80
Corporate and other domestic debt securities ⁽²⁾	541	3	-	544
Foreign debt securities ⁽³⁾⁽⁶⁾	6,640	27	(97)	6,570
Equity securities ⁽⁴⁾	130	10	-	140
Total available-for-sale securities	<u>\$51,791</u>	<u>\$1,840</u>	<u>\$(350)</u>	<u>\$53,281</u>
Securities held-to-maturity:				
U.S. Government sponsored enterprises: ⁽⁵⁾				
Mortgage-backed securities	\$ 1,421	\$ 195	\$ -	\$ 1,616
U.S. Government agency issued or guaranteed:				
Mortgage-backed securities	79	13	-	92
Collateralized mortgage obligations	308	44	-	352
Obligations of U.S. states and political subdivisions	61	3	-	64
Asset backed securities collateralized by residential mortgages				
	<u>166</u>	<u>9</u>	<u>(1)</u>	<u>174</u>
Total held-to-maturity securities	<u>\$ 2,035</u>	<u>\$ 264</u>	<u>\$ (1)</u>	<u>\$ 2,298</u>

⁽¹⁾ Includes securities at amortized cost of \$155 million and \$27 million issued or guaranteed by FNMA at September 30, 2012 and December 31, 2011, respectively, and \$13 million issued or guaranteed by FHLMC at both September 30, 2012 and December 31, 2011, respectively.

⁽²⁾ At September 30, 2012 and December 31, 2011, other domestic debt securities included \$16 million and \$516 million, respectively, of securities at amortized cost fully backed by the Federal Deposit Insurance Corporation ("FDIC").

⁽³⁾ At September 30, 2012 and December 31, 2011, foreign debt securities included of \$1.5 billion and \$2.7 billion, respectively, of securities fully backed by foreign governments.

⁽⁴⁾ Includes preferred equity securities at amortized cost issued by FNMA of \$2 million at December 31, 2011. Balance at December 31, 2011 reflects a cumulative other-than-temporary impairment charge of \$173 million.

⁽⁵⁾ Includes securities at amortized cost of \$532 million and \$591 million issued or guaranteed by FNMA at September 30, 2012 and December 31, 2011, respectively, and \$680 million and \$830 million issued and guaranteed by FHLMC at September 30, 2012 and December 31, 2011, respectively.

⁽⁶⁾ There were no foreign debt securities issued by the governments of Greece, Ireland, Italy, Portugal or Spain at either September 30, 2012 or December 31, 2011.

A summary of gross unrealized losses and related fair values as of September 30, 2012 and December 31, 2011, classified as to the length of time the losses have existed as follows:

September 30, 2012	One Year or Less			Greater Than One Year		
	Number of Securities	Gross Unrealized Losses	Aggregate Fair Value of Investment	Number of Securities	Gross Unrealized Losses	Aggregate Fair Value of Investment
(dollars are in millions)						
Securities available-for-sale:						
U.S. Treasury	3	\$ (2)	\$2,595	6	\$ (28)	\$ 591
U.S. Government sponsored enterprises	2	(2)	231	12	-	8
U.S. Government agency issued or guaranteed	19	(4)	116	-	-	-
Obligations of U.S. states and political subdivisions	4	-	29	1	-	7
Asset backed securities	4	-	54	13	(97)	339
Foreign debt securities	5	(8)	1,455	8	(49)	2,979
Equity securities	-	-	-	-	-	-
Securities available-for-sale	<u>37</u>	<u>\$(16)</u>	<u>\$4,480</u>	<u>40</u>	<u>\$(174)</u>	<u>\$3,924</u>
Securities held-to-maturity:						
U.S. Government sponsored enterprises	12	\$ -	\$ -	52	\$ -	\$ -
U.S. Government agency issued or guaranteed	56	-	-	969	-	3
Obligations of U.S. states and political subdivisions	2	-	-	2	-	1
Asset backed securities	<u>1</u>	<u>-</u>	<u>4</u>	<u>2</u>	<u>-</u>	<u>7</u>
Securities held-to-maturity	<u>71</u>	<u>\$ -</u>	<u>\$ 4</u>	<u>1,025</u>	<u>\$ -</u>	<u>\$ 11</u>

December 31, 2011	One Year or Less			Greater Than One Year		
	Number of Securities	Gross Unrealized Losses	Aggregate Fair Value of Investment	Number of Securities	Gross Unrealized Losses	Aggregate Fair Value of Investment
	(dollars are in millions)					
Securities available-for-sale:						
U.S. Treasury	5	\$ (1)	\$ 4,978	12	\$(120)	\$2,592
U.S. Government sponsored enterprises	6	-	8	15	-	9
U.S. Government agency issued or guaranteed	14	(6)	833	2	-	4
Obligations of U.S. states and political subdivisions	3	(1)	20	3	-	25
Asset backed securities	2	-	45	22	(125)	387
Foreign debt securities	15	(97)	4,223	-	-	-
Securities available-for-sale	<u>45</u>	<u>\$(105)</u>	<u>\$10,107</u>	<u>54</u>	<u>\$(245)</u>	<u>\$3,017</u>
Securities held-to-maturity:						
U.S. Government sponsored enterprises	47	\$ -	\$ -	11	\$ -	\$ -
U.S. Government agency issued or guaranteed	629	-	2	463	-	1
Obligations of U.S. states and political subdivisions	2	-	-	4	-	2
Asset backed securities	-	-	-	4	(1)	14
Securities held-to-maturity	<u>678</u>	<u>\$ -</u>	<u>\$ 2</u>	<u>482</u>	<u>\$ (1)</u>	<u>\$ 17</u>

Net unrealized gains increased within the available-for-sale portfolio in the first nine months of 2012 largely due to a decrease in interest rates on U.S. Treasury securities since December 31, 2011. We have reviewed the securities for which there is an unrealized loss for other-than-temporary impairment in accordance with our accounting policies. During the three and nine months ended September 30, 2012 and 2011, none of our debt securities were determined to have either initial other-than-temporary impairment or changes to previous other-than-temporary impairment estimates relating to the credit component. Changes in the non-credit portion during 2011 represented a reversal of a portion of previously recorded impairment losses that were recognized in other comprehensive income.

We do not consider any debt securities to be other-than-temporarily impaired at September 30, 2012 as we expect to recover the amortized cost basis of these securities and we neither intend nor expect to be required to sell these securities prior to recovery, even if that equates to holding securities until their individual maturities. However, other-than-temporary impairments may occur in future periods if the credit quality of the securities deteriorates.

On-going Assessment for Other-Than-Temporary Impairment On a quarterly basis, we perform an assessment to determine whether there have been any events or economic circumstances to indicate that a security with an unrealized loss has suffered other-than-temporary impairment. A debt security is considered impaired if its fair value is less than its amortized cost at the reporting date. If impaired, we assess whether the unrealized loss is other-than-temporary.

An unrealized loss is generally deemed to be other-than-temporary and a credit loss is deemed to exist if the present value of the expected future cash flows is less than the amortized cost basis of the debt security. As a result, the credit loss component of an other-than-temporary impairment write-down for debt securities is recorded in earnings while the remaining portion of the impairment loss is recognized, net of tax, in other comprehensive income provided we do not intend to sell the underlying debt security and it is more-likely-than-not that we would not have to sell the debt security prior to recovery.

For all securities held in the available-for-sale or held-to-maturity portfolio for which unrealized losses have existed for a period of time, we do not have the intention to sell and believe we will not be required to sell the securities for contractual, regulatory or liquidity reasons as of the reporting date. As debt securities issued by U.S. Treasury, U.S. Government agencies and government sponsored entities accounted for 89 percent and 84 percent of total available-for-sale and held-to-maturity securities as of September 30, 2012 and December 31, 2011 respectively, our assessment for credit loss was concentrated on private label asset-backed securities. Substantially all of the private label asset-backed securities are supported by residential mortgages, home equity loans or commercial mortgages. Our assessment for credit loss was concentrated on this particular asset class because of the following inherent risk factors:

- The recovery of the U.S. economy has been slow;
- The continued uncertainty in the U.S. housing markets with high levels of pending foreclosure volume;
- A lack of traction in government sponsored programs in loan modifications;
- A lack of refinancing activities within certain segments of the mortgage market, even at the current low interest rate environment, and the re-default rate for refinanced loans;
- The unemployment rate remains high despite recent improvement and although consumer confidence is improving, it remains low compared to historical levels;
- The decline in the occupancy rate in commercial properties; and
- The severity and duration of unrealized loss.

In determining whether a credit loss exists and the period over which the debt security is expected to recover, we considered the following factors:

- The length of time and the extent to which the fair value has been less than the amortized cost basis;
- The level of credit enhancement provided by the structure, which includes but is not limited to credit subordination positions, over collateralization, protective triggers and financial guarantees provided by monoline wraps;
- Changes in the near term prospects of the issuer or underlying collateral of a security such as changes in default rates, loss severities given default and significant changes in prepayment assumptions;
- The level of excess cash flows generated from the underlying collateral supporting the principal and interest payments of the debt securities; and
- Any adverse change to the credit conditions of the issuer, the monoline insurer or the security such as credit downgrades by the rating agencies.

We use a standard valuation model to measure the credit loss for available-for-sale and held-to-maturity securities. The valuation model captures the composition of the underlying collateral and the cash flow structure of the security. Management develops inputs to the model based on external analyst reports and forecasts and internal credit assessments. Significant inputs to the model include delinquencies, collateral types and related contractual features, estimated rates of default, loss given default and prepayment assumptions. Using the inputs, the model estimates cash flows generated from the underlying collateral and distributes those cash flows to respective tranches of securities considering credit subordination and other credit enhancement features. The projected future cash flows attributable to the debt security held are discounted using the effective interest rates determined at the original acquisition date if the security bears a fixed rate of return. The discount rate is adjusted for the floating index rate for securities which bear a variable rate of return, such as LIBOR-based instruments.

For the three and nine months ended September 30, 2012 and 2011, there were no other-than-temporary impairment losses recognized related to credit loss. At September 30, 2012 and 2011, there were no remaining non-credit component unrealized loss amounts recognized in other comprehensive income.

The following table summarizes the changes in the credit loss component of other-than-temporarily impaired debt securities which were recognized in income:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Credit losses at the beginning of the period	\$-	\$1	\$-	\$ 36
Reduction of credit losses previously recognized on sold securities	-	-	-	(4)
Reduction of credit losses previously recognized on held to maturity securities due to deconsolidation of VIE	-	-	-	(31)
Ending balance of credit losses	<u>\$-</u>	<u>\$1</u>	<u>\$-</u>	<u>\$ 1</u>

At September 30, 2012, we held 28 individual asset-backed securities in the available-for-sale portfolio, of which 8 were also wrapped by a monoline insurance company. The asset-backed securities backed by a monoline wrap comprised \$328 million of the total aggregate fair value of asset-backed securities of \$593 million at September 30, 2012. The gross unrealized losses on these securities were \$96 million at September 30, 2012. We did not take into consideration the value of the monoline wrap of any non-investment grade monoline insurers as of September 30, 2012 and, therefore, we only considered the financial guarantee of monoline insurers on securities for purposes of evaluating other-than-temporary impairment with a fair value of \$104 million. No security wrapped by a below investment grade monoline insurance company was deemed to be other-than-temporarily impaired at September 30, 2012.

At December 31, 2011, we held 45 individual asset-backed securities in the available-for-sale portfolio, of which 9 were also wrapped by a monoline insurance company. The asset-backed securities backed by a monoline wrap comprised \$349 million of the total aggregate fair value of asset-backed securities of \$818 million at December 31, 2011. The gross unrealized losses on these securities were \$121 million at December 31, 2011. We did not take into consideration the value of the monoline wrap of any non-investment grade monoline insurers as of December 31, 2011 and, therefore, we only considered the financial guarantee of monoline insurers on securities for purposes of evaluating other-than-temporary impairment with a fair value of \$114 million. One security wrapped by a below investment grade monoline insurance company with an aggregate fair value of less than \$1 million was deemed to be other-than-temporarily impaired at December 31, 2011.

As discussed above, certain asset-backed securities have an embedded financial guarantee provided by monoline insurers. Because the financial guarantee is not a separate and distinct contract from the asset-backed security, they are considered as a single unit of account for fair value measurement and impairment assessment purposes. The monoline insurers are regulated by the insurance commissioners of the relevant states and certain monoline insurers that write the financial guarantee contracts are public companies. In evaluating the extent of our reliance on investment grade monoline insurance companies, consideration is given to our assessment of the creditworthiness of the monoline and other market factors. We perform both a credit as well as a liquidity analysis on the monoline insurers each quarter. Our analysis also compares market-based credit default spreads, when available, to assess the appropriateness of our monoline insurer's creditworthiness. Based on the public information available, including the regulatory reviews and actions undertaken by the state insurance commissions and the published financial results, we determine the degree of reliance to be placed on the financial guarantee policy in estimating the cash flows to be collected for the purpose of recognizing and measuring impairment loss.

A credit downgrade to non-investment grade is a key but not the only factor in determining the credit risk or the monoline insurer's ability to fulfill its contractual obligation under the financial guarantee arrangement. Although a monoline may have been down-graded by the credit rating agencies or have been ordered to commute its operations by the insurance commissioners, it may retain the ability and the obligation to continue to pay claims in the near term. We evaluate the short-term liquidity of and the ability to pay claims by the monoline insurers in estimating the amounts of cash flows expected to be collected from specific asset-backed securities for the purpose of assessing and measuring credit loss.

The following table summarizes realized gains and losses on investment securities transactions attributable to available-for-sale securities.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Gross realized gains	\$59	\$ 73	\$ 260	\$ 213
Gross realized losses	(9)	(24)	(115)	(108)
Net realized gains	<u>\$50</u>	<u>\$ 49</u>	<u>\$ 145</u>	<u>\$ 105</u>

The amortized cost and fair values of securities available-for-sale and securities held-to-maturity at September 30, 2012, are summarized in the table below by contractual maturity. Expected maturities differ from contractual maturities because borrowers have the right to prepay obligations without prepayment penalties in certain cases. Securities available-for-sale amounts exclude equity securities as they do not have stated maturities. The table below also reflects the distribution of maturities of debt securities held at September 30, 2012, together with the approximate yield of the portfolio. The yields shown are calculated by dividing annual interest income, including the accretion of discounts and the amortization of premiums, by the amortized cost of securities outstanding at September 30, 2012.

As of September 30, 2012	Within One Year		After One But Within Five Years		After Five But Within Ten Years		After Ten Years	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
(dollars are in millions)								
Available-for-sale:								
U.S. Treasury	\$2,002	.26%	\$22,945	.45%	\$2,774	2.08%	\$ 2,891	2.99%
U.S. Government sponsored enterprises ..	-	-	295	2.77	2,675	3.29	766	3.44
U.S. Government agency issued or guaranteed	-	-	5	4.60	100	1.97	19,060	3.13
Obligations of U.S. states and political subdivisions	-	-	40	4.16	376	3.84	359	3.84
Asset backed securities	-	-	1	1.46	11	.46	671	3.04
Other domestic debt securities	16	.62	-	-	-	-	24	3.90
Foreign debt securities	625	4.27	4,863	1.83	-	-	-	-
Total amortized cost	<u>\$2,643</u>	1.21%	<u>\$28,149</u>	.72%	<u>\$5,936</u>	2.73%	<u>\$23,771</u>	3.13%
Total fair value	<u>\$2,644</u>		<u>\$28,202</u>		<u>\$6,535</u>		<u>\$24,976</u>	
Held-to-maturity:								
U.S. Government sponsored enterprises ..	\$ -	-%	\$ 8	7.78%	\$ 1	7.87%	\$ 1,203	6.16%
U.S. Government agency issued or guaranteed	-	-	2	7.58	3	7.68	352	6.49
Obligations of U.S. states and political subdivisions	4	5.37	15	5.11	10	4.58	15	4.96
Asset backed securities	-	-	-	-	-	-	128	6.26
Total amortized cost	<u>\$ 4</u>	5.37%	<u>\$ 25</u>	6.13%	<u>\$ 14</u>	5.49%	<u>\$ 1,698</u>	6.23%
Total fair value	<u>\$ 4</u>		<u>\$ 26</u>		<u>\$ 15</u>		<u>\$ 1,932</u>	

Investments in Federal Home Loan Bank (“FHLB”) stock and Federal Reserve Bank (“FRB”) stock of \$143 million and \$483 million, respectively, were included in other assets at September 30, 2012. Investments in Federal Home Loan Bank (“FHLB”) stock and Federal Reserve Bank (“FRB”) stock of \$133 million and \$483 million, respectively, were included in other assets at December 31, 2011.

6. Loans

Loans consisted of the following:

	September 30, 2012	December 31, 2011
	(in millions)	
Commercial loans:		
Construction and other real estate	\$ 7,920	\$ 7,860
Business banking and middle markets enterprises	12,497	10,225
Global banking ⁽¹⁾	19,011	12,658
Other commercial	<u>3,140</u>	<u>2,906</u>
Total commercial	<u>42,568</u>	<u>33,649</u>
Consumer loans:		
Home equity mortgages	2,387	2,563
Other residential mortgages	15,086	14,113
Credit cards	796	828
Other consumer	<u>615</u>	<u>714</u>
Total consumer	<u>18,884</u>	<u>18,218</u>
Total loans	<u>\$61,452</u>	<u>\$51,867</u>

⁽¹⁾ Represents large multinational firms including globally focused U.S. corporate and financial institutions and USD lending to select high quality Latin American and other multinational customers managed by HSBC on a global basis.

Net deferred origination costs totaled \$30 million and \$48 million at September 30, 2012 and December 31, 2011, respectively.

At September 30, 2012 and December 31, 2011, we had net unamortized premium on our loans of \$29 million and \$28 million, respectively. We amortized net premiums of \$2 million and \$20 million on our loans for the three and nine months ended September 30, 2012, respectively, compared to \$10 million and \$38 million on our loans for the three and nine months ended September 30, 2011.

Age Analysis of Past Due Loans The following table summarizes the past due status of our loans at September 30, 2012 and December 31, 2011. The aging of past due amounts are determined based on the contractual delinquency status of payments under the loan. An account is generally considered to be contractually delinquent when payments have not been made in accordance with the loan terms. Delinquency status may be affected by customer account management policies and practices such as re-age or modification.

At September 30, 2012	Days Past Due			Total Past Due	Current	Total Loans
	1 - 29 days	30 - 89 days	90+ days			
(in millions)						
Commercial loans:						
Construction and other real estate	\$ 94	\$ 72	\$ 105	\$ 271	\$ 7,649	\$ 7,920
Business banking and middle market enterprises	486	82	52	620	11,877	12,497
Global banking	284	-	8	292	18,719	19,011
Other commercial	605	9	26	640	2,500	3,140
Total commercial	<u>1469</u>	<u>163</u>	<u>191</u>	<u>1,823</u>	<u>40,745</u>	<u>42,568</u>
Consumer loans:						
HELOC and home equity mortgages	380	20	86	486	1,901	2,387
Other residential mortgages	104	460	907	1,471	13,615	15,086
Credit cards	29	15	15	59	737	796
Other consumer	7	5	32	44	571	615
Total consumer	<u>520</u>	<u>500</u>	<u>1,040</u>	<u>2,060</u>	<u>16,824</u>	<u>18,884</u>
Total loans	<u>\$1,989</u>	<u>\$663</u>	<u>\$1,231</u>	<u>\$3,883</u>	<u>\$57,569</u>	<u>\$61,452</u>

At December 31, 2011	Days Past Due			Total Past Due	Current	Total Loans
	1 - 29 days	30 - 89 days	90+ days			
(in millions)						
Commercial loans:						
Construction and other real estate	\$ 72	\$ 31	\$ 231	\$ 334	\$ 7,526	\$ 7,860
Business banking and middle market enterprises	615	58	71	744	9,481	10,225
Global banking	898	34	74	1,006	11,652	12,658
Other commercial	350	84	21	455	2,451	2,906
Total commercial	<u>1,935</u>	<u>207</u>	<u>397</u>	<u>2,539</u>	<u>31,110</u>	<u>33,649</u>
Consumer loans:						
HELOC and home equity mortgages	181	54	89	324	2,239	2,563
Other residential mortgages	109	526	815	1,450	12,663	14,113
Credit cards	37	20	20	77	751	828
Other consumer	11	6	35	52	662	714
Total consumer	<u>338</u>	<u>606</u>	<u>959</u>	<u>1,903</u>	<u>16,315</u>	<u>18,218</u>
Total loans	<u>\$2,273</u>	<u>\$813</u>	<u>\$1,356</u>	<u>\$4,442</u>	<u>\$47,425</u>	<u>51,867</u>

Nonaccrual Loans Nonaccrual loans totaled \$1.8 billion at both September 30, 2012 and December 31, 2011, respectively. Interest income that would have been recorded if such nonaccrual loans had been current and in accordance with contractual terms was approximately \$37 million and \$92 million for the three and nine months ended September 30, 2012, respectively, compared to \$27 million and \$86 million for the three and nine months ended September 30, 2011, respectively. Interest income (expense) that was included in finance and other interest

income on these loans was \$10 million for both the three and nine months ended September 30, 2012, respectively, compared to \$4 million and \$13 million for the three and nine months ended September 30, 2011, respectively. For an analysis of reserves for credit losses, see Note 7, "Allowance for Credit Losses."

Nonaccrual loans and accruing receivables 90 days or more delinquent are summarized in the following table:

	September 30, 2012	December 31, 2011
	(in millions)	
Nonaccrual loans:		
Commercial:		
Real Estate:		
Construction and land loans	\$ 98	\$ 103
Other real estate	353	512
Business banking and middle markets enterprises	46	58
Global banking	142	137
Other commercial	19	15
Total commercial	<u>658</u>	<u>825</u>
Consumer:		
Residential mortgages, excluding home equity mortgages	979	815
Home equity mortgages	97	89
Total residential mortgages ⁽¹⁾⁽²⁾	1,076	904
Other consumer loans	5	8
Total consumer loans	<u>1,081</u>	<u>912</u>
Nonaccrual loans held for sale	51	91
Total nonaccruing loans	<u>1,790</u>	<u>1,828</u>
Accruing loans contractually past due 90 days or more:		
Commercial:		
Real Estate:		
Construction and land loans	-	-
Other real estate	1	1
Business banking and middle market enterprises	7	11
Other commercial	1	2
Total commercial	<u>9</u>	<u>14</u>
Consumer:		
Credit card receivables	15	20
Other consumer	27	27
Total consumer loans	<u>42</u>	<u>47</u>
Total accruing loans contractually past due 90 days or more	<u>51</u>	<u>61</u>
Total nonperforming loans	<u>\$1,841</u>	<u>\$1,889</u>

⁽¹⁾ Nonaccrual residential mortgages includes all receivables which are 90 or more days contractually delinquent as well as second lien loans where the first lien loan that we own or service is 90 or more days contractually delinquent.

⁽²⁾ In the third quarter of 2012, we reclassified \$83 million of residential mortgage loans discharged under Chapter 7 bankruptcy and not re-affirmed to nonaccrual, consistent with recently issued regulatory guidance. Interest income reversed on these loans was not material.

Impaired Loans A loan is considered to be impaired when it is deemed probable that not all principal and interest amounts due according to the contractual terms of the loan agreement will be collected. Probable losses from impaired loans are quantified and recorded as a component of the overall allowance for credit losses. Commercial and consumer loans for which we have modified the loan terms as part of a troubled debt restructuring are considered to be impaired loans. Additionally, commercial loans in nonaccrual status, or that have been partially charged-off or assigned a specific allowance for credit losses are also considered impaired loans.

Troubled debt restructurings Troubled debt restructurings (“TDR Loans”) represent loans for which the original contractual terms have been modified to provide for terms that are less than what we would be willing to accept for new loans with comparable risk because of deterioration in the borrower’s financial condition.

Modifications to consumer and commercial loans may include changes to one or more terms of the loan, including, but not limited to, a change in interest rate, extension of the amortization period, reduction in payment amount and partial forgiveness or deferment of principal. A substantial amount of our modifications involve interest rate reductions which lower the amount of interest income we are contractually entitled to receive in future periods. Through lowering the interest rate and other loan term changes, we believe we are able to increase the amount of cash flow that will ultimately be collected from the loan, given the borrower’s financial condition. TDR Loans are reserved for either based on the present value of expected future cash flows discounted at the loans’ original effective interest rate which generally results in a higher reserve requirement for these loans or in the case of certain secured commercial loans, the estimated fair value of the underlying collateral. Once a consumer loan is classified as a TDR Loan, it continues to be reported as such until it is paid off or charged-off. For commercial loans, if subsequent performance is in accordance with the new terms and such terms reflect current market rates at the time of restructure, they will no longer be reported as a TDR loan beginning in the year after restructure.

The following table presents information about receivables which were modified during the three and nine months ended September 30, 2012 and as a result of this action became classified as TDR Loans.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Commercial loans:				
Construction and other real estate	\$ 38	\$27	\$105	\$ 40
Business banking and middle market enterprises	1	-	22	6
Total commercial	39	27	127	46
Consumer loans:				
Residential mortgages	220	56	328	189
Credit cards	1	2	3	5
Total consumer	221	58	331	194
Total	\$260	\$85	\$458	\$240

The following tables present information about our TDR Loans and the related credit loss reserves for TDR Loans:

	September 30, 2012	December 31, 2011
	(in millions)	
TDR Loans ⁽¹⁾⁽²⁾ :		
Commercial loans:		
Construction and other real estate	\$ 375	\$ 342
Business banking and middle market enterprises	84	94
Other commercial	<u>33</u>	<u>37</u>
Total commercial	<u>492</u>	<u>473</u>
Consumer loans:		
Residential mortgages	883	608
Credit cards	<u>16</u>	<u>21</u>
Total consumer	<u>899</u>	<u>629</u>
Total TDR Loans ⁽³⁾ :	<u>\$1,391</u>	<u>\$1,102</u>
	September 30, 2012	December 31, 2011
	(in millions)	
Allowance for credit losses on TDR Loans ⁽⁴⁾ :		
Commercial loans:		
Construction and other real estate	\$ 30	\$ 17
Business banking and middle market enterprises	3	3
Total commercial	<u>33</u>	<u>20</u>
Consumer loans:		
Residential mortgages	113	94
Credit cards	<u>5</u>	<u>7</u>
Total consumer	<u>118</u>	<u>101</u>
Total Allowance for credit losses on TDR Loans	<u>\$151</u>	<u>\$121</u>

(1) TDR Loans are considered to be impaired loans. For consumer loans, all such loans are considered impaired loans regardless of accrual status. For commercial loans, impaired loans include other loans in addition to TDRs which totaled \$378 million and \$614 million at September 30, 2012 and December 31, 2011, respectively.

(2) The TDR Loan balances included in the table above reflect the current carrying amount of TDR Loans and includes all basis adjustments on the loan, such as unearned income, unamortized deferred fees and costs on originated loans, partial charge-offs and premiums or discounts on purchased loans. The following table reflects the unpaid principal balance of TDR Loans:

	September 30, 2012	December 31, 2011
	(in millions)	
Commercial loans:		
Construction and other real estate	\$ 407	\$ 393
Business banking and middle market enterprises	124	147
Other commercial	<u>36</u>	<u>40</u>
Total commercial	<u>567</u>	<u>580</u>
Consumer loans:		
Residential mortgages	1,018	682
Credit cards	<u>16</u>	<u>20</u>
Total consumer	<u>1,034</u>	<u>702</u>
Total	<u>\$1,601</u>	<u>\$1,282</u>

(3) Includes balances of \$525 million and \$331 million at September 30, 2012 and December 31, 2011, respectively, which are classified as nonaccrual loans.

(4) Included in the allowance for credit losses.

In the third quarter of 2012, we added \$186 million of loans discharged under Chapter 7 bankruptcy and not re-affirmed to our residential mortgage TDR Loan balances, consistent with recently issued regulatory guidance. The impact on the allowance for credit losses was insignificant. These loans will be written down to the lower of amortized cost or fair value of the collateral less cost to sell during the fourth quarter of 2012.

Additional information relating to TDR Loans is presented in the table below.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Average balance of TDR Loans:				
Commercial loans:				
Construction and other real estate	\$ 364	\$ 330	\$ 361	\$ 360
Business banking and middle market enterprises	85	87	92	88
Other commercial	34	44	34	47
Total commercial	<u>483</u>	<u>461</u>	<u>487</u>	<u>495</u>
Consumer loans:				
Residential mortgages	745	550	676	529
Credit cards	17	23	16	24
Total consumer	<u>762</u>	<u>573</u>	<u>692</u>	<u>553</u>
Total average balance of TDR Loans	<u>\$1,245</u>	<u>\$1,034</u>	<u>\$1,179</u>	<u>\$1,048</u>
Interest income recognized on TDR Loans:				
Commercial loans:				
Construction and other real estate	\$ 2	\$ 2	\$ 6	\$ 7
Other commercial	3	1	6	4
Total commercial	<u>5</u>	<u>3</u>	<u>12</u>	<u>11</u>
Consumer loans:				
Residential mortgages	8	5	22	15
Credit cards	-	-	-	1
Total consumer	<u>8</u>	<u>5</u>	<u>22</u>	<u>16</u>
Total interest income recognized on TDR Loans	<u>\$ 13</u>	<u>\$ 8</u>	<u>\$ 34</u>	<u>\$ 27</u>

The following table presents loans which were classified as TDR Loans during the previous 12 months which became 90 days or greater contractually delinquent (for consumer loans 60 days or greater contractually delinquent) during the three and nine months ended September 30, 2012:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Commercial loans:				
Construction and other real estate	\$ -	\$ -	\$ -	\$48
Business banking and middle market enterprises	-	-	-	-
Total commercial	-	-	-	48
Consumer loans:				
Residential mortgages	57	4	159	9
Credit cards	-	1	-	3
Total consumer	57	5	159	12
Total	<u>\$57</u>	<u>\$5</u>	<u>\$159</u>	<u>\$60</u>

Impaired commercial loans Impaired commercial loan statistics are summarized in the following table:

	Amount with Impairment Reserves	Amount without Impairment Reserves	Total Impaired Commercial Loans ⁽¹⁾⁽²⁾	Impairment Reserve
	(in millions)			
At September 30, 2012:				
Construction and other real estate	\$235	\$298	\$ 533	\$102
Business banking and middle market enterprises	58	50	108	10
Global banking	125	18	143	15
Other commercial	3	83	86	1
Total	<u>\$421</u>	<u>\$449</u>	<u>\$ 870</u>	<u>\$128</u>
At December 31, 2011:				
Construction and other real estate	\$391	\$342	\$ 733	\$114
Business banking and middle market enterprises	68	59	127	12
Global banking	137	-	137	90
Other commercial	1	89	90	-
Total	<u>\$597</u>	<u>\$490</u>	<u>\$1,087</u>	<u>\$216</u>

⁽¹⁾ Includes impaired commercial loans which are also considered TDR Loans as follows:

	September 30, 2012	December 31, 2011
	(in millions)	
Construction and other real estate	\$375	\$342
Business banking and middle market enterprises	84	94
Other commercial	33	37
Total	<u>\$492</u>	<u>\$473</u>

- (2) The impaired commercial loan balances included in the table above reflect the current carrying amount of the loan and includes all basis adjustments, such as unamortized deferred fees and costs on originated loans, any premiums or discounts and any principal write-downs. The unpaid principal balance of impaired commercial loans included in the table above are as follows:

	September 30, 2012	December 31, 2011
	(in millions)	
Construction and other real estate	\$565	\$ 784
Business banking and middle market enterprises	148	180
Global banking	143	137
Other commercial	89	93
Total	<u>\$945</u>	<u>\$1,194</u>

The following table presents information about average impaired commercial loan balances and interest income recognized on the impaired commercial loans:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Average balance of impaired commercial loans:				
Construction and other real estate	\$562	\$ 703	\$628	\$ 745
Business banking and middle market enterprises	112	156	122	157
Global banking	129	111	103	100
Other commercial	87	123	88	116
Total average balance of impaired commercial loans	<u>\$890</u>	<u>\$1,093</u>	<u>\$941</u>	<u>\$1,118</u>
Interest income recognized on impaired commercial loans:				
Construction and other real estate	\$ 5	\$ 1	\$ 8	\$ 5
Business banking and middle market enterprises	2	1	4	3
Other commercial	1	1	2	2
Total interest income recognized on impaired commercial loans	<u>\$ 8</u>	<u>\$ 3</u>	<u>\$ 14</u>	<u>\$ 10</u>

Commercial Loan Credit Quality Indicators The following credit quality indicators are monitored for our commercial loan portfolio:

Criticized asset classifications These classifications are based on the risk rating standards of our primary regulator. Problem loans are assigned various criticized facility grades. We also assign obligor grades which are used under our allowance for credit losses methodology. Criticized assets for commercial loans are summarized in the following table:

	Special Mention	Substandard	Doubtful	Total
	(in millions)			
At September 30, 2012:				
Construction and other real estate	\$ 680	\$ 782	\$116	\$1,578
Business banking and middle market enterprises	383	155	9	547
Global banking	99	83	124	306
Other commercial	38	75	8	121
Total commercial	<u>\$1,200</u>	<u>\$1,095</u>	<u>\$257</u>	<u>\$2,552</u>
At December 31, 2011:				
Construction and other real estate	\$1,009	\$ 990	\$186	\$2,185
Business banking and middle market enterprises	445	241	12	698
Global banking	45	397	109	551
Other commercial	99	131	-	230
Total commercial	<u>\$1,598</u>	<u>\$1,759</u>	<u>\$307</u>	<u>\$3,664</u>

Nonperforming The status of our commercial loan portfolio is summarized in the following table:

	Performing Loans	Nonaccrual Loans	Accruing Loans Contractually Past Due 90 days or More	Total
(in millions)				
At September 30, 2012:				
Construction and other real estate	\$ 7,468	\$451	\$ 1	\$ 7,920
Business banking and middle market enterprise	12,444	46	7	12,497
Global banking	18,869	142	-	19,011
Other commercial	3,120	19	1	3,140
Total commercial	<u>\$41,901</u>	<u>\$658</u>	<u>\$ 9</u>	<u>\$42,568</u>
At December 31, 2011:				
Construction and other real estate	\$ 7,244	\$615	\$ 1	\$ 7,860
Business banking and middle market enterprise	10,156	58	11	10,225
Global banking	12,521	137	-	12,658
Other commercial	2,889	15	2	2,906
Total commercial	<u>\$32,810</u>	<u>\$825</u>	<u>\$14</u>	<u>\$33,649</u>

Credit risk profile The following table shows the credit risk profile of our commercial loan:

	Investment Grade ⁽¹⁾	Non-Investment Grade	Total
(in millions)			
At September 30, 2012:			
Construction and other real estate	\$ 3,851	\$ 4,069	\$ 7,920
Business banking and middle market enterprises	6,271	6,226	12,497
Global banking	15,967	3,044	19,011
Other commercial	1,203	1,937	3,140
Total commercial	<u>\$27,292</u>	<u>\$15,276</u>	<u>\$42,568</u>
At December 31, 2011:			
Construction and other real estate	\$ 3,133	\$ 4,727	\$ 7,860
Business banking and middle market enterprises	4,612	5,613	10,225
Global banking	9,712	2,946	12,658
Other commercial	843	2,063	2,906
Total commercial	<u>\$18,300</u>	<u>\$15,349</u>	<u>\$33,649</u>

⁽¹⁾ Investment grade includes commercial loans with borrowers that have credit ratings of at least BBB- or above or the equivalent based on our internal credit rating system.

Consumer Loan Credit Quality Indicators The following credit quality indicators are monitored for our consumer loan portfolio:

Delinquency The following table summarizes dollars of two-months-and-over contractual delinquency and as a percent of total loans and loans held for sale (“delinquency ratio”) for our consumer loan:

	September 30, 2012		December 31, 2011	
	Dollars of Delinquency	Delinquency Ratio	Dollars of Delinquency	Delinquency Ratio
(dollars are in millions)				
Consumer:				
Residential mortgage, excluding home equity mortgages ⁽¹⁾	\$1,100	7.04%	\$1,101	7.19%
Home equity mortgages	67	2.81	99	2.89
Total residential mortgages	1,167	6.48	1,200	6.41
Credit card receivables	22	2.76	28	2.25
Other consumer	29	4.26	30	3.17
Total consumer	\$1,218	6.25%	\$1,258	6.01%

⁽¹⁾ At September 30, 2012 and December 31, 2011, residential mortgage loan delinquency includes \$970 million and \$803 million, respectively, of loans that are carried at the lower of amortized cost or fair value of the collateral less cost to sell.

Nonperforming The status of our consumer loan portfolio is summarized in the following table:

	Performing Loans	Nonaccrual Loans	Accruing Loans Contractually Past Due 90 days or More	Total
At September 30, 2012:				
Consumer:				
Residential mortgage, excluding home equity mortgages ⁽¹⁾	\$14,107	\$ 979	\$ -	\$15,086
Home equity mortgages	2,290	97	-	2,387
Total residential mortgages	16,397	1,076	-	17,473
Credit card receivables	781	-	15	796
Other consumer	583	5	27	615
Total consumer	\$17,761	\$1,081	\$42	\$18,884
At December 31, 2011:				
Consumer:				
Residential mortgage, excluding home equity mortgages	\$13,298	\$ 815	\$ -	\$14,113
Home equity mortgages	2,474	89	-	2,563
Total residential mortgages	15,772	904	-	16,676
Credit card receivables	808	-	20	828
Other consumer	679	8	27	714
Total consumer	\$17,259	\$ 912	\$47	\$18,218

⁽¹⁾ In the third quarter of 2012, we reclassified \$83 million of residential mortgage loans discharged under Chapter 7 bankruptcy and not re-affirmed to nonaccrual, consistent with recently issued regulatory guidance. Interest income reversed on these loans was not material.

Troubled debt restructurings See discussion of impaired loans above for further details on this credit quality indicator.

Concentrations of Credit Risk Our loan portfolio includes the following types of loans:

- High loan-to-value (“LTV”) loans – Certain residential mortgages on primary residences with LTV ratios equal to or exceeding 90 percent at the time of origination and no mortgage insurance, which could result in the potential inability to recover the entire investment in loans involving foreclosed or damaged properties.
- Interest-only loans – A loan which allows a customer to pay the interest-only portion of the monthly payment for a period of time which results in lower payments during the initial loan period. However, subsequent events affecting a customer’s financial position could affect the ability of customers to repay the loan in the future when the principal payments are required.
- Adjustable rate mortgage (“ARM”) loans – A loan which allows us to adjust pricing on the loan in line with market movements. A customer’s financial situation and the general interest rate environment at the time of the interest rate reset could affect the customer’s ability to repay or refinance the loan after the adjustment.

The following table summarizes the balances of high LTV, interest-only and ARM loans in our loan portfolios, including certain loans held for sale, at September 30, 2012 and December 31, 2011, respectively. Loans may appear in more than one category.

	September 30, 2012	December 31, 2011
	(in billions)	
Residential mortgage loans with high LTV and no mortgage insurance ⁽¹⁾	\$.9	\$1.1
Interest-only residential mortgage loans	4.0	3.9
ARM loans ⁽²⁾	10.2	9.9

⁽¹⁾ Residential mortgage loans with high LTV and no mortgage insurance includes both fixed rate and adjustable rate mortgages. Excludes \$34 million and \$68 million of sub-prime residential mortgage loans held for sale at September 30, 2012 and December 31, 2011, respectively.

⁽²⁾ ARM loan balances above exclude \$23 million and \$28 million of sub-prime residential mortgage loans held for sale at September 30, 2012 and December 31, 2011, respectively. During the remainder of 2012 and during 2013, approximately \$43 million and \$334 million, respectively, of these ARM loans will experience their first interest rate reset.

Concentrations of first and second liens within the outstanding residential mortgage loan portfolio are summarized in the following table. Amounts in the table exclude closed end first lien loans held for sale of \$0.5 billion and \$2.0 billion at September 30, 2012 and December 31, 2011, respectively.

	September 30, 2012	December 31, 2011
	(in millions)	
Closed end:		
First lien	\$15,086	\$14,113
Second lien	197	237
Revolving:		
Second lien	2,190	2,326
Total	<u>\$17,473</u>	<u>\$16,676</u>

7. Allowance for Credit Losses

An analysis of the allowance for credit losses is presented in the following table:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Balance at beginning of period	\$619	\$747	\$ 743	\$ 852
Provision for credit losses	84	78	173	171
Charge-offs	(76)	(75)	(329)	(300)
Recoveries	10	29	50	56
Allowance on loans transferred to held for sale	-	(30)	-	(30)
Balance at end of period	<u>\$637</u>	<u>\$749</u>	<u>\$ 637</u>	<u>\$ 749</u>

The following table summarizes the changes in the allowance for credit losses by product and the related loan balance by product during the three and nine months ended September 30, 2012 and 2011:

	Commercial				Consumer				Total
	Construction and Other Real Estate	Business Banking and Middle Market Enterprises	Global banking	Other Comm'l	Residential Mortgage, Excl Home Equity Mortgages	Home Equity Mortgages	Credit Card	Other Consumer	
(in millions)									
Three Months Ended									
September 30, 2012:									
Allowance for credit losses –									
beginning of period	\$ 198	\$ 80	\$ 44	\$ 18	\$ 188	\$ 47	\$ 31	\$ 13	\$ 619
Provision charged to income	(11)	18	12	-	33	13	15	4	84
Charge offs	(9)	(8)	-	-	(24)	(18)	(14)	(3)	(76)
Recoveries	3	2	-	-	3	-	2	-	10
Net charge offs	(6)	(6)	-	-	(21)	(18)	(12)	(3)	(66)
Allowance for credit losses – end of period	<u>\$ 181</u>	<u>\$ 92</u>	<u>\$ 56</u>	<u>\$ 18</u>	<u>\$ 200</u>	<u>\$ 42</u>	<u>\$ 34</u>	<u>\$ 14</u>	<u>\$ 637</u>
Ending balance: collectively evaluated for impairment	\$ 79	\$ 82	\$ 41	\$ 17	\$ 93	\$ 36	\$ 29	\$ 14	\$ 391
Ending balance: individually evaluated for impairment ⁽¹⁾	102	10	15	1	107	6	5	-	246
Total allowance for credit losses	<u>\$ 181</u>	<u>\$ 92</u>	<u>\$ 56</u>	<u>\$ 18</u>	<u>\$ 200</u>	<u>\$ 42</u>	<u>\$ 34</u>	<u>\$ 14</u>	<u>\$ 637</u>
Loans:									
Collectively evaluated for impairment	\$7,387	\$12,389	\$18,868	\$3,054	\$13,462	\$2,365	\$780	\$615	\$58,920
Individually evaluated for impairment ⁽¹⁾	533	108	143	86	345	22	16	-	1,253
Loans carried at the lower of amortized cost or fair value less cost to sell	-	-	-	-	1,279	-	-	-	1,279
Total loans	<u>\$7,920</u>	<u>\$12,497</u>	<u>\$19,011</u>	<u>\$3,140</u>	<u>\$15,086</u>	<u>\$2,387</u>	<u>\$796</u>	<u>\$615</u>	<u>\$61,452</u>
Three Months Ended									
September 30, 2011:									
Allowance for credit losses –									
beginning of period	\$ 229	\$ 96	\$ 110	\$ 21	\$ 162	\$ 62	\$ 44	\$ 23	\$ 747
Provision charged to income	(10)	5	28	(23)	53	8	12	5	78
Charge offs	(3)	(11)	-	-	(24)	(15)	(16)	(6)	(75)
Recoveries	1	3	-	20	1	-	3	1	29
Net charge offs	(2)	(8)	-	20	(23)	(15)	(13)	(5)	(46)
Allowance on loans transferred to held for sale	-	(10)	-	-	(4)	(6)	(6)	(4)	(30)
Allowance for credit losses – end of period	<u>\$ 217</u>	<u>\$ 83</u>	<u>\$ 138</u>	<u>\$ 18</u>	<u>\$ 188</u>	<u>\$ 49</u>	<u>\$ 37</u>	<u>\$ 19</u>	<u>\$ 749</u>
Ending balance: collectively evaluated for impairment	\$ 114	\$ 68	\$ 31	\$ 14	\$ 102	\$ 45	\$ 30	\$ 19	\$ 423
Ending balance: individually evaluated for impairment ⁽¹⁾	103	15	107	4	86	4	7	-	326
Total allowance for credit losses	<u>\$ 217</u>	<u>\$ 83</u>	<u>\$ 138</u>	<u>\$ 18</u>	<u>\$ 188</u>	<u>\$ 49</u>	<u>\$ 37</u>	<u>\$ 19</u>	<u>\$ 749</u>
Loans:									
Collectively evaluated for impairment	\$7,066	\$ 9,842	\$11,908	\$1,650	\$12,653	\$2,604	\$766	\$733	\$47,222
Individually evaluated for impairment ⁽¹⁾	707	155	147	144	137	14	22	-	1,326
Loans carried at the lower of amortized cost or fair value less cost to sell	-	-	-	-	1,052	-	-	-	1,052
Total loans	<u>\$7,773</u>	<u>\$ 9,997</u>	<u>\$12,055</u>	<u>\$1,794</u>	<u>\$13,842</u>	<u>\$2,618</u>	<u>\$788</u>	<u>\$733</u>	<u>\$49,600</u>

	Commercial				Consumer				Total
	Construction and Other Real Estate	Business Banking and Middle Market Enterprises	Global banking	Other Comm'l	Residential Mortgage, Excl Home Equity Mortgages	Home Equity Mortgages	Credit Card	Other Consumer	
(in millions)									
Nine Months Ended									
September 30, 2012:									
Allowance for credit losses – beginning of period	\$ 212	\$ 78	\$ 131	\$ 21	\$ 192	\$ 52	\$ 39	\$ 18	\$ 743
Provision charged to income	(36)	39	9	(9)	72	55	35	8	173
Charge offs	(12)	(31)	(84)	-	(73)	(65)	(47)	(17)	(329)
Recoveries	17	6	-	6	9	-	7	5	50
Net charge offs	5	(25)	(84)	6	(64)	(65)	(40)	(12)	(279)
Allowance for credit losses – end of period	<u>\$ 181</u>	<u>\$ 92</u>	<u>\$ 56</u>	<u>\$ 18</u>	<u>\$ 200</u>	<u>\$ 42</u>	<u>\$ 34</u>	<u>\$ 14</u>	<u>\$ 637</u>
Nine Months Ended									
September 30, 2011:									
Allowance for credit losses – beginning of period	\$ 243	\$ 132	\$ 116	\$ 32	\$ 167	\$ 77	\$ 58	\$ 27	\$ 852
Provision charged to income	11	(4)	22	(33)	98	31	32	14	171
Charge offs	(46)	(44)	-	(2)	(78)	(53)	(56)	(21)	(300)
Recoveries	9	9	-	21	4	-	9	4	56
Net charge offs	(37)	(35)	-	19	(74)	(53)	(47)	(17)	(244)
Allowance on loans transferred to held for sale	-	(10)	-	-	(3)	(6)	(6)	(5)	(30)
Allowance for credit losses – end of period	<u>\$ 217</u>	<u>\$ 83</u>	<u>\$ 138</u>	<u>\$ 18</u>	<u>\$ 188</u>	<u>\$ 49</u>	<u>\$ 37</u>	<u>\$ 19</u>	<u>\$ 749</u>

(1) For consumer loans, these amounts represent TDR Loans for which we evaluate reserves using a discounted cash flow methodology. Each loan is individually identified as a TDR Loan and then grouped together with other TDR Loans with similar characteristics. The discounted cash flow analysis is then applied to these groups of TDR Loans. The loan balance above excludes TDR loans that are carried at the lower of amortized cost or fair value of the collateral less cost to sell which totaled \$516 million and \$303 million at September 30, 2012 and 2011, respectively.

We estimate probable losses for consumer loans and certain small balance commercial loans which do not qualify as troubled debt restructures using a roll rate migration analysis that estimates the likelihood that a loan will progress through the various stages of delinquency and ultimately charge-off. This has historically resulted in the identification of a loss emergence period for these loans collectively evaluated for impairment using a roll rate migration analysis which approximates less than 12 months of loss coverage in the allowance for credit losses for certain loan products. A loss coverage of 12 months in our allowance for credit losses would be more aligned with U.S. bank industry practice. Our regulators have indicated they would like us to more closely align our loss coverage period with industry practice. During the fourth quarter of 2012, we will review our estimate of loss emergence to determine what changes should be made to our credit loss estimate which could result in an increase to our allowance for credit losses in the fourth quarter of 2012 in an amount that is not expected to exceed 15 percent of our total allowance for credit losses at September 30, 2012.

8. Loans Held for Sale

Loans held for sale consisted of the following:

	September 30, 2012	December 31, 2011
	(in millions)	
Commercial loans	<u>\$ 443</u>	<u>\$ 965</u>
Consumer loans:		
Residential mortgages	548	2,058
Credit card receivables	-	416
Other consumer	<u>65</u>	<u>231</u>
Total consumer	<u>613</u>	<u>2,705</u>
Total loans held for sale	<u><u>\$1,056</u></u>	<u><u>\$3,670</u></u>

Included in loans held for sale at December 31, 2011 was \$2.5 billion of loans being sold as part of our agreement to sell certain branches to First Niagara, including \$521 million of commercial loans, \$1.4 billion of residential mortgages, \$416 million of credit card receivables and \$161 million of other consumer loans. Prior to sale, credit card, private label credit card and closed-end loans included in the sale to Capital One were reflected in Assets of discontinued operations on our balance sheet.

We originate commercial loans in connection with our participation in a number of leveraged acquisition finance syndicates. A substantial majority of these loans were originated with the intent of selling them to unaffiliated third parties and are classified as commercial loans held for sale at September 30, 2012 and December 31, 2011. The fair value of commercial loans held for sale under this program was \$424 million and \$377 million at September 30, 2012 and December 31, 2011, respectively. We have elected to designate all of the leveraged acquisition finance syndicated loans classified as held for sale at fair value under the fair value option. See Note 12, "Fair Value Option," for additional information.

Commercial loans held for sale also includes commercial real estate loans of \$19 million and \$55 million at September 30, 2012 and December 31, 2011, respectively, which are originated with the intent to sell to government sponsored enterprises.

In addition to the residential mortgage loans sold to First Niagara discussed above, residential mortgage loans held for sale include subprime residential mortgage loans with a fair value of \$94 million and \$181 million at September 30, 2012 and December 31, 2011, respectively, which were acquired from unaffiliated third parties and from HSBC Finance with the intent of securitizing or selling the loans to third parties. Also included in residential mortgage loans held for sale are first lien mortgage loans originated and held for sale primarily to various government sponsored enterprises. Gains and losses from the sale of residential mortgage loans are reflected as a component of residential mortgage banking revenue in the accompanying consolidated statement of income (loss). We retained the servicing rights in relation to the mortgages upon sale.

In addition to routine sales to government sponsored enterprises upon origination, we sold subprime residential mortgage loans with a carrying amount of \$64 million and \$179 million in the nine months ended September 30, 2012 and 2011, respectively.

Other consumer loans held also includes student loans, which we no longer originate, of \$65 million and \$70 million at September 30, 2012 and December 31, 2011, respectively.

Excluding the commercial loans designated under fair value option discussed above, loans held for sale are recorded at the lower of amortized cost or fair value. The cumulative fair value adjustment on loans held for sale was \$169 million and \$251 million at September 30, 2012 and December 31, 2011, respectively.

Loans held for sale are subject to market risk, liquidity risk and interest rate risk, in that their value will fluctuate as a result of changes in market conditions, as well as the interest rate and credit environment. Interest rate risk for residential mortgage loans held for sale is partially mitigated through an economic hedging program to offset changes in the fair value of the mortgage loans held for sale. Trading related revenue associated with this economic hedging program, which is included in net interest income and residential mortgage banking revenue in the consolidated statement of income (loss), were losses of \$4 million during the three months ended September 30, 2012 and no gains or losses during the nine months ended September 30, 2012, compared to gains of \$3 million and losses of \$8 million during the three and nine months ended September 30, 2011, respectively.

9. Intangible Assets

Intangible assets consisted of the following:

	September 30, 2012	December 31, 2011
	(in millions)	
Mortgage servicing rights	\$181	\$227
Purchased credit card relationships	62	-
Other	<u>10</u>	<u>15</u>
Total other intangible assets, net	<u>\$253</u>	<u>\$242</u>

Mortgage Servicing Rights (“MSRs”) A servicing asset is a contract under which estimated future revenues from contractually specified cash flows, such as servicing fees and other ancillary revenues, are expected to more than adequately compensate the servicer for performing the servicing. We recognize the right to service mortgage loans as a separate and distinct asset at the time they are acquired or when originated loans are sold.

MSRs are subject to credit, prepayment and interest rate risk, in that their value will fluctuate as a result of changes in these economic variables. Interest rate risk is mitigated through an economic hedging program that uses securities and derivatives to offset changes in the fair value of MSRs. Since the hedging program involves trading activity, risk is quantified and managed using a number of risk assessment techniques, which are addressed in more detail in the 2011 Form 10-K.

Residential mortgage servicing rights Residential MSRs are initially measured at fair value at the time that the related loans are sold and are re-measured at fair value at each reporting date. Changes in fair value of the MSRs are reflected in residential mortgage banking revenue in the period in which the changes occur. Fair value is determined based upon the application of valuation models and other inputs. The valuation models incorporate assumptions market participants would use in estimating future cash flows. The reasonableness of these valuation models is periodically validated by reference to external independent broker valuations and industry surveys.

Fair value of residential MSRs is calculated using the following critical assumptions:

	September 30, 2012	December 31, 2011
Annualized constant prepayment rate (“CPR”)	23.2%	21.4%
Constant discount rate	10.8%	11.3%
Weighted average life	3.2 years	3.4 years

Residential MSR activity is summarized in the following table:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Fair value of MSRs:				
Beginning balance	\$187	\$ 363	\$220	\$ 394
Additions related to loan sales	6	7	20	32
Changes in fair value due to:				
Change in valuation inputs or assumptions used in the valuation models	(5)	(110)	(20)	(132)
Realization of cash flows	(15)	(23)	(47)	(57)
Ending balance	<u>\$173</u>	<u>\$ 237</u>	<u>\$173</u>	<u>\$ 237</u>

Information regarding residential mortgage loans serviced for others, which are not included in the consolidated balance sheet, is summarized in the following table:

	September 30, 2012	December 31, 2011
	(in millions)	
Outstanding principal balances at period end	<u>\$33,584</u>	<u>\$37,839</u>
Custodial balances maintained and included in noninterest bearing deposits at period end	<u>\$ 838</u>	<u>\$ 838</u>

Servicing fees collected are included in residential mortgage banking revenue and totaled \$21 million and \$68 million during the three and nine months ended September 30, 2012, respectively, compared to \$27 million and \$83 million during the three and nine months ended September 30, 2011, respectively.

Commercial Mortgage Servicing Rights Commercial MSRs, which are measured at the lower of carrying amount or fair value, totaled \$8 million and \$7 million at September 30, 2012 and December 31, 2011.

Purchased credit card relationships In March 2012, we purchased from HSBC Finance the account relationships associated with \$746 million of credit card receivables which were not included in the sale to Capital One at a fair value of \$108 million. Approximately \$43 million of this value was associated with the credit card receivables sold to First Niagara. The remaining \$65 million was included in intangible assets and is being amortized over its estimated useful life of ten years.

Other Intangible Assets Other intangible assets, which result from purchase business combinations, are comprised of favorable lease arrangements of \$9 million and \$12 million at September 30, 2012 and December 31, 2011, respectively, and customer lists in the amount of \$1 million and \$3 million at September 30, 2012 and December 31, 2011, respectively.

10. Goodwill

Goodwill was \$2.2 billion at both September 30, 2012 and December 31, 2011, and includes accumulated impairment losses of \$54 million. Goodwill of \$398 million was allocated to the branch operations sold to First Niagara. See Note 3, "Branch Assets and Liabilities Held for Sale," for further discussion.

During the third quarter of 2012, we completed our annual impairment test of goodwill and determined that the fair value of all our reporting units exceeded their carrying amounts, including goodwill. Our goodwill impairment testing is, however, highly sensitive to certain assumptions and estimates used. In the event that

significant deterioration in economic or credit conditions occur, or changes in the strategy or performance of our business or product offerings occur, particularly as it relates to our Global Banking and Markets and Private Banking reporting units, an interim impairment test will be required. At July 1, 2012, the carrying value including goodwill of our Global Banking and Markets and Private Banking reporting units was 91 percent and 93 percent, respectively, of their fair value.

11. Derivative Financial Instruments

In the normal course of business, we enter into derivative contracts for trading, market making and risk management purposes. For financial reporting purposes, a derivative instrument is designated in one of the following categories: (a) financial instruments held for trading, (b) hedging instruments designated as a qualifying hedge under derivative accounting principles or (c) a non-qualifying economic hedge. The derivative instruments held are predominantly swaps, futures, options and forward contracts. All freestanding derivatives, including bifurcated embedded derivatives, are stated at fair value. Where we enter into enforceable master netting arrangements with counterparties, the master netting arrangements permit us to net those derivative asset and liability positions and to offset cash collateral held and posted with the same counterparty.

Derivatives Held for Risk Management Purposes Our risk management policy requires us to identify, analyze and manage risks arising from the activities conducted during the normal course of business. We use derivative instruments as an asset and liability management tool to manage our exposures to interest rate, foreign currency and credit risks in existing assets and liabilities, commitments and forecasted transactions. The accounting for changes in fair value of a derivative instrument will depend on whether the derivative has been designated and qualifies for hedge accounting under derivative accounting principles.

Accounting principles for qualifying hedges require detailed documentation that describes the relationship between the hedging instrument and the hedged item, including, but not limited to, the risk management objectives and hedging strategy and the methods to assess the effectiveness of the hedging relationship. We designate derivative instruments to offset the fair value risk and cash flow risk arising from fixed-rate and floating-rate assets and liabilities as well as forecasted transactions. We assess the hedging relationships, both at the inception of the hedge and on an ongoing basis, using a regression approach to determine whether the designated hedging instrument is highly effective in offsetting changes in the fair value or cash flows of the hedged item. We discontinue hedge accounting when we determine that a derivative is not expected to be highly effective going forward or has ceased to be highly effective as a hedge, the hedging instrument is terminated, or when the designation is removed by us.

In the tables that follow below, the fair value disclosed does not include swap collateral that we either receive or deposit with our interest rate swap counterparties. Such swap collateral is recorded on our balance sheet at an amount which approximates fair value.

Fair Value Hedges In the normal course of business, we hold fixed-rate loans and securities and issue fixed-rate senior and subordinated debt obligations. The fair value of fixed-rate (USD and non-USD denominated) assets and liabilities fluctuates in response to changes in interest rates or foreign currency exchange rates. We utilize interest rate swaps, interest rate forward and futures contracts and foreign currency swaps to minimize the effect on earnings caused by interest rate and foreign currency volatility.

The changes in fair value of a derivative designated in a qualifying fair value hedge, along with the effective portion of the changes in the fair value of the hedged asset or liability that is attributable to the hedged risk, are recorded in current period earnings. We recognized a net gain of \$17 million and a loss of \$3 million during the three and nine months ended September 30, 2012, respectively, compared to net losses of \$45 million and \$46 million during the three and nine months ended September 30, 2011, respectively, which are reported in other income in the consolidated statement of income (loss) which represents the ineffective portion of all fair value hedges. The interest accrual related to the derivative contract is recognized in interest income.

The changes in fair value of the hedged item designated in a qualifying hedge are captured as an adjustment to the carrying amount of the hedged item (basis adjustment). If the hedging relationship is terminated and the hedged item continues to exist, the basis adjustment is amortized over the remaining life of the hedged item. We recorded basis adjustments for active fair value hedges which decreased the carrying amount of our debt by \$3 million and \$9 million during the three and nine months ended September 30, 2012, respectively, compared to \$1 million and \$6 million during the three and nine months ended September 30, 2011, respectively. We amortized \$3 million and \$9 million of basis adjustments related to terminated and/or re-designated fair value hedge relationships during the three and nine months ended September 30, 2012, respectively, compared to \$3 million and \$8 million during the three and nine months ended September 30, 2011, respectively. The total accumulated unamortized basis adjustment amounted to an increase in the carrying amount of our debt of \$53 million as of both September 30, 2012 and December 31, 2011. Basis adjustments for active fair value hedges of available-for-sale securities increased the carrying amount of the securities by \$44 million and \$231 million during the three and nine months ended September 30, 2012, respectively, compared to an increase in carrying amount of \$1.2 billion and \$1.3 billion during the three and nine months ended September 30, 2011, respectively. Total accumulated unamortized basis adjustments for active fair value hedges of available-for-sale securities amounted to an increase in carrying amount of \$937 million and \$1.1 billion as of September 30, 2012 and December 31, 2011, respectively.

The following table presents the fair value of derivative instruments that are designated and qualifying as fair value hedges and their location on the balance sheet.

Derivative Assets ⁽¹⁾			Derivative Liabilities ⁽¹⁾		
Balance Sheet Location	Fair Value as of		Balance Sheet Location	Fair Value as of	
	September 30, 2012	December 31, 2011		September 30, 2012	December 31, 2011
(in millions)					
Interest rate contracts . . . Other assets	<u>\$9</u>	<u>\$4</u>	Interest, taxes and other liabilities	<u>\$933</u>	<u>\$1,134</u>

⁽¹⁾ The derivative asset and derivative liabilities presented above may be eligible for netting. Balance sheet categories in the above table represent the location of the assets and liabilities absent the netting of the balances.

The following table presents information on gains and losses on derivative instruments designated and qualifying as hedging instruments in fair value hedges and the hedged items in fair value hedges and their location on the consolidated statement of income (loss).

	Gain (Loss) on Derivative		Gain (Loss) on Hedged Items		Gain (Loss) on Derivative		Gain (Loss) on Hedged Items	
	Interest Income (Expense)	Other Income	Interest Income (Expense)	Other Income	Interest Income (Expense)	Other Income	Interest Income (Expense)	Other Income
	2012				2011			
(in millions)								
Three Months Ended September 30,								
Interest rate contracts/AFS								
securities	\$ (33)	\$ (41)	\$141	\$ 58	\$ 4	\$(1,322)	\$187	\$1,278
Interest rate contracts/commercial								
loans	-	-	-	-	(6)	1	-	(1)
Interest rate contracts/ subordinated debt	<u>3</u>	<u>3</u>	<u>(15)</u>	<u>(3)</u>	<u>14</u>	<u>10</u>	<u>(32)</u>	<u>(11)</u>
Total	<u>\$ (30)</u>	<u>\$ (38)</u>	<u>\$126</u>	<u>\$ 55</u>	<u>\$ 12</u>	<u>\$(1,311)</u>	<u>\$155</u>	<u>\$1,266</u>
Nine Months Ended September 30,								
Interest rate contracts/AFS								
securities	\$(117)	\$(326)	\$482	\$323	\$(18)	\$(1,640)	\$506	\$1,598
Interest rate contracts/commercial								
loans	-	-	-	-	(17)	1	-	(3)
Interest rate contracts/ subordinated debt	<u>10</u>	<u>9</u>	<u>(46)</u>	<u>(9)</u>	<u>38</u>	<u>4</u>	<u>(70)</u>	<u>(6)</u>
Total	<u>\$(107)</u>	<u>\$(317)</u>	<u>\$436</u>	<u>\$314</u>	<u>\$ 3</u>	<u>\$(1,635)</u>	<u>\$436</u>	<u>\$1,589</u>

Cash Flow Hedges We own or issue floating rate financial instruments and enter into forecasted transactions that give rise to cash flow risk exposure. As a part of our risk management strategy, we use interest rate swaps, currency swaps and futures contracts to mitigate risk associated with variability in the cash flows. We also hedge the variability in interest cash flows arising from on-line savings deposits and certain commercial loans.

Changes in fair value associated with the effective portion of a derivative instrument designated as a qualifying cash flow hedge are recognized initially in other comprehensive income (loss). When the hedged cash flows affect earnings, the associated gain or loss from the hedging derivative previously recognized in accumulated other comprehensive income (loss) is reclassified to earnings. If a cash flow hedge of a forecasted transaction is de-designated because it is no longer highly effective, or if the hedge relationship is terminated, the cumulative gain or loss on the hedging derivative to that date will continue to be reported in accumulated other comprehensive income (loss) unless it is probable that the hedged forecasted transaction will not occur by the end of the of the specified periods forecasted at inception, at which time the cumulative gain or loss is released into earnings. As of September 30, 2012 and December 31, 2011, active cash flow hedge relationships extend or mature through July 2036. During the three and nine months ended September 30, 2012, \$4 million and \$12 million, respectively, of losses related to terminated and/or re-designated cash flow hedge relationships were reclassified to earnings from accumulated other comprehensive income (loss). During the next twelve months, we expect to reclassify \$14 million of remaining losses in accumulated other comprehensive income to earnings resulting from these terminated and/or re-designated cash flow hedges. During the three and nine months ended September 30, 2011, \$4 million and \$9 million, respectively, of losses related to terminated and/or re-designated cash flow hedge relationships were amortized to earnings from accumulated other comprehensive income (loss). The interest accrual related to the derivative contract is recognized in interest income.

The following table presents the fair value of derivative instruments that are designated and qualifying as cash flow hedges and their location on the consolidated balance sheet.

	Derivative Assets ⁽¹⁾			Derivative Liabilities ⁽¹⁾		
	Balance Sheet Location	Fair Value as of		Balance Sheet Location	Fair Value as of	
		September 30, 2012	December 31, 2011		September 30, 2012	December 31, 2011
						(in millions)
Interest rate contracts	Other assets	<u>\$45</u>	<u>\$29</u>	Interest, taxes & other liabilities	<u>\$274</u>	<u>\$248</u>

⁽¹⁾ The derivative assets and derivative liabilities presented above may be eligible for netting. Balance sheet categories in the above table represent the location of the assets and liabilities absent the netting of the balances.

The following table presents information on gains and losses on derivative instruments designated and qualifying as hedging instruments in cash flow hedges (including amounts recognized in AOCI from all terminated cash flow hedges) and their locations in the consolidated statement of income (loss).

	Gain (Loss) Recognized in AOCI on Derivative (Effective Portion)		Location of Gain (Loss) Reclassified from AOCI into Income (Effective Portion)	Loss Reclassified From AOCI into Income (Effective Portion)		Location of Loss Recognized in Income on the Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	Loss Recognized in Income on the Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)	
	2012	2011		2012	2011		2012	2011
	(in millions)							
Three Months Ended								
September 30,								
Interest rate contracts	\$14	\$(205)	Other income	\$ (4)	\$(4)	Other income	\$-	\$(6)
Nine Months Ended								
September 30,								
Interest rate contracts	\$ 4	\$(219)	Other income	\$(12)	\$(9)	Other income	\$-	\$(7)

Trading and Other Derivatives In addition to risk management, we enter into derivative instruments for trading and market making purposes, to repackage risks and structure trades to facilitate clients' needs for various risk taking and risk modification purposes. We manage our risk exposure by entering into offsetting derivatives with other financial institutions to mitigate the market risks, in part or in full, arising from our trading activities with our clients. In addition, we also enter into buy protection credit derivatives with other market participants to manage our counterparty credit risk exposure. Where we enter into derivatives for trading purposes, realized and unrealized gains and losses are recognized in trading revenue or residential mortgage banking revenue. Credit losses arising from counterparty risk on over-the-counter derivative instruments are recognized as an adjustment to the fair value of the derivatives and are recorded in trading revenue.

Derivative instruments designated as economic hedges that do not qualify for hedge accounting are recorded at fair value through earnings. Realized and unrealized gains and losses are recognized in other income or residential mortgage banking revenue while the derivative asset or liability positions are reflected as other assets or other liabilities. As of September 30, 2012, we have entered into credit default swaps which are designated as economic hedges against the credit risks within our loan portfolio. In the event of an impairment loss occurring in a loan that is economically hedged, the impairment loss is recognized as provision for credit losses while the gain on the credit default swap is recorded as other income (loss). In addition, we also from time to time have designated certain forward purchase or sale of to-be-announced ("TBA") securities to economically hedge mortgage servicing rights. Changes in the fair value of TBA positions, which are considered derivatives, are recorded in residential mortgage banking revenue.

The following table presents the fair value of derivative instruments held for trading purposes and their location on the consolidated balance sheet.

	Derivative Assets ⁽¹⁾			Derivative Liabilities ⁽¹⁾		
	Balance Sheet Location	Fair Value as of		Balance Sheet Location	Fair Value as of	
		September 30, 2012	December 31, 2011		September 30, 2012	December 31, 2011
						(in millions)
Interest rate contracts	Trading assets	\$74,031	\$60,719	Trading liabilities	\$74,065	\$61,280
Foreign exchange contracts . . .	Trading assets	14,147	15,654	Trading liabilities	13,677	15,413
Equity contracts	Trading assets	1,070	1,165	Trading liabilities	1,067	1,164
Precious Metals contracts	Trading assets	771	1,842	Trading liabilities	1,910	1,248
Credit contracts	Trading assets	8,218	14,388	Trading liabilities	8,486	14,285
Total		<u>\$98,237</u>	<u>\$93,768</u>		<u>\$99,205</u>	<u>\$93,390</u>

⁽¹⁾ The derivative assets and derivative liabilities presented above may be eligible for netting. Balance sheet categories in the above table represent the location of the assets and liabilities absent the netting of the balances.

The following table presents the fair value of derivative instruments held for other purposes and their location on the balance sheet.

	Derivative Assets ⁽¹⁾			Derivative Liabilities ⁽¹⁾		
	Balance Sheet Location	Fair Value as of		Balance Sheet Location	Fair Value as of	
		September 30, 2012	December 31, 2011		September 30, 2012	December 31, 2011
						(in millions)
Interest rate contracts	Other assets	\$ 986	\$ 957	Interest, taxes and other liabilities	\$113	\$106
Foreign exchange contracts	Other assets	33	11	Interest, taxes and other liabilities	31	13
Equity contracts	Other assets	546	51	Interest, taxes and other liabilities	107	87
Credit contracts	Other assets	1	2	Interest, taxes and other liabilities	5	8
Total		<u>\$1,566</u>	<u>\$1,021</u>		<u>\$256</u>	<u>\$214</u>

⁽¹⁾ The derivative assets and derivative liabilities presented above may be eligible for netting and consequently may be shown net against a different line item on the consolidated balance sheet. Balance sheet categories in the above table represent the location of the assets and liabilities absent the netting of the balances.

The following table presents information on gains and losses on derivative instruments held for trading purposes and their locations on the statement of income.

Location of Gain (Loss) Recognized in Income on Derivatives		Amount of Gain (Loss) Recognized in Income on Derivatives			
		Three Months Ended September 30,		Nine Months Ended September 30,	
		2012	2011	2012	2011
		(in millions)			
Interest rate contracts	Trading revenue	\$ (24)	\$ (87)	\$ (8)	\$ (206)
Interest rate contracts	Residential mortgage banking revenue	7	120	28	118
Foreign exchange contracts . .	Trading revenue	3	(246)	648	131
Equity contracts	Trading revenue	2	101	62	105
Precious Metals contracts	Trading revenue	44	175	96	97
Credit contracts	Trading revenue	(27)	(176)	(1,695)	(86)
Total		\$ 5	\$(113)	\$ (869)	\$ 159

The following table presents information on gains and losses on derivative instruments held for other purposes and their locations on the statement of income.

Location of Gain (Loss) Recognized in Income on Derivatives		Amount of Gain (Loss) Recognized in Income on Derivatives			
		Three Months Ended September 30,		Nine Months Ended September 30,	
		2012	2011	2012	2011
		(in millions)			
Interest rate contracts	Other income	\$ 15	\$ 494	\$ 120	\$ 628
Interest rate contracts	Residential mortgage banking revenue	(5)	3	-	(8)
Foreign exchange contracts . .	Other income	23	23	73	22
Equity contracts	Other income	351	(508)	597	(316)
Credit contracts	Other income	-	5	(3)	2
Total		\$ 384	\$ 17	\$ 787	\$ 328

Credit-Risk Related Contingent Features We enter into total return swap, interest rate swap, cross-currency swap and credit default swap contracts, which contain provisions that require us to maintain a specific credit rating from each of the major credit rating agencies. Sometimes the derivative instrument transactions are a part of broader structured product transactions. If HSBC Bank USA's credit ratings were to fall below the current ratings, the counterparties to our derivative instruments could demand additional collateral to be posted with them. The amount of additional collateral required to be posted will depend on whether HSBC Bank USA is downgraded by one or more notches as well as whether the downgrade is in relation to long-term or short-term ratings. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that are in a liability position as of September 30, 2012, is \$10.0 billion for which we have posted collateral of \$10.3 billion. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that are in a liability position as of December 31, 2011, is \$10.3 billion for which we have posted collateral of \$8.5 billion. Substantially all of the collateral posted is in the form of cash which is reflected in either interest bearing deposits with banks or other assets. See Note 20, "Guarantee Arrangements and Pledged Assets" for further details.

In the event of a credit downgrade, we do not expect HSBC Bank USA's long-term ratings to go below A2 and A or the short-term ratings to go below P-2 and A-1 by Moody's and S&P, respectively. The following tables summarize our obligation to post additional collateral (relative to the current collateral level) in certain

hypothetical commercially reasonable downgrade scenarios. It is not appropriate to accumulate or extrapolate information presented in the tables below to determine our total obligation because the information presented to determine the obligation in hypothetical rating scenarios is not mutually exclusive.

Moody's Short-Term Ratings	Long-Term Ratings		
	A1	A2	A3
	(in millions)		
P-1	\$-	\$71	\$230
P-2	2	6	230

S&P Short-Term Ratings	Long-Term Ratings		
	AA-	A+	A
	(in millions)		
A-1+	\$ -	\$ -	\$ 65
A-1	35	100	259

We would be required to post \$41 million of additional collateral on total return swaps and certain other transactions if HSBC Bank USA is downgraded by S&P and Moody's by two notches on our long term rating accompanied by one notch downgrade in our short term rating.

Notional Value of Derivative Contracts The following table summarizes the notional values of derivative contracts.

	September 30, 2012	December 31, 2011
	(in billions)	
Interest rate:		
Futures and forwards	\$ 389.3	\$ 320.3
Swaps	2,657.0	2,325.1
Options written	64.9	69.9
Options purchased	65.0	67.3
	<u>3,176.2</u>	<u>2,782.6</u>
Foreign Exchange:		
Swaps, futures and forwards	820.4	725.0
Options written	51.9	39.7
Options purchased	53.0	40.4
Spot	77.3	60.1
	<u>1,002.6</u>	<u>865.2</u>
Commodities, equities and precious metals:		
Swaps, futures and forwards	54.1	50.2
Options written	9.5	8.2
Options purchased	20.4	17.1
	<u>84.0</u>	<u>75.5</u>
Credit derivatives	526.0	657.3
Total	<u>\$4,788.8</u>	<u>\$4,380.6</u>

12. Fair Value Option

We report our results to HSBC in accordance with its reporting basis, International Financial Reporting Standards (“IFRSs”). We have elected to apply fair value option accounting to selected financial instruments in most cases to align the measurement attributes of those instruments under U.S. GAAP and IFRSs and to simplify the accounting model applied to those financial instruments. We elected to apply fair value option (“FVO”) reporting to certain commercial loans including commercial leveraged acquisition finance loans and related unfunded commitments, certain fixed rate long-term debt issuances and hybrid instruments which include all structured notes and structured deposits. Changes in fair value of these assets and liabilities are reported as gain (loss) on instruments designated at fair value and related derivatives in the consolidated statement of income (loss).

Loans We elected to apply FVO to all commercial leveraged acquisition finance loans held for sale and related unfunded commitments. The election allows us to account for these loans and commitments at fair value which is consistent with the manner in which the instruments are managed. As of September 30, 2012, commercial leveraged acquisition finance loans held for sale and related unfunded commitments of \$424 million carried at fair value had an aggregate unpaid principal balance of \$449 million. As of December 31, 2011, commercial leveraged acquisition finance loans held for sale and related unfunded commitments of \$377 million carried at fair value had an aggregate unpaid principal balance of \$448 million.

These loans are included in loans held for sale in the consolidated balance sheet. Interest from these loans is recorded as interest income in the consolidated statement of income (loss). Because a substantial majority of the loans elected for the fair value option are floating rate assets, changes in their fair value are primarily attributable to changes in loan-specific credit risk factors. The components of gain (loss) related to loans designated at fair value are summarized in the table below. As of September 30, 2012 and December 31, 2011, no loans for which the fair value option has been elected are 90 days or more past due or on nonaccrual status.

Long-Term Debt (Own Debt Issuances) We elected to apply FVO to certain fixed-rate long-term debt for which we had applied or otherwise would elect to apply fair value hedge accounting. The election allows us to achieve a similar accounting effect without meeting the rigorous hedge accounting requirements. We measure the fair value of these debt issuances based on inputs observed in the secondary market. Changes in fair value of these instruments are attributable to changes of our own credit risk and interest rates.

Fixed-rate debt accounted for under FVO at September 30, 2012 carried at a fair value of \$2.0 billion had an aggregate unpaid principal balance of \$1.8 billion. Fixed-rate debt accounted for under FVO at December 31, 2011 carried at a fair value of \$1.7 billion had an aggregate unpaid principal balance of \$1.8 billion. Interest on the fixed-rate debt accounted for under FVO is recorded as interest expense in the consolidated statement of income (loss). The components of gain (loss) related to long-term debt designated at fair value are summarized in the table below.

Hybrid Instruments We elected to apply fair value option accounting to all of our hybrid instruments, inclusive of structured notes and structured deposits, issued after January 1, 2006. As of September 30, 2012, interest bearing deposits in domestic offices included \$9.4 billion of structured deposits accounted for under FVO which had an unpaid principal balance of \$9.0 billion. As of December 31, 2011, interest bearing deposits in domestic offices included \$9.8 billion of structured deposits accounted for under FVO which had an unpaid principal balance of \$9.6 billion. Long-term debt at September 30, 2012 included structured notes of \$5.7 billion accounted for under FVO which had an unpaid principal balance of \$5.5 billion. Long-term debt at December 31, 2011 included structured notes of \$3.4 billion accounted for under FVO which had an unpaid principal balance of \$3.5 billion. Interest on this debt is recorded as interest expense in the consolidated statement of income (loss). We enter into derivative contracts to offset our exposure to interest rate risk on these instruments. The components of gain (loss) related to hybrid instruments designated at fair value which reflect the instruments described above are summarized in the table below.

Components of Gain on Instruments at Fair Value and Related Derivatives Gain (loss) on instruments designated at fair value and related derivatives includes the changes in fair value related to both interest and credit risk as well as the mark-to-market adjustment on derivatives related to the debt designated at fair value and net realized gains or losses on these derivatives. The components of gain (loss) on instruments designated at fair value and related derivatives related to the changes in fair value of fixed rate debt accounted for under FVO are as follows:

	Three Months Ended September 30,							
	2012				2011			
	Loans	Long-Term Debt	Hybrid Instruments	Total	Loans	Long-Term Debt	Hybrid Instruments	Total
	(in millions)							
Interest rate component	\$ 1	\$ 14	\$(389)	\$(374)	\$ (5)	\$ (296)	\$ 300	\$ (1)
Credit risk component	14	(179)	(39)	(204)	(41)	368	48	375
Total mark-to-market on financial instruments designated at fair value	15	(165)	(428)	(578)	(46)	72	348	374
Net realized gains on the financial instrument	1	-	-	1	(3)	-	-	(3)
Mark-to-market on the related derivatives	-	(21)	396	375	1	328	(338)	(9)
Net realized gain (losses) on the related derivatives	-	15	-	15	-	17	-	17
Gain (loss) on instruments designated at fair value and related derivatives	<u>\$16</u>	<u>\$(171)</u>	<u>\$(32)</u>	<u>\$(187)</u>	<u>\$(48)</u>	<u>\$ 417</u>	<u>\$ 10</u>	<u>\$379</u>
	Nine Months Ended September 30,							
	2012				2011			
	Loans	Long-Term Debt	Hybrid Instruments	Total	Loans	Long-Term Debt	Hybrid Instruments	Total
	(in millions)							
Interest rate component	\$ 2	\$ (26)	\$(744)	\$(768)	\$ (7)	\$ (312)	\$(11)	\$(330)
Credit risk component	48	(269)	(62)	(283)	(25)	375	86	436
Total mark-to-market on financial instruments designated at fair value	50	(295)	(806)	(1,051)	(32)	63	75	106
Net realized gains on the financial instrument	-	-	-	-	(1)	-	-	(1)
Mark-to-market on the related derivatives	-	6	741	747	-	344	(58)	286
Net realized gain (losses) on the related long-term debt derivatives	-	46	-	46	-	49	-	49
Gain (loss) on instruments designated at fair value and related derivatives	<u>\$50</u>	<u>\$(243)</u>	<u>\$(65)</u>	<u>\$(258)</u>	<u>\$(33)</u>	<u>\$ 456</u>	<u>\$ 17</u>	<u>\$ 440</u>

13. Income Taxes

The following table presents our effective tax rates.

	2012		2011	
	(dollars are in millions)			
Three Months Ended September 30,				
Tax expense (benefit) at the U.S. federal statutory income tax rate	\$(278)	(35.0)%	\$ 101	35.0%
Increase (decrease) in rate resulting from:				
State and local taxes, net of federal benefit	14	1.8	5	1.8
Valuation allowance on deferred tax assets	-	-	8	2.7
Non-deductible expense accrual related to certain regulatory matters	280	35.3	-	-
Non-deductible goodwill related to sale of branches	33	4.2	-	-
Validation of current liability accounts	(34)	(4.3)	-	-
Tax exempt interest income	(6)	(.8)	(3)	(1.0)
Low income housing and other tax credits	(21)	(2.6)	(21)	(7.0)
Foreign tax credits and other credits	(8)	(1.0)	(8)	(3.4)
Impact of foreign operations	8	1.0	31	11.2
Uncertain tax provision reserves	(9)	(1.1)	6	1.9
Other	8	1.0	(2)	(.7)
Effective tax rate	<u>\$ (12)</u>	<u>(1.5)%</u>	<u>\$ 117</u>	<u>40.5%</u>
Nine Months Ended September 30,				
Tax expense (benefit) at the U.S. federal statutory income tax rate	\$(328)	(35.0)%	\$ 235	35.0%
Increase (decrease) in rate resulting from:				
State and local taxes, net of federal benefit	23	2.5	42	6.0
Change in tax rate used to value deferred taxes	(10)	(1.1)	-	-
Valuation allowance on deferred tax assets	-	-	(135)	(19.3)
Non-deductible expense accrual related to certain regulatory matters	525	56.0	-	-
Non-deductible goodwill related to sale of branches	139	14.8	-	-
Validation of current liability accounts	22	2.3	-	-
Tax exempt interest income	(11)	(1.2)	(8)	(1.1)
Low income housing and other tax credits	(63)	(6.7)	(63)	(9.0)
Foreign tax credits and other credits	(23)	(2.5)	(20)	(3.0)
Impact of foreign operations	23	2.5	43	6.3
Uncertain tax provision	57	6.1	151	21.5
Other	3	.4	(7)	(.9)
Effective tax rate	<u>\$ 357</u>	<u>38.1%</u>	<u>\$ 238</u>	<u>35.5%</u>

The effective tax rate for the three and nine months ended September 30, 2012 reflects non-deductible goodwill related to the branches sold to First Niagara, a non-deductible expense accrual related to certain regulatory matters, prior period adjustments to the current liability account, including the reversal of an accrued foreign tax expense related to Brazilian withholding taxes corrected in the current year, changes in the uncertain tax reserve accrual, the utilization of low income housing credits and the impact of state taxes. The effective tax rate for the nine months ended September 30, 2012 also reflects the effect of a change in state rates used to value deferred taxes. The effective tax rate for the three and nine months ended September 30, 2011 primarily reflects the impact of foreign operations, the utilization of low income housing and other tax credits, the impact of state taxes, changes in uncertain tax positions and, as it relates to the nine month period, the release of valuation allowance reserves previously established on foreign tax credits.

HSBC North America Consolidated Income Taxes We are included in HSBC North America's consolidated Federal income tax return and in various combined state income tax returns. As such, we have entered into a tax

allocation agreement with HSBC North America and its subsidiary entities (the “HNAH Group”) included in the consolidated returns which govern the current amount of taxes to be paid or received by the various entities included in the consolidated return filings. As a result, we have looked at the HNAH Group’s consolidated deferred tax assets and various sources of taxable income, including the impact of HSBC and HNAH Group tax planning strategies, in reaching conclusions on recoverability of deferred tax assets. Where a valuation allowance is determined to be necessary at the HSBC North America consolidated level, such allowance is allocated to principal subsidiaries within the HNAH Group as described below in a manner that is systematic, rational and consistent with the broad principles of accounting for income taxes.

The HNAH Group evaluates deferred tax assets for recoverability using a consistent approach which considers the relative impact of negative and positive evidence, including historical financial performance, projections of future taxable income, future reversals of existing taxable temporary differences, tax planning strategies and any available carryback capacity.

In evaluating the need for a valuation allowance, the HNAH Group estimates future taxable income based on management approved business plans, future capital requirements and ongoing tax planning strategies, including capital support from HSBC necessary as part of such plans and strategies. The HNAH Group has continued to consider the impact of the economic environment on the North American businesses and the expected growth of the deferred tax assets. This evaluation process involves significant management judgment about assumptions that are subject to change from period to period.

In conjunction with the HNAH Group deferred tax evaluation process, based on our forecasts of future taxable income, which include assumptions about the depth and severity of home price depreciation and the U.S. economic environment, including unemployment levels and their related impact on credit losses, we currently anticipate that our results of future operations will generate sufficient taxable income to allow us to realize our deferred tax assets. However, since these market conditions have created losses in the HNAH Group in recent periods and volatility in our pre-tax book income, our analysis of the realizability of the deferred tax assets significantly discounts any future taxable income expected from continuing operations and relies to a greater extent on continued capital support from our parent, HSBC, including tax planning strategies implemented in relation to such support. HSBC has indicated they remain fully committed and have the capacity and willingness to provide capital as needed to run operations, maintain sufficient regulatory capital, and fund certain tax planning strategies.

Only those tax planning strategies that are both prudent and feasible, and which management has the ability and intent to implement, are incorporated into our analysis and assessment. The primary and most significant strategy is HSBC’s commitment to reinvest excess HNAH Group capital to reduce debt funding or otherwise invest in assets to ensure that it is more likely than not that the deferred tax assets will be utilized.

Currently, it has been determined that the HNAH Group’s primary tax planning strategy, in combination with other tax planning strategies, provides support for the realization of the net deferred tax assets recorded for the HNAH Group. Such determination is based on HSBC’s business forecasts and assessment as to the most efficient and effective deployment of HSBC capital, most importantly including the length of time such capital will need to be maintained in the U.S. for purposes of the tax planning strategy.

During the first quarter of 2011, the HNAH Group identified an additional tax planning strategy that provided support for the realization of the deferred tax assets recorded for its foreign tax credits and certain state related deferred tax assets. The use of foreign tax credits is limited by the HNAH Group’s U.S. tax liability and the availability of foreign source income. The tax planning strategy included the purchase of foreign bonds and REMIC residual interests. These purchases are expected to generate sufficient foreign source taxable income to allow for the utilization of the foreign tax credits before the credits expire unused and recognition of certain state deferred tax assets.

Notwithstanding the above, the HNAH Group had valuation allowances against certain state deferred tax assets and certain Federal tax loss carry forwards for which the aforementioned tax planning strategies did not provide appropriate support.

HNAH Group valuation allowances are allocated to the principal subsidiaries, including us. The methodology allocates the valuation allowance to the principal subsidiaries based primarily on the entity's relative contribution to the growth of the HSBC North America consolidated deferred tax asset against which the valuation allowance is being recorded.

If future results differ from the HNAH Group's current forecasts or the tax planning strategies were to change, a valuation allowance against some or all of the remaining net deferred tax assets may need to be established which could have a material adverse effect on our results of operations, financial condition and capital position. The HNAH Group will continue to update its assumptions and forecasts of future taxable income, including relevant tax planning strategies, and assess the need for such incremental valuation allowances.

Absent the capital support from HSBC and implementation of the related tax planning strategies, the HNAH Group, including us, would be required to record a valuation allowance against the remaining deferred tax assets.

HSBC USA Inc. Income Taxes We recognize deferred tax assets and liabilities for the future tax consequences related to the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and for tax credits and state net operating losses. Our net deferred tax assets, including both deferred tax liabilities and valuation allowances, totaled \$1.0 billion and \$0.9 billion as of September 30, 2012 and December 31, 2011, respectively.

During the third quarter of 2012, the Internal Revenue Service ("IRS") Appeals Office closed its review covering the tax periods 2004 and 2005 after the settlement was approved by the Joint Committee of Taxation. There is no resulting impact to our uncertain tax reserves.

The IRS began its audit of our 2006 and 2007 income tax returns in 2009, with an anticipated completion in 2012. The IRS began their examination of 2008 and 2009 during the third quarter of 2011, with an anticipated completion in 2013.

We remain subject to state and local income tax examinations for years 2004 and forward. We are currently under audit by various state and local tax jurisdictions. Uncertain tax positions are reviewed on an ongoing basis and are adjusted in light of changing facts and circumstances, including progress of tax audits, developments in case law and the closing of statute of limitations. Such adjustments are reflected in the tax provision. As a result of a 2011 state court decision related to a state tax uncertainty, we no longer believe that we can uphold the more likely than not conclusion taken on one of these uncertain tax positions. Therefore, tax reserves of approximately \$285 million (net of federal tax benefit) and related accrued interest expense of \$134 million were recorded through the third quarter of 2012 to recognize the estimated tax exposure on this matter.

It is reasonably possible that there could be a change in the amount of our unrecognized tax benefits within the next 12 months due to settlements or statutory expirations in various state and local tax jurisdictions. The total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate was \$329 million and \$276 million at September 30, 2012 and December 31, 2011.

It is our policy to recognize accrued interest related to unrecognized tax positions in interest expense in the consolidated statement of income (loss) and to recognize penalties related to unrecognized tax positions as a component of other servicing and administrative expenses in the consolidated statement of income (loss). We had accruals for the payment of interest and penalties associated with uncertain tax positions of \$150 million and \$130 million at September 30, 2012 and December 31, 2011.

14. Accumulated Other Comprehensive Income

Accumulated other comprehensive income includes certain items that are reported directly within a separate component of shareholders' equity. The following tables present changes in accumulated other comprehensive income balances.

Three Months Ended September 30,	2012	2011
	(in millions)	
Unrealized gains on securities available-for-sale, not other-than temporarily impaired:		
Balance at beginning of period	\$1,004	\$ 239
Other comprehensive income for period:		
Net unrealized holding gains arising during period, net of tax of \$89 million and \$470 million, respectively	126	683
Reclassification adjustment for gains realized in net income, net of tax of \$(20) million and \$(20) million, respectively	(29)	(28)
Total other comprehensive income for period	97	655
Balance at end of period	1,101	894
Unrealized losses on derivatives designated as cash flow hedges:		
Balance at beginning of period	(229)	(104)
Other comprehensive income (loss) for period:		
Net gains (losses) arising during period, net of tax of \$6 million and \$(86) million, respectively	9	(126)
Reclassification adjustment for losses realized in net income, net of tax of \$2 million and \$2 million, respectively	2	2
Total other comprehensive income (loss) for period	11	(124)
Balance at end of period	(218)	(228)
Pension and postretirement benefit liability:		
Balance at beginning of period	(11)	(7)
Balance at end of period	(11)	(7)
Total accumulated other comprehensive income at end of period	\$ 872	\$ 659

Nine Months Ended September 30,	2012	2011
	(in millions)	
Unrealized gains on securities available-for-sale, not other-than temporarily impaired:		
Balance at beginning of period	\$ 883	\$ 97
Other comprehensive income for period:		
Net unrealized holding gains arising during period, net of tax of \$217 million and \$602 million, respectively	303	858
Reclassification adjustment for gains realized in net income, net of tax of \$(60) million and \$(43) million, respectively	(85)	(61)
Total other comprehensive income for period	218	797
Balance at end of period	<u>1,101</u>	<u>894</u>
Unrealized gains (losses) on other-than-temporarily impaired debt securities available-for-sale:		
Balance at beginning of period	-	(1)
Other comprehensive income for period:		
Reclassification adjustment for losses realized in net income, net of tax of less than \$1 million	-	1
Total other comprehensive income (loss) for period	-	1
Balance at end of period	-	-
Unrealized gains (losses) on other-than-temporarily impaired debt securities held-to-maturity:		
Balance at beginning of period	-	(153)
Other comprehensive income for period:		
Net unrealized other-than-temporary impairment arising during period	-	11
Adjustment to reverse other-than-temporary impairment due to deconsolidation of VIE	-	142
Total other comprehensive income for period	-	153
Balance at end of period	-	-
Unrealized losses on derivatives designated as cash flow hedges:		
Balance at beginning of period	(229)	(87)
Other comprehensive loss for period:		
Net gains (losses) arising during period, net of tax of \$1 million and \$(114) million, respectively	4	(146)
Reclassification adjustment for losses realized in net income, net of tax of \$5 million and \$4 million, respectively	7	5
Total other comprehensive income (loss) for period	11	(141)
Balance at end of period	<u>(218)</u>	<u>(228)</u>
Pension and postretirement benefit liability:		
Balance at beginning of period	(12)	(9)
Other comprehensive income for period:		
Amortization of prior service cost and transition obligation included in net income, net of tax of less than \$1 million in 2012 and 2011	1	2
Total other comprehensive income for period	1	2
Balance at end of period	<u>(11)</u>	<u>(7)</u>
Total accumulated other comprehensive income at end of period	<u>\$ 872</u>	<u>\$ 659</u>

15. Pensions and Other Postretirement Benefits

The components of pension expense for the defined benefit pension plan reflected in our consolidated statement of income (loss) are shown in the table below and reflect the portion of the pension expense of the combined HSBC North America Pension Plan (either the “HSBC North America Pension Plan” or the “Plan”) which has been allocated to HUSI.:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Service cost – benefits earned during the period	\$ 3	\$ 4	\$ 11	\$ 12
Interest cost on projected benefit obligation	15	20	52	57
Expected return on assets	(25)	(22)	(66)	(63)
Recognized losses	16	9	34	27
Curtailment benefit recognized	(29)	-	(31)	-
Amortization of prior service cost	(2)	(2)	(4)	(4)
Net periodic pension cost (income)	<u>\$(22)</u>	<u>\$ 9</u>	<u>\$ (4)</u>	<u>\$ 29</u>

Pension expense declined in 2012 due largely to the recognition of a \$27 million curtailment benefit associated with the decision in the third quarter of 2012 to cease all future contributions under the Cash Balance formula and freeze the Plan effective January 1, 2013. While participants with existing balances will continue to receive interest credits until the account is distributed, they will no longer accrue benefits beginning in 2013. Also contributing to the decrease in pension expense was higher expected returns on plan assets driven by higher asset levels, including additional contributions to the Plan during 2012 and 2011, as well as lower interest cost as a result of a decrease in the number of active participants in the Plan.

Components of the net periodic benefit cost for our postretirement benefits other than pensions are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Service cost	\$1	\$ -	\$1	\$ -
Interest cost	-	1	2	\$3
Amortization of transition obligation	1	1	2	2
Net periodic postretirement benefit cost	<u>\$2</u>	<u>\$2</u>	<u>\$5</u>	<u>\$5</u>

16. Related Party Transactions

In the normal course of business, we conduct transactions with HSBC and its subsidiaries. These transactions occur at prevailing market rates and terms and include funding arrangements, derivative execution, purchases and sales of receivables, servicing arrangements, information technology and some centralized services, item and statement processing services, banking and other miscellaneous services. All extensions of credit by HSBC Bank USA to other HSBC affiliates (other than FDIC-insured banks) are legally required to be secured by eligible collateral. The following table presents related party balances and the income and expense generated by related party transactions:

	September 30, 2012	December 31, 2011
	(in millions)	
Assets:		
Cash and due from banks	\$ 458	\$ 263
Interest bearing deposits with banks	908	1,416
Federal funds sold and securities purchased under resale agreements	-	228
Trading assets ⁽¹⁾	22,697	22,367
Loans	2,843	858
Other	977	248
Total assets	<u>\$27,883</u>	<u>\$25,380</u>
Liabilities:		
Deposits	\$16,805	\$18,153
Trading liabilities ⁽¹⁾	24,695	25,298
Short-term borrowings	2,725	2,916
Long-term debt	3,989	3,988
Other	631	451
Total liabilities	<u>\$48,845</u>	<u>\$50,806</u>

⁽¹⁾ Trading assets and liabilities exclude the impact of netting which allow the offsetting of amounts relating to certain contracts if certain conditions are met.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Income/(Expense):				
Interest income	\$ 12	\$ 16	\$ 38	\$ 46
Interest expense	(23)	(23)	(70)	(57)
Net interest expense	<u>\$ (11)</u>	<u>\$ (7)</u>	<u>\$ (32)</u>	<u>\$ (11)</u>
Servicing and other fees with HSBC affiliates:				
Fees and commissions:				
HSBC Finance	\$ 6	\$ 2	\$ 8	\$ 6
HSBC Markets (USA) Inc. (“HMUS”)	4	9	14	19
Other HSBC affiliates	17	13	59	53
Other HSBC affiliates income	<u>36</u>	<u>25</u>	<u>84</u>	<u>73</u>
Total affiliate income	<u>\$ 63</u>	<u>\$ 49</u>	<u>\$ 165</u>	<u>\$ 151</u>
Residential mortgage banking revenue	<u>\$ -</u>	<u>\$ 3</u>	<u>\$ 3</u>	<u>\$ 7</u>
Support services from HSBC affiliates:				
HSBC Finance	\$ 5	\$ 8	\$ 22	\$ 27
HMUS	81	70	227	192
HSBC Technology & Services (USA) Inc. (“HTSU”)	237	279	711	725
Other HSBC affiliates	<u>39</u>	<u>55</u>	<u>140</u>	<u>148</u>
Total support services from HSBC affiliates	<u>\$362</u>	<u>\$412</u>	<u>\$1,100</u>	<u>\$1,092</u>
Stock based compensation expense with HSBC	<u>\$ 8</u>	<u>\$ 14</u>	<u>\$ 27</u>	<u>\$ 38</u>

Transactions Conducted with HSBC Finance Corporation

- In July 2004, we sold the account relationships associated with \$970 million of credit card receivables to HSBC Finance and on a daily basis through March 2012, we purchased new receivable originations on these credit card accounts. As discussed in Note 9, “Intangible Assets,” on March 29, 2012 we re-purchased these account relationships from HSBC Finance for \$108 million and as a result, we stopped purchasing new originations on these credit card accounts from HSBC Finance. We purchased \$492 million of credit card receivables from HSBC Finance during the nine months ended September 30, 2012, compared to purchases of credit card receivables of \$582 million and \$1.7 billion, respectively, during the three and nine months ended September 30, 2011. HSBC Finance continued to service these loans for us for a fee through April 30, 2012. At December 31, 2011, HSBC Finance was servicing credit card receivables on our behalf of \$1.2 billion. Effective with the close of the sale of our General Motors and Union Plus credit card receivables and our private label credit card and closed-end receivables on May 1, 2012, these loans are now serviced by Capital One for a fee. Premiums paid are amortized to interest income over the estimated life of the receivables purchased. We paid HSBC Finance fees for servicing these loans of \$7 million during the nine months ended September 30, 2012, compared to \$4 million and \$11 million during the three and nine months ended September 30, 2011.
- In 2003 and 2004, we purchased approximately \$3.7 billion of residential mortgage loans from HSBC Finance. HSBC Finance continues to service these loans for us for a fee. At September 30, 2012 and December 31, 2011, HSBC Finance was servicing \$1.2 billion and \$1.3 billion, respectively, of residential mortgage loans for us. We paid HSBC Finance fees for servicing these loans of \$1 million and \$3 million during the three and nine months ended September 30, 2012, respectively, compared to \$1 million and \$3 million during the year-ago periods.

- In the fourth quarter of 2009, an initiative was begun to streamline the servicing of real estate secured receivables across North America. As a result, certain functions that we had previously performed for our mortgage customers were being performed by HSBC Finance for all North America mortgage customers, including our mortgage customers. Additionally, we began performing certain functions for all North America mortgage customers where these functions had been previously provided separately by each entity. During 2011, we began a process to separate these functions so that each entity will be servicing its own mortgage customers when the process is completed. During the three and nine months ended September 30, 2012 we paid \$2 million and \$5 million, respectively, for services we received from HSBC Finance and received less than one million and \$3 million, respectively, for services we provided to HSBC Finance. During the three and nine months ended September 30, 2011 we paid \$2 million and \$5 million, respectively, for services we received from HSBC Finance and received \$3 million and \$7 million, respectively, for services we provided to HSBC Finance.
- In July 2010, certain employees in the real estate receivable default servicing department of HSBC Finance were transferred to the mortgage loan servicing department of a subsidiary of HSBC Bank USA and subsequently to HSBC Bank USA. These employees continue to service defaulted real estate secured receivables for HSBC Finance and we receive a fee for providing these services. During the three and nine months ended September 30, 2012 we received servicing revenue from HSBC Finance of \$14 million and \$42 million, respectively, compared to \$15 million and \$47 million during the year-ago periods.
- We extended a secured \$1.5 billion uncommitted 364 day credit facility to certain subsidiaries of HSBC Finance in December 2009. This facility was renewed for an additional 364 days in November 2011. There were no balances outstanding at September 30, 2012 and December 31, 2011.
- During the fourth quarter of 2011, we extended an unsecured \$3.0 billion 364-day uncommitted revolving credit facility to HSBC Finance which allowed for borrowings with maturities of up to 15 years. During the second quarter of 2012, an amendment was executed to increase this uncommitted revolving credit agreement to \$4.0 billion. As of September 30, 2012, \$512 million was outstanding under this loan agreement with a maturity of September 2017. We received interest income totaling \$1million for both the three and nine months ended September 30, 2012 on this borrowing. As of December 31, 2011, there were no amounts outstanding.
- In May 2012, we extended a \$2.0 billion 364-day committed revolving credit facility to HSBC Finance. There were no balances outstanding at September 30, 2012.

Transactions Conducted with HSBC Finance Corporation Involving Discontinued Operations

- As it relates to our discontinued credit card and private label operations, in January 2009, we purchased the GM and UP Portfolios from HSBC Finance, with an outstanding principal balance of \$12.4 billion at the time of sale, at a total net premium of \$113 million. Additionally, in December 2004, we purchased the private label credit card receivable portfolio as well as private label commercial and closed end loans from HSBC Finance. HSBC Finance retained the customer account relationships for both the GM and UP receivables and the private label credit card receivables and by agreement prior to these loans being sold to Capital One on May 1, 2012, we purchased on a daily basis substantially all new originations from these account relationships from HSBC Finance. Premiums paid for these receivables were amortized to interest income over the estimated life of the receivables purchased and are included as a component of income from discontinued operations. HSBC Finance continued to service these credit card loans for us for a fee. Information regarding these loans is summarized in the table below.

	Private Label		Credit Card			Total
	Cards	Commercial and Closed End Loans ⁽¹⁾	General Motors	Union Privilege	Other	
(in billions)						
Loans serviced by HSBC Finance:						
September 30, 2012	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
December 31, 2011	12.5	.3	4.1	3.5	.8	21.2
Total loans purchased on a daily basis from HSBC Finance during:						
Three months ended September 30, 2012	-	-	-	-	-	-
Three months ended September 30, 2011	3.7	-	3.2	.8	.4	8.1
Nine months ended September 30, 2012	4.4	-	3.9	1.0	.6	9.9
Nine months ended September 30, 2011	10.5	-	9.6	2.3	1.3	23.7

⁽¹⁾ Private label commercial loans were previously included in other commercial loans and private label closed end loans were included in other consumer loans in Note 6, "Loans".

Fees paid for servicing these loan portfolios, which are included as a component of income from discontinued operations, totaled \$199 million during the nine months ended September 30, 2012, respectively, compared to \$149 million and \$447 million during the three and nine months ended September 30, 2011, respectively. No fees were paid during the three months ended September 30, 2012 following the sale of certain credit card operations to Capital One.

The GM and UP credit card receivables as well as the private label credit card receivables were purchased from HSBC Finance on a daily basis at a sales price for each type of portfolio determined using a fair value calculated semi-annually in April and October by an independent third party based on the projected future cash flows of the receivables. The projected future cash flows were developed using various assumptions reflecting the historical performance of the receivables and adjusting for key factors such as the anticipated economic and regulatory environment. The independent third party used these projected future cash flows and a discount rate to determine a range of fair values. We used the mid-point of this range as the sales price. If significant information became available that altered the projected future cash flows, an analysis was performed to determine if fair value rates needed to be updated prior to the normal semi-annual cycles.

- Certain of our consolidated subsidiaries have revolving lines of credit totaling \$1.0 billion with HSBC Finance. There were no balances outstanding under any of these lines of credit at December 31, 2011. These credit facilities were terminated in May 2012.
- We extended a \$1.0 billion committed unsecured 364 day credit facility to HSBC Bank Nevada, a subsidiary of HSBC Finance, in December 2009. This facility was renewed for an additional 364 days in November 2011. There were no balances outstanding at December 31, 2011. This credit facility was terminated in May 2012.

Transactions Conducted with HSBC Markets (USA) Inc. (“HMUS”)

- We utilize a subsidiary of HMUS, HSBC Securities (USA) Inc. (“HSI”) for broker dealer, debt and preferred stock underwriting, customer referrals, loan syndication and other treasury and traded markets related services, pursuant to service level agreements. Fees charged by HSI for broker dealer, loan syndication services, treasury and traded markets related services are included in support services from HSBC affiliates. Debt underwriting fees charged by HSI are deferred as a reduction of long-term debt and amortized to interest expense over the life of the related debt. Preferred stock issuance costs charged by HSI are recorded as a reduction of capital surplus. Customer referral fees paid to HSI are netted against customer fee income, which is included in other fees and commissions.
- We have extended loans and lines, some of them uncommitted, to HMUS and its subsidiaries in the amount of \$2.8 billion at September 30, 2012 and December 31, 2011. At September 30, 2012 and December 31, 2011, \$270 million and \$229 million, respectively, was outstanding on these loans and lines. Interest income on these loans and lines totaled \$1 million and \$3 million during the three and nine months ended September 30, 2012, respectively, compared to \$1 million and \$5 million during the three and nine months ended September 30, 2011, respectively.

Other Transactions with HSBC Affiliates

- In January 2011, we acquired Halbis Capital Management (USA) Inc (Halbis), an asset management business, from an affiliate, Halbis Capital Management (UK) Ltd. as part of a reorganization which resulted in an increase to additional paid-in-capital of approximately \$21 million.
- In April 2011, we completed the sale of our European Banknotes Business with assets of \$123 million to HSBC Bank plc.
- HNAH extended a \$1.0 billion senior note to us in August 2009. This is a five year floating rate note which matures in August 2014. In addition, in April 2011, we issued senior notes in the amount of \$3.0 billion to HNAH. These notes mature in three equal installments of \$1.0 billion in April 2013, 2015 and 2016. The notes bear interest at 90 day USD Libor plus a spread, with each maturity at a different spread. Interest expense on these notes totaled \$16 million and \$49 million during the three and nine months ended September 30, 2012, respectively, compared to \$14 million and \$31 million during the three and nine months ended September 30, 2011, respectively.
- In addition to purchases of U.S. Treasury and U.S. Government Agency securities, we have periodically purchased both foreign-denominated and USD denominated marketable securities from certain affiliates including HSI, HSBC Asia-Pacific, HSBC Mexico, HSBC London, HSBC Brazil, HSBC Chile and HSBC Canada. Marketable securities outstanding from these purchases are reflected in trading assets and totaled \$15 million and \$8.5 billion at September 30, 2012 and December 31, 2011, respectively.
- We have also entered into credit derivatives transactions, primarily in the form of credit default swaps, with certain affiliates. The notional value of these derivative contracts was \$45.9 billion and \$45.1 billion at September 30, 2012 and December 31, 2011, respectively. The net credit exposure (defined as the recorded fair value of the derivative liability) related to the contracts was \$1.2 billion and \$1.0 billion at September 30, 2012 and December 31, 2011, respectively.
- We had a committed unused line of credit with HSBC France of \$2.5 billion at December 31, 2011. The facility was terminated effective July 30, 2012.
- We have a committed unused line of credit with HSBC Investment (Bahamas) Limited of \$500 million at September 30, 2012.

- We have an uncommitted unused line of credit with HSBC North America Inc. (“HNAI”) of \$150 million at both September 30, 2012 and December 31, 2011.
- We have extended lines of credit to various other HSBC affiliates totaling \$460 million at September 30, 2012 and December 31, 2011. At September 30, 2012 and December 31, 2011, there were no amounts outstanding under these lines of credit.
- We routinely enter into derivative transactions with HSBC affiliates as part of a global HSBC strategy to offset interest rate or other market risks associated with debt issues and derivative contracts with unaffiliated third parties. The notional value of derivative contracts related to these contracts was approximately \$1,023 billion and \$887 billion at September 30, 2012 and December 31, 2011, respectively. The net credit exposure (defined as the recorded fair value of derivative receivables) related to the contracts was approximately \$22.7 billion and \$22.4 billion at September 30, 2012 and December 31, 2011, respectively. Our Global Banking and Markets business accounts for these transactions on a mark to market basis, with the change in value of contracts with HSBC affiliates substantially offset by the change in value of related contracts entered into with unaffiliated third parties.
- HSBC North America’s technology and certain centralized support services including human resources, corporate affairs, risk management, legal, compliance, tax, finance and other shared services are centralized within HTSU. Technology related assets and software purchased are generally purchased and owned by HTSU. HTSU also provides certain item processing and statement processing activities. The fees we pay to HTSU for centralized support services and processing activities are included in Support services from HSBC affiliates in the consolidated statement of income (loss).
- Our domestic employees participate in a defined benefit pension plan sponsored by HSBC North America. Additional information regarding pensions is provided in Note 15, “Pension and Other Postretirement Benefits.”
- Employees participate in one or more stock compensation plans sponsored by HSBC. Our share of the expense of these plans on a pre-tax basis was \$7 million and \$27 million during the three and nine months ended September 30, 2012, respectively, compared to \$14 million and \$38 million during the three and nine months ended September 30, 2011, respectively.
- We use HSBC Global Resourcing (UK) Ltd., an HSBC affiliate located outside of the United States, to provide various support services to our operations including among other areas customer service, systems, collection and accounting functions. The expenses related to these services of \$5 million and \$18 million during the three and nine months ended September 30, 2012, respectively, compared to \$7 million and \$21 million in the year-ago periods. These amounts are included as a component of Support services from HSBC affiliates in the table above. Billing for these services was processed by HTSU.
- We did not pay any dividends to our immediate parent, HNAI, on our common stock during the nine months ended September 30, 2012 and 2011.

17. Regulatory Capital

Capital amounts and ratios of HSBC USA Inc. and HSBC Bank USA, calculated in accordance with current banking regulations, are summarized in the following table.

	September 30, 2012			December 31, 2011		
	Capital Amount	Well-Capitalized Minimum Ratio ⁽¹⁾	Actual Ratio	Capital Amount	Well-Capitalized Minimum Ratio ⁽¹⁾	Actual Ratio
(dollars are in millions)						
Total capital ratio:						
HSBC USA Inc.	\$ 20,262	10.00%	19.20%	\$ 21,908	10.00%	18.39%
HSBC Bank USA	20,876	10.00	20.28	22,390	10.00	18.86
Tier 1 capital ratio:						
HSBC USA Inc.	13,981	6.00	13.25	15,179	6.00	12.74
HSBC Bank USA	14,897	6.00	14.47	15,996	6.00	13.48
Tier 1 common ratio:						
HSBC USA Inc.	11,574	5.00 ⁽²⁾	10.97	12,773	5.00 ⁽²⁾	10.72
HSBC Bank USA	14,897	5.00	14.47	15,996	5.00	13.48
Tier 1 leverage ratio:						
HSBC USA Inc.	13,981	3.00 ⁽³⁾	7.35	15,179	3.00 ⁽³⁾	7.43
HSBC Bank USA	14,897	5.00	8.01	15,996	5.00	7.98
Risk weighted assets:						
HSBC USA Inc.	105,534			119,099		
HSBC Bank USA	102,938			118,688		

⁽¹⁾ HSBC USA Inc and HSBC Bank USA are categorized as “well-capitalized,” as defined by their principal regulators. To be categorized as well-capitalized under regulatory guidelines, a banking institution must have the minimum ratios reflected in the above table, and must not be subject to a directive, order, or written agreement to meet and maintain specific capital levels.

⁽²⁾ There is no Tier 1 common ratio component in the definition of a well-capitalized bank holding company. The ratio shown is the required minimum Tier 1 common ratio as included in the Federal Reserve Board’s final rule regarding capital plans for U.S. bank holding companies with total consolidated assets of \$50 billion or more.

⁽³⁾ There is no Tier 1 leverage ratio component in the definition of a well-capitalized bank holding company. The ratio shown is the minimum required ratio.

We did not receive any cash capital contributions from our immediate parent, HNAI, during the first nine months of 2012. During the nine months ended September 30, 2012 we contributed \$2 million to our subsidiary, HSBC Bank USA, in part to provide capital support for receivables purchased from our affiliate, HSBC Finance Corporation. See Note 16, “Related Party Transactions,” for additional information.

As part of the regulatory approvals with respect to the aforementioned receivable purchases completed in January 2009, HSBC Bank USA and HSBC made certain additional capital commitments to ensure that HSBC Bank USA holds sufficient capital with respect to the purchased receivables that are or may become “low-quality assets”, as defined by the Federal Reserve Act. These capital requirements, which require a risk-based capital charge of 100 percent for each “low-quality asset” transferred or arising in the purchased portfolios rather than the eight percent capital charge applied to similar assets that are not part of the transferred portfolios, are applied both for purposes of satisfying the terms of the commitments and for purposes of measuring and reporting HSBC Bank USA’s risk-based capital and related ratios. This treatment applies as long as the low-quality assets are owned by an insured bank. During 2011, HSBC Bank USA sold low-quality credit card receivables with a net carrying value of approximately \$266 million to a non-bank subsidiary of HSBC USA Inc. to reduce the capital requirement associated with these assets. Capital ratios and amounts at December 31, 2011 in the table above reflect this reporting. The remaining purchased receivables subject to this requirement were sold to Capital One as part of the previously discussed sale which was completed on May 1, 2012.

Regulatory guidelines impose certain restrictions that may limit the inclusion of deferred tax assets in the computation of regulatory capital. We closely monitor the deferred tax assets for potential limitations or exclusions. At September 30, 2012 and December 31, 2011, deferred tax assets of \$999 million and \$363 million, respectively, were excluded in the computation of regulatory capital.

18. Business Segments

We have four distinct segments that we utilize for management reporting and analysis purposes, which are generally based upon global business. Our segment results are reported on a continuing operations basis. There have been no changes in the basis of our segmentation or measurement of segment profit as compared with the presentation in our 2011 Form 10-K.

Net interest income of each segment represents the difference between actual interest earned on assets and interest incurred on liabilities of the segment, adjusted for a funding charge or credit. Segments are charged a cost to fund assets (e.g. customer loans) and receive a funding credit for funds provided (e.g. customer deposits) based on equivalent market rates. The objective of these charges/credits is to transfer interest rate risk from the segments to one centralized unit in Global Banking and Markets and more appropriately reflect the profitability of segments.

Certain other revenue and operating expense amounts are also apportioned among the business segments based upon the benefits derived from this activity or the relationship of this activity to other segment activity. These inter-segment transactions are accounted for as if they were with third parties.

Our segment results are presented in accordance with IFRSs (a non-U.S. GAAP financial measure) on a legal entity basis (“IFRS Basis”) as operating results are monitored and reviewed, trends are evaluated and decisions about allocating resources, such as employees are made almost exclusively on an IFRSs basis since we report results to our parent, HSBC in accordance with its reporting basis, IFRSs. We continue to monitor capital adequacy, establish dividend policy and report to regulatory agencies on a U.S. GAAP legal entity basis.

Results for each segment on an IFRSs basis, as well as a reconciliation of total results under IFRSs to U.S. GAAP consolidated totals, are as follows:

	IFRS Consolidated Amounts					Adjustments/ Reconciling Items	Total	IFRS Adjustments ⁽⁴⁾	IFRS Reclassi- fications ⁽⁵⁾	U.S. GAAP Consolidated Totals
	RBWM	CMB	GBM	PB	Other					
(in millions)										
Three months ended										
September 30, 2012:										
Net interest income ⁽¹⁾	\$ 209	\$ 168	\$ 129	\$ 45	\$ (9)	\$ (3)	\$ 539	\$ (22)	\$ (7)	\$ 510
Other operating income	138	173	251	26	(201)	3	390	5	2	397
Total operating income	347	341	380	71	(210)	-	929	(17)	(5)	907
Loan impairment charges ⁽³⁾	72	6	6	2	-	-	86	(4)	2	84
	275	335	374	69	(210)	-	843	(13)	(7)	823
Operating expenses ⁽²⁾	368	175	249	57	823	-	1,672	(48)	(7)	1,617
Profit before income tax expense	\$ (93)	\$ 160	\$ 125	\$ 12	\$ (1,033)	\$ -	\$ (829)	\$ 35	\$ -	\$ (794)
Balances at end of period:										
Total assets	\$23,726	\$24,012	\$221,734	\$ 7,093	\$ 92	\$ -	\$276,657	(73,460)	(65)	\$203,132
Total loans, net	16,334	19,066	32,559	5,290	-	-	73,249	(1,124)	(11,310)	60,815
Goodwill	581	357	480	326	-	-	1,744	484	-	2,228
Total deposits	35,494	22,012	44,669	12,319	-	-	114,494	(5,897)	12,738	121,335
Three months ended										
September 30, 2011:										
Net interest income ⁽¹⁾	\$ 259	\$ 180	\$ 120	\$ 44	\$ (6)	\$(11)	\$ 586	\$ (71)	\$ 106	\$ 621
Other operating income	148	114	67	27	380	11	747	10	(90)	667
Total operating income	407	294	187	71	374	-	1,333	(61)	16	1,288
Loan impairment charges ⁽³⁾	76	(5)	28	(24)	-	-	75	1	2	78
	331	299	159	95	374	-	1,258	(62)	14	1,210
Operating expenses ⁽²⁾	368	177	270	65	14	-	894	13	14	921
Profit before income tax expense	\$ (37)	\$ 122	\$ (111)	\$ 30	\$ 360	\$ -	\$ 364	\$ (75)	\$ -	\$ 289
Balances at end of period:										
Total assets	\$25,629	\$20,144	\$232,769	\$ 5,946	\$ 92	\$ -	\$284,580	\$(96,198)	\$ 60	\$188,442
Total loans, net	16,118	16,173	25,592	4,462	-	-	62,345	(5,880)	(7,614)	48,851
Goodwill	581	357	480	326	-	-	1,744	485	-	2,228
Total deposits	47,314	27,215	47,906	11,929	-	-	134,364	(5,029)	3,506	132,841
Nine Months Ended										
September 30, 2012:										
Net interest income ⁽¹⁾	\$ 653	\$ 490	\$ 439	\$ 137	\$ (19)	\$(10)	\$ 1,690	\$ (73)	\$ 15	\$ 1,632
Other operating income	497	578	742	83	(341)	10	1,569	41	17	1,627
Total operating income	1,150	1,068	1,181	220	(360)	-	3,259	(32)	32	3,259
Loan impairment charges ⁽³⁾	174	(3)	(2)	(3)	-	-	166	-	7	173
	976	1,071	1,183	223	(360)	-	3,093	(32)	25	3,086
Operating expenses ⁽²⁾	1,010	550	744	178	1,565	-	4,047	(48)	25	4,024
Profit before income tax expense	\$ (34)	\$ 521	\$ 439	\$ 45	\$(1,925)	\$ -	\$ (954)	\$ 16	\$ -	\$ (938)
Nine Months Ended										
September 30, 2011:										
Net interest income ⁽¹⁾	\$ 756	\$ 527	\$ 382	\$ 134	\$ (73)	\$(26)	\$ 1,700	\$ (104)	\$ 198	\$ 1,794
Other operating income	337	325	756	97	363	26	1,904	34	(148)	1,790
Total operating income	1,093	852	1,138	231	290	-	3,604	(70)	50	3,584
Loan impairment charges ⁽³⁾	166	7	1	(34)	-	-	140	6	25	171
	927	845	1,137	265	290	-	3,464	(76)	25	3,413
Operating expenses ⁽²⁾	1,187	553	735	194	51	-	2,720	(3)	25	2,742
Profit before income tax expense	\$ (260)	\$ 292	\$ 402	\$ 71	\$ 239	\$ -	\$ 744	\$ (73)	\$ -	\$ 671

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- (1) Net interest income of each segment represents the difference between actual interest earned on assets and interest paid on liabilities of the segment adjusted for a funding charge or credit. Segments are charged a cost to fund assets (e.g. customer loans) and receive a funding credit for funds provided (e.g. customer deposits) based on equivalent market rates. The objective of these charges/credits is to transfer interest rate risk from the segments to one centralized unit in Treasury and more appropriately reflect the profitability of segments.
 - (2) Expenses for the segments include fully apportioned corporate overhead expenses.
 - (3) The provision assigned to the segments is based on the segments' net charge offs and the change in allowance for credit losses.
 - (4) Represents adjustments associated with differences between IFRSs and U.S. GAAP basis of accounting.
 - (5) Represents differences in financial statement presentation between IFRSs and U.S. GAAP.

Further discussion of the differences between IFRSs and U.S. GAAP are presented in Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Form 10-Q under the caption "Basis of Reporting." A summary of the significant differences between U.S. GAAP and IFRSs as they impact our results are presented below:

Net Interest Income

Effective interest rate – The calculation of effective interest rates under IFRS 39, "Financial Instruments: Recognition and Measurement" ("IAS 39"), requires an estimate of changes in estimated contractual cash flows, including fees and points paid or received between parties to the contract that are an integral part of the effective interest rate to be included. U.S. GAAP generally prohibits recognition of interest income to the extent the net interest in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation. Under U.S. GAAP, prepayment penalties are generally recognized as received. U.S. GAAP also includes interest income on loans originated as held for sale which is included in other operating income for IFRSs.

Deferred loan origination costs and fees – Certain loan fees and incremental direct loan costs, which would not have been incurred but for the origination of loans, are deferred and amortized to earnings over the life of the loan under IFRSs. Certain loan fees and direct incremental loan origination costs, including internal costs directly attributable to the origination of loans in addition to direct salaries, are deferred and amortized to earnings under U.S. GAAP.

Loan origination deferrals under IFRSs are more stringent and generally result in lower costs being deferred than permitted under U.S. GAAP. In addition, all deferred loan origination fees, costs and loan premiums must be recognized based on the expected life of the loan under IFRSs as part of the effective interest calculation while under U.S. GAAP they may be recognized on either a contractual or expected life basis.

Derivative interest expense – Under IFRSs, net interest income includes the interest element for derivatives which corresponds to debt designated at fair value. For U.S. GAAP, this is included in gain (loss) on instruments designated at fair value and related derivatives which is a component of other revenues.

Other Operating Income (Total Other Revenues)

Derivatives – Effective January 1, 2008, U.S. GAAP removed the observability requirement of valuation inputs to allow up-front recognition of the difference between transaction price and fair value in the consolidated statement of income (loss). Under IFRSs, recognition is permissible only if the inputs used in calculating fair value are based on observable inputs. If the inputs are not observable, profit and loss is deferred and is recognized (1) over the period of contract, (2) when the data becomes observable, or (3) when the contract is settled.

Loans held for sale – IFRSs requires loans originated with the intent to sell to be classified as trading assets and recorded at their fair value. Under U.S. GAAP, loans designated as held for sale are reflected as loans and recorded at the lower of amortized cost or fair value. Under IFRSs, the income related to loans held for sale is reported in trading revenue. Under U.S. GAAP, the income related to loans held for sale is reported similarly to loans held for investment.

For loans transferred to held for sale subsequent to origination, IFRSs requires these receivables to be reported separately on the balance sheet when certain criteria are met which is generally later than under U.S. GAAP, but does not change the recognition and measurement criteria. Accordingly, for IFRSs purposes such loans continue to be accounted for and impairment continues to be measured in accordance with IAS 39 with any gain or loss recorded at the time of sale (unless credit impairment is required to be recognized in accordance with IAS 39). U.S. GAAP requires loans that meet the held for sale classification requirements be transferred to a held for sale category at the lower of amortized cost or fair value. Under U.S. GAAP, the component of the lower of amortized cost or fair value adjustment related to credit risk is recorded in the statement of income (loss) as provision for credit losses while the component related to interest rates and liquidity factors is reported in the statement of income (loss) in other revenues.

IFRS reclassification of fair value measured financial assets during 2008 – Certain securities were reclassified from “trading assets” to “loans and receivables” under IFRSs as of July 1, 2008 pursuant to an amendment to IAS 39 and are no longer marked to market. In November 2008, additional securities were similarly transferred to loans and receivables. These securities continue to be classified as “trading assets” under U.S. GAAP.

Additionally, certain Leverage Acquisition Finance (“LAF”) loans were classified as trading assets for IFRSs and to be consistent, an irrevocable fair value option was elected on these loans under U.S. GAAP on January 1, 2008. These loans were reclassified to “loans and advances” as of July 1, 2008 pursuant to the IAS 39 amendment discussed above. Under U.S. GAAP, these loans are classified as “held for sale” and carried at fair value due to the irrevocable nature of the fair value option.

Other-than-temporary impairments – Under U.S. GAAP, a decline in fair value of an available-for-sale debt security below its amortized cost may indicate that the security is other-than-temporarily impaired under certain conditions. IFRSs do not have an “other than temporary” impairment concept. Under IFRSs, a decline in fair value of an available-for-sale debt security below its amortized cost is considered evidence of impairment if the decline can, at least partially, be attributed to an incurred loss event that impacts the estimated future cash flows of the security (i.e., a credit loss event). Thus a security may not be considered impaired if the decline in value is the result of events that do not negatively impact the estimated future cash flows of the security (e.g., an increase in the risk-free interest rate). However, until the entity sells the security, it will have to assess the security for credit losses at each reporting date.

Another difference between U.S. GAAP and IFRSs is the amount of the loss that an entity recognizes in earnings on an impaired (other-than-temporarily impaired for U.S. GAAP) available-for-sale debt security. Under U.S. GAAP, if an entity has decided to sell a debt security whose fair value has declined below its amortized cost, or will be more likely than not required to sell the debt security before it recovers its amortized cost basis, it will recognize an impairment loss in earnings equal to the difference between the debt security’s carrying amount and its fair value. If the entity has not decided to sell the debt security and will not be more likely than not required to sell the debt security before it recovers its amortized cost basis, but nonetheless expects that it will not recover the security’s amortized cost basis, it will bifurcate the impairment loss into a credit loss component and a non-credit loss component, and recognize the credit loss component in earnings and the non-credit loss component in other comprehensive income. Under IFRSs, the entity recognizes the entire decline in fair value below amortized cost in earnings.

REO expense – Other revenues under IFRSs include losses on sale and the lower of amortized cost or fair value of the collateral less cost to sell adjustments on REO properties which are classified as other expense under U.S. GAAP.

Securities – Under IFRSs, securities include HSBC shares held for stock plans at fair value. These shares held for stock plans are measured at fair value through other comprehensive income. If it is determined that these shares have become impaired, the unrealized loss in accumulated other comprehensive income is reclassified to profit or loss. There is no similar requirement under U.S. GAAP.

Loan Impairment Charges (Provision for Credit Losses)

IFRSs requires a discounted cash flow methodology for estimating impairment on pools of homogeneous customer loans which requires the discounting of cash flows including recovery estimates at the original effective interest rate of the pool of customer loans. The amount of impairment relating to the discounting of future cash flows unwinds with the passage of time, and is recognized in interest income. Also under IFRSs, if the recognition of a write-down to fair value on secured loans decreases because collateral values have improved and the improvement can be related objectively to an event occurring after recognition of the write-down, such write-down can be reversed, which is not permitted under U.S. GAAP. Additionally under IFRSs, future recoveries on charged-off loans or loans written down to fair value less cost to obtain title and sell are accrued for on a discounted basis and a recovery asset is recorded. Subsequent recoveries are recorded to earnings under U.S. GAAP, but are adjusted against the recovery asset under IFRSs. Under IFRSs, interest on impaired loans is recorded at the effective interest rate on the customer loan balance net of impairment allowances, and therefore reflects the collectibility of the loans.

As discussed above, under U.S. GAAP, the credit risk component of the lower of amortized cost or fair value adjustment related to the transfer of receivables to held for sale is recorded in the consolidated statement of income (loss) as provision for credit losses. There is no similar requirement under IFRSs.

As previously discussed, in the third quarter of 2011 we adopted new guidance under U.S. GAAP for determining whether a restructuring of a receivable meets the criteria to be considered a TDR Loan. Credit loss reserves on TDR Loans are established based on the present value of expected future cash flows discounted at the loans' original effective interest rate.

Operating Expenses

Pension and other postretirement benefit costs – Pension expense under U.S. GAAP is generally higher than under IFRSs as a result of the amortization of the amount by which actuarial losses exceeded the higher of 10 percent of the projected benefit obligation or fair value of plan assets (the “corridor.”). In 2012, amounts include a higher pension curtailment benefit under U.S. GAAP as a result of the decision in the third quarter to cease all future benefit accruals under the Cash Balance formula of the HSBC North America Pension Plan and freeze the plan effective January 1, 2013. Under IFRS the impact of this plan change was recorded through other comprehensive income. In 2011, amounts reflect a pension curtailment gain relating to the branch sales as under IFRSs recognition occurs when “demonstrably committed to the transaction” as compared to U.S. GAAP when recognition occurs when the transaction is completed. Furthermore, in 2010, changes to future accruals for legacy participants under the HSBC North America Pension Plan were accounted for as a plan curtailment under IFRSs, which resulted in immediate income recognition. Under U.S. GAAP, these changes were considered to be a negative plan amendment which resulted in no immediate income recognition.

Share-based bonus arrangements – Under IFRSs, the recognition of compensation expense related to share-based bonuses begins on January 1 of the current year for awards expected to be granted in the first quarter of the following year. Under U.S. GAAP, the recognition of compensation expense related to share-based bonuses does not begin until the date the awards are granted.

Property – Under IFRSs, the carrying amount of property held for own use reflects revaluation surpluses recorded prior to January 1, 2004. Consequently, the carrying amounts of tangible fixed assets and shareholders' equity are lower under U.S. GAAP than under IFRSs. There is a correspondingly lower depreciation charge and higher net income as well as higher gains (or smaller losses) on the disposal of fixed assets under U.S. GAAP. For investment properties, net income under U.S. GAAP does not reflect the unrealized gain or loss recorded under IFRSs for the period. In addition, the sale of our 452 Fifth Avenue property, including the 1 W. 39th Street building in April 2010, resulted in the recognition of a gain under IFRSs while under U.S. GAAP, such gain is deferred and recognized over eight years due to our continuing involvement.

Litigation accrual – Under U.S. GAAP, litigation accruals are recorded when it is probable a liability has been incurred and the amount is reasonably estimable. Under IFRSs, a present obligation must exist for an accrual to be recorded. In certain cases, this creates differences in the timing of accrual recognition between IFRSs and U.S. GAAP.

Assets

Customer loans (Loans) – On an IFRSs basis loans designated as held for sale at the time of origination and accrued interest are classified as trading assets. However, the accounting requirements governing when receivables previously held for investment are transferred to a held for sale category are more stringent under IFRSs than under U.S. GAAP which results in loans generally being reported as held for sale later than under U.S. GAAP. IFRSs also allows for reversals of write-downs to fair value on secured loans when collateral values have improved, which is not permitted under U.S. GAAP.

Derivatives – Under U.S. GAAP, derivative receivables and payables with the same counterparty may be reported on a net basis in the balance sheet when there is an executed International Swaps and Derivatives Association, Inc. (“ISDA”) Master Netting Arrangement. In addition, under U.S. GAAP, fair value amounts recognized for the obligation to return cash collateral received or the right to reclaim cash collateral paid are offset against the fair value of derivative instruments. Under IFRSs, these agreements do not necessarily meet the requirements for offset, and therefore such derivative receivables and payables are presented gross on the balance sheet.

Goodwill – IFRSs and U.S. GAAP require goodwill to be tested for impairment at least annually, or more frequently if circumstances indicate that goodwill may be impaired. For IFRSs, goodwill was amortized until 2005, however goodwill was amortized under U.S. GAAP until 2002, which resulted in a lower carrying amount of goodwill under IFRSs.

VIEs – The requirements for consolidation of variable interest entities (“VIEs”) under U.S. GAAP are based on both the power to direct the activities that most significantly impact the VIE’s economic performance and the obligation to absorb losses, or the right to receive benefits that could potentially be significant to the VIE. As a result, under U.S. GAAP we were determined to be the primary beneficiary of and consolidated a commercial paper conduit effective January 1, 2010. However in the first quarter of 2011, changes involving liquidity asset purchase agreements were made that caused us to no longer be considered the primary beneficiary and this commercial paper conduit was deconsolidated at March 31, 2011. Under IFRSs this conduit is not consolidated.

19. Variable Interest Entities

In the ordinary course of business, we have organized special purpose entities (“SPEs”) primarily to structure financial products to meet our clients’ investment needs and to securitize financial assets held to meet our own funding needs. For disclosure purposes, we aggregate SPEs based on the purpose, risk characteristics and business activities of the SPEs. A SPE is a variable interest entity (“VIE”) if it lacks sufficient equity investment at risk to finance its activities without additional subordinated financial support or, as a group, the holders of the equity investment at risk lack either a) the power through voting or similar rights to direct the activities of the entity that most significantly impacts the entity’s economic performance; or b) the obligation to absorb the entity’s expected losses, the right to receive the expected residual returns, or both.

Variable Interest Entities We consolidate VIEs in which we hold a controlling financial interest as evidenced by the power to direct the activities of a VIE that most significantly impact its economic performance and the obligation to absorb losses of, or the right to receive benefits from, the VIE that could be potentially significant to the VIE and therefore are deemed to be the primary beneficiary. We take into account our entire involvement in a VIE (explicit or implicit) in identifying variable interests that individually or in the aggregate could be significant enough to warrant our designation as the primary beneficiary and hence require us to consolidate the

VIE or otherwise require us to make appropriate disclosures. We consider our involvement to be significant where we, among other things, (i) provide liquidity put options or other liquidity facilities to support the VIE's debt obligations; (ii) enter into derivative contracts to absorb the risks and benefits from the VIE or from the assets held by the VIE; (iii) provide a financial guarantee that covers assets held or liabilities issued; (iv) design, organize and structure the transaction; and (v) retain a financial or servicing interest in the VIE.

We are required to evaluate whether to consolidate a VIE when we first become involved and on an ongoing basis. In almost all cases, a qualitative analysis of our involvement in the entity provides sufficient evidence to determine whether we are the primary beneficiary. In rare cases, a more detailed analysis to quantify the extent of variability to be absorbed by each variable interest holder is required to determine the primary beneficiary.

Consolidated VIEs The following table summarizes assets and liabilities related to our consolidated VIEs as of September 30, 2012 and December 31, 2011 which are consolidated on our balance sheet. Assets and liabilities exclude intercompany balances that eliminate in consolidation:

	September 30, 2012		December 31, 2011	
	Consolidated Assets	Consolidated Liabilities	Consolidated Assets	Consolidated Liabilities
(in millions)				
Low income housing limited liability partnership:				
Interest bearing deposits with banks	\$ 83	\$ -	\$108	\$ -
Other assets	566	-	520	-
Long term debt	-	55	-	55
Other liabilities	-	181	-	166
Total	<u>\$649</u>	<u>\$236</u>	<u>\$628</u>	<u>\$221</u>

Low income housing limited liability partnership In 2009, all low income housing investments held by us were transferred to a Limited Liability Partnership ("LLP") in exchange for debt and equity while a non-affiliated third party invested cash for an equity interest that is mandatorily redeemable at a future date. The LLP was created in order to ensure the utilization of future tax benefits from these low income housing tax projects. The LLP was deemed to be a VIE as it does not have sufficient equity investment at risk to finance its activities. Upon entering into this transaction, we concluded that we are the primary beneficiary of the LLP due to the nature of our continuing involvement and, as a result, consolidate the LLP and report the equity interest issued to the third party investor in other liabilities and the assets of the LLP in other assets on our consolidated balance sheet. The investments held by the LLP represent equity investments in the underlying low income housing partnerships for which the LLP applies equity-method accounting. The LLP does not consolidate the underlying partnerships because it does not have the power to direct the activities of the partnerships that most significantly impact the economic performance of the partnerships.

Unconsolidated VIEs We also have variable interests in other VIEs that were not consolidated at September 30, 2012 and December 31, 2011 because we were not the primary beneficiary. The following table provides additional information on those unconsolidated VIEs, the variable interests held by us and our maximum exposure to loss arising from our involvements in those VIEs as of September 30, 2012 and December 31, 2011:

	Variable Interests Held Classified as Assets	Variable Interests Held Classified as Liabilities	Total Assets in Unconsolidated VIEs	Maximum Exposure to Loss
(in millions)				
As of September 30, 2012:				
Asset-backed commercial paper conduits	\$ -	\$ -	\$14,261	\$1,550
Structured note vehicles	<u>1,650</u>	<u>171</u>	<u>6,853</u>	<u>2,023</u>
Total	<u>\$1,650</u>	<u>\$171</u>	<u>\$21,114</u>	<u>\$3,573</u>
As of December 31, 2011:				
Asset-backed commercial paper conduits	\$ -	\$ -	\$14,989	\$ 677
Structured note vehicles	<u>1,392</u>	<u>88</u>	<u>6,605</u>	<u>1,793</u>
Total	<u>\$1,392</u>	<u>\$ 88</u>	<u>\$21,594</u>	<u>\$2,470</u>

Information on the types of variable interest entities with which we are involved, the nature of our involvement and the variable interests held in those entities is presented below.

Asset-backed commercial paper conduits We provide liquidity facilities to a number of multi-seller and single-seller asset-backed commercial paper conduits (“ABCP conduits”) sponsored by HSBC affiliates and by third parties. These conduits support the financing needs of customers by facilitating the customers’ access to commercial paper markets.

Customers sell financial assets, such as trade receivables, to ABCP conduits, which fund the purchases by issuing short-term highly-rated commercial paper collateralized by the assets acquired. In a multi-seller conduit, any number of companies may be originating and selling assets to the conduit whereas a single-seller conduit acquires assets from a single company. We, along with other financial institutions, provide liquidity facilities to ABCP conduits in the form of lines of credit or asset purchase commitments. Liquidity facilities provided to multi-seller conduits support transactions associated with a specific seller of assets to the conduit and we would only be required to provide support in the event of certain triggers associated with those transactions and assets. Liquidity facilities provided to single-seller conduits are not identified with specific transactions or assets and we would be required to provide support upon occurrence of certain triggers that generally affect the conduit as a whole. Our obligations are generally pari passu with those of other institutions that also provide liquidity support to the same conduit or for the same transactions. We do not provide any program-wide credit enhancements to ABCP conduits.

Each seller of assets to an ABCP conduit typically provides credit enhancements in the form of asset overcollateralization and, therefore, bears the risk of first loss related to the specific assets transferred. We do not transfer our own assets to the conduits. We do not provide the majority of the liquidity facilities to any of these ABCP conduits. We have no ownership interests in, perform no administrative duties for, and do not service any of the assets held by the conduits. We are not the primary beneficiary and do not consolidate any of the ABCP conduits to which we provide liquidity facilities. Credit risk related to the liquidity facilities provided is managed by subjecting these facilities to our normal underwriting and risk management processes. The \$1.6 billion maximum exposure to loss presented in the table above represents the maximum amount of loans and asset purchases we could be required to fund under the liquidity facilities. The maximum loss exposure is estimated assuming the facilities are fully drawn and the underlying collateralized assets are in default with zero recovery value.

Structured note vehicles Our involvement in structured note vehicles includes derivatives such as interest rate and currency swaps and investments in the vehicles’ debt instruments. With respect to several of these VIEs, we hold variable interests in the form of total return swaps entered into in connection with the transfer of certain

assets to the VIEs. In these transactions, we transferred financial assets from our trading portfolio to the VIEs and entered into total return swaps under which we receive the total return on the transferred assets and pay a market rate of return. The transfers of assets in these transactions do not qualify as sales under the applicable accounting literature and are accounted for as secured borrowings. Accordingly, the transferred assets continue to be recognized as trading assets on our balance sheet and the funds received are recorded as liabilities in long-term debt. As of September 30, 2012, we recorded approximately \$78 million of trading assets and \$104 million of long-term liabilities on our balance sheet as a result of “failed sale” accounting treatment for certain transfers of financial assets. As of December 31, 2011, we recorded approximately \$73 million of trading assets and \$89 million of long-term liabilities on our balance sheet as a result of “failed sale” accounting treatment for certain transfers of financial assets. The financial assets and financial liabilities were not legally ours and we have no control over the financial assets which are restricted solely to satisfy the liability.

In addition to our variable interests, we also hold credit default swaps with these structured note VIEs under which we receive credit protection on specified reference assets in exchange for the payment of a premium. Through these derivatives, the VIEs assume the credit risk associated with the reference assets which are then passed on to the holders of the debt instruments they issue. Because they create rather than absorb variability, the credit default swaps we hold are not considered variable interests.

We record all investments in, and derivative contracts with, unconsolidated structured note vehicles at fair value on our consolidated balance sheet. Our maximum exposure to loss is limited to the recorded amounts of these instruments.

Beneficial interests issued by third-party sponsored securitization entities We hold certain beneficial interests issued by third-party sponsored securitization entities which may be considered VIEs. The investments are transacted at arm’s-length and decisions to invest are based on a credit analysis of the underlying collateral assets or the issuer. We are a passive investor in these issuers and do not have the power to direct the activities of these issuers. As such, we do not consolidate these securitization entities. Additionally, we do not have other involvements in servicing or managing the collateral assets or provide financial or liquidity support to these issuers which potentially give rise to risk of loss exposure. These investments are an integral part of the disclosure in Note 5, “Securities” and Note 22, “Fair Value Measurements” and, therefore, are not disclosed in this note to avoid redundancy.

Consolidated VIEs of Discontinued Credit Card and Private Label Operations We have historically utilized entities that are structured as trusts to securitize certain private label and other credit card receivables where securitization provides an attractive source of low cost funding. We transferred certain private label and other credit card receivables to these trusts which in turn issue debt instruments collateralized by the transferred receivables. As our affiliate was the servicer of the assets of these trusts we performed a detailed analysis and determined that we retained the benefits and risks and were the primary beneficiary of the trusts and, as a result, consolidated them. In 2011, in connection with our agreement to sell certain credit card operations to Capital One, all remaining loans in the private label and other credit card receivables VIEs were transferred to a wholly-owned subsidiary of HSBC Bank USA. As of September 30, 2012, there were no remaining balances related to these consolidated VIEs. As of December 31, 2011 the only remaining balance related to these consolidated VIEs which are part of our discontinued credit card operations was \$541 million of other liabilities which represents tax related liabilities of these VIEs and are included as a component of liabilities of discontinued operations on our consolidated balance sheet.

20. *Guarantee Arrangements and Pledged Assets*

Guarantee Arrangements As part of our normal operations, we enter into credit derivatives and various off-balance sheet guarantee arrangements with affiliates and third parties. These arrangements arise principally in connection with our lending and client intermediation activities and include standby letters of credit and certain credit derivative transactions. The contractual amounts of these arrangements represent our maximum possible credit exposure in the event that we are required to fulfill the maximum obligation under the contractual terms of the guarantee.

The following table presents total carrying value and contractual amounts of our sell protection credit derivatives and major off-balance sheet guarantee arrangements as of September 30, 2012 and December 31, 2011. Following the table is a description of the various arrangements.

	September 30, 2012		December 31, 2011	
	Carrying Value	Notional	Carrying Value	Notional
	(in millions)			
Credit derivatives ⁽¹⁾⁽⁴⁾	<u>\$ (1,194)</u>	<u>\$ 262,985</u>	<u>\$(7,759)</u>	<u>\$ 330,395</u>
Financial standby letters of credit, net of participations ⁽²⁾⁽³⁾	-	<u>5,097</u>	-	4,705
Performance (non-financial) guarantees ⁽²⁾⁽³⁾	-	<u>3,023</u>	-	3,088
Liquidity asset purchase agreements ⁽³⁾	-	<u>1,550</u>	-	677
Total	<u>\$ (1,194)</u>	<u>\$ 272,655</u>	<u>\$(7,759)</u>	<u>\$ 338,865</u>

⁽¹⁾ Includes \$45.9 billion and \$45.1 billion issued for the benefit of HSBC affiliates at September 30, 2012 and December 31, 2011, respectively.

⁽²⁾ Includes \$757 million and \$707 million issued for the benefit of HSBC affiliates at September 30, 2012 and December 31, 2011, respectively.

⁽³⁾ For standby letters of credit and liquidity asset purchase agreements, maximum loss represents losses to be recognized assuming the letter of credit and liquidity facilities have been fully drawn and the obligors have defaulted with zero recovery.

⁽⁴⁾ For credit derivatives, the maximum loss is limited to the recorded amounts of these instruments.

Credit-Risk Related Arrangements:

Credit derivatives Credit derivatives are financial instruments that transfer the credit risk of a reference obligation from the credit protection buyer to the credit protection seller who is exposed to the credit risk without buying the reference obligation. We sell credit protection on underlying reference obligations (such as loans or securities) by entering into credit derivatives, primarily in the form of credit default swaps, with various institutions. We account for all credit derivatives at fair value. Where we sell credit protection to a counterparty that holds the reference obligation, the arrangement is effectively a financial guarantee on the reference obligation. Under a credit derivative contract, the credit protection seller will reimburse the credit protection buyer upon occurrence of a credit event (such as bankruptcy, insolvency, restructuring or failure to meet payment obligations when due) as defined in the derivative contract, in return for a periodic premium. Upon occurrence of a credit event, we will pay the counterparty the stated notional amount of the derivative contract and receive the underlying reference obligation. The recovery value of the reference obligation received could be significantly lower than its notional principal amount when a credit event occurs.

Certain derivative contracts are subject to master netting arrangements and related collateral agreements. A party to a derivative contract may demand that the counterparty post additional collateral in the event its net exposure exceeds certain predetermined limits and when the credit rating falls below a certain grade. We set the collateral requirements by counterparty such that the collateral covers various transactions and products, and is not allocated to specific individual contracts.

We manage our exposure to credit derivatives using a variety of risk mitigation strategies where we enter into offsetting hedge positions or transfer the economic risks, in part or in entirety, to investors through the issuance of structured credit products. We actively manage the credit and market risk exposure in the credit derivative portfolios on a net basis and, as such, retain no or a limited net sell protection position at any time. The following table summarizes our net credit derivative positions as of September 30, 2012 and December 31, 2011:

	September 30, 2012		December 31, 2011	
	Carrying (Fair) Value	Notional	Carrying (Fair) Value	Notional
	(in millions)			
Sell-protection credit derivative positions	<u>\$ (1,194)</u>	<u>\$ 262,985</u>	<u>\$(7,759)</u>	<u>\$ 330,395</u>
Buy-protection credit derivative positions	<u>1,162</u>	<u>263,055</u>	<u>8,131</u>	<u>326,882</u>
Net position ⁽¹⁾	<u>\$ (32)</u>	<u>\$ (70)</u>	<u>\$ 372</u>	<u>\$ 3,513</u>

⁽¹⁾ Positions are presented net in the table above to provide a complete analysis of our risk exposure and depict the way we manage our credit derivative portfolio. The offset of the sell-protection credit derivatives against the buy-protection credit derivatives may not be legally binding in the absence of master netting agreements with the same counterparty. Furthermore, the credit loss triggering events for individual sell protection credit derivatives may not be the same or occur in the same period as those of the buy protection credit derivatives thereby not providing an exact offset.

Standby letters of credit A standby letter of credit is issued to a third party for the benefit of a customer and is a guarantee that the customer will perform or satisfy certain obligations under a contract. It irrevocably obligates us to pay a specified amount to the third party beneficiary if the customer fails to perform the contractual obligation. We issue two types of standby letters of credit: performance and financial. A performance standby letter of credit is issued where the customer is required to perform some nonfinancial contractual obligation, such as the performance of a specific act, whereas a financial standby letter of credit is issued where the customer's contractual obligation is of a financial nature, such as the repayment of a loan or debt instrument. As of September 30, 2012, the total amount of outstanding financial standby letters of credit (net of participations) and performance guarantees were \$5.1 billion and \$3.0 billion, respectively. As of December 31, 2011, the total amount of outstanding financial standby letters of credit (net of participations) and performance guarantees were \$4.7 billion and \$3.1 billion, respectively.

The issuance of a standby letter of credit is subject to our credit approval process and collateral requirements. We charge fees for issuing letters of credit commensurate with the customer's credit evaluation and the nature of any collateral. Included in other liabilities are deferred fees on standby letters of credit, which represent the value of the stand-ready obligation to perform under these guarantees, amounting to \$43 million and \$44 million at September 30, 2012 and December 31, 2011, respectively. Also included in other liabilities is an allowance for credit losses on unfunded standby letters of credit of \$21 million and \$22 million at September 30, 2012 and December 31, 2011, respectively.

Below is a summary of the credit ratings of credit risk related guarantees including the credit ratings of counterparties against which we sold credit protection and financial standby letters of credit as of September 30, 2012 as an indicative proxy of payment risk:

Notional/Contractual Amounts	Average Life (in years)	Credit Ratings of the Obligors or the Transactions		
		Investment Grade	Non-Investment Grade	Total
(dollars are in millions)				
Sell-protection Credit Derivatives ⁽¹⁾				
Single name CDS	2.5	\$138,852	\$35,086	\$173,938
Structured CDS	1.7	43,798	4,008	47,806
Index credit derivatives	3.1	25,999	733	26,732
Total return swaps	7.2	11,355	3,154	14,509
Subtotal		220,004	42,981	262,985
Standby Letters of Credit ⁽²⁾	1.3	7,087	1,033	8,120
Total		\$227,091	\$44,014	\$271,105

⁽¹⁾ The credit ratings in the table represent external credit ratings for classification as investment grade and non-investment grade.

⁽²⁾ External ratings for most of the obligors are not available. Presented above are the internal credit ratings which are developed using similar methodologies and rating scale equivalent to external credit ratings for purposes of classification as investment grade and non-investment grade.

Our internal groupings are determined based on HSBC's risk rating systems and processes which assign a credit grade based on a scale which ranks the risk of default of a customer. The groupings are determined and used for managing risk and determining level of credit exposure appetite based on the customer's operating performance, liquidity, capital structure and debt service ability. In addition, we also incorporate subjective judgments into the risk rating process concerning such things as industry trends, comparison of performance to industry peers and perceived quality of management. We compare our internal risk ratings to outside external rating agency benchmarks, where possible, at the time of formal review and regularly monitor whether our risk ratings are comparable to the external ratings benchmark data.

A non-investment grade rating of a referenced obligor has a negative impact to the fair value of the credit derivative and increases the likelihood that we will be required to perform under the credit derivative contract. We employ market-based parameters and, where possible, use the observable credit spreads of the referenced obligors as measurement inputs in determining the fair value of the credit derivatives. We believe that such market parameters are more indicative of the current status of payment/performance risk than external ratings by the rating agencies which may not be forward-looking in nature and, as a result, lag behind those market-based indicators.

Mortgage Loan Repurchase Obligations

Sale of mortgage loans In the ordinary course of business, we originate and sell mortgage loans primarily to government sponsored entities ("GSEs") and provide various representations and warranties related to, among other things, the ownership of the loans, the validity of the liens, the loan selection and origination process, and the compliance to the origination criteria established by the agencies. In the event of a breach of our representations and warranties, we may be obligated to repurchase the loans with identified defects or to indemnify the buyers. Our contractual obligation arises only when the breach of representations and warranties are discovered and repurchase is demanded.

We typically first become aware that a GSE or other third party is evaluating a particular loan for repurchase when we receive a request to review the underlying loan file. Generally, the reviews focus on severely delinquent

loans to identify alleged fraud, misrepresentation or file documentation issues. Upon completing its review, the GSE or other third party may submit a repurchase demand. Historically, most file requests have not resulted in repurchase demands. After receipt of a repurchase demand, we perform a detailed evaluation of the substance of the request and appeal any claim that we believe is either unsubstantiated or contains errors, leveraging both dedicated internal as well as retained external resources. In some cases, we ultimately are not required to repurchase a loan as we are able to resolve the purported defect. From initial inquiry to ultimate resolution, a typical case is usually resolved within 3 months, however some cases may take as long as 12 months to resolve. Acceptance of a repurchase demand will involve either a) repurchase of the loan at the unpaid principal balance plus accrued interest or b) reimbursement for any realized loss on a liquidated property (“make-whole” payment).

To date, a majority of the repurchase demands we have received primarily relate to prime loans sourced during 2004 through 2008 from the legacy broker channel which we exited in late 2008. Loans sold to GSEs and other third parties originated in 2004 through 2008 subject to representations and warranties for which we may be liable had an outstanding principal balance of approximately \$16.1 billion and \$19.3 billion at September 30, 2012 and December 31, 2011, respectively, including \$10.3 billion and \$12.1 billion, respectively, of loans sourced from our legacy broker channel.

The following table shows the trend in repurchase demands received on loans sold to GSEs and other third parties by loan origination vintage during the three and nine months ended September 30, 2012 and 2011, respectively:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Pre- 2004	\$ 2	\$ 1	\$ 5	\$ 4
2004	5	1	16	10
2005	6	6	19	20
2006	20	11	65	35
2007	51	34	170	104
2008	28	15	106	73
Post 2008	4	14	15	59
Total repurchase demands received ⁽¹⁾	<u>\$116</u>	<u>\$82</u>	<u>\$396</u>	<u>\$305</u>

⁽¹⁾ Includes repurchase demands on loans sourced from our legacy broker channel of \$98 million and \$61 million for the three months ended September 30, 2012 and 2011, respectively and \$330 million and \$218 million for the nine months ended September 30, 2012 and 2011, respectively.

The following table provides information about outstanding repurchase demands received from GSEs and other third parties at September 30, 2012 and December 31, 2011:

	September 30, 2012	December 31, 2011
	(in millions)	
GSEs	\$110	\$ 77
Others	58	25
Total ⁽¹⁾	<u>\$168</u>	<u>\$102</u>

⁽¹⁾ Includes repurchase demands on loans sourced from our legacy broker channel of \$143 million and \$87 million at September 30, 2012 and December 31, 2011, respectively.

In estimating our repurchase liability arising from breaches of representations and warranties, we consider the following:

- The level of outstanding repurchase demands in inventory and our historical defense rate;
- The level of outstanding requests for loan files and the related historical repurchase request conversion rate and defense rate on such loans; and
- The level of potential future demands based on historical conversion rates of loans which we have not received a loan file request but are two or more payments delinquent or expected to become delinquent at an estimated conversion rate.

The following table summarizes the change in our estimated repurchase liability for loans sold to the GSEs and other third parties during the three and nine months ended September 30, 2012 and 2011 for obligations arising from the breach of representations and warranties associated with the sale of these loans:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Balance at beginning of period	\$222	\$237	\$ 237	\$262
Increase in liability recorded through earnings	28	1	81	41
Realized losses	(34)	(29)	(102)	(94)
Balance at end of period	<u>\$216</u>	<u>\$209</u>	<u>\$ 216</u>	<u>\$209</u>

Our reserve for potential repurchase liability exposures relates primarily to previously originated mortgages through broker channels. Our mortgage repurchase liability of \$216 million at September 30, 2012 represents our best estimate of the loss that has been incurred including interest, resulting from various representations and warranties in the contractual provisions of our mortgage loan sales. Because the level of mortgage loan repurchase losses are dependent upon economic factors, investor demand strategies and other external risk factors such as housing market trends that may change, the level of the liability for mortgage loan repurchase losses requires significant judgment. As these estimates are influenced by factors outside our control, there is uncertainty inherent in these estimates making it reasonably possible that they could change.

Written Put Options, Non Credit-Risk Related and Indemnity Arrangements:

Liquidity asset purchase agreements We provide liquidity facilities to a number of multi-seller and single-seller asset-backed commercial paper conduits sponsored by affiliates and third parties. The conduits finance the purchase of individual assets by issuing commercial paper to third party investors. Each liquidity facility is transaction specific and has a maximum limit. Pursuant to the liquidity agreements, we are obligated, subject to certain limitations, to purchase the eligible assets from the conduit at an amount not to exceed the face value of the commercial paper in the event the conduit is unable to refinance its commercial paper. A liquidity asset purchase agreement is essentially a conditional written put option issued to the conduit where the exercise price is the face value of the commercial paper. As of September 30, 2012 and December 31, 2011, we have issued \$1.5 billion and \$677 million, respectively, of liquidity facilities to provide liquidity support to the commercial paper issued by various conduits See Note 19, “Variable Interest Entities,” for further information.

Visa covered litigation We are an equity member of Visa Inc. (“Visa”). Prior to its initial public offering (“IPO”) on March 19, 2008, Visa completed a series of transactions to reorganize and restructure its operations and to convert membership interests into equity interests. Pursuant to the restructuring, we, along with all the Class B shareholders, agreed to indemnify Visa for the claims and obligations arising from certain specific covered litigations. Class B shares are convertible into listed Class A shares upon (i) settlement of the covered

litigations or (ii) the third anniversary of the IPO, whichever is later. Visa used a portion of the IPO proceeds to establish a \$3.0 billion escrow account to fund future claims arising from those covered litigations (the escrow was subsequently increased to \$4.1 billion). In 2009 and 2010, Visa exercised its rights to sell shares of existing Class B shareholders in order to increase the escrow account and announced that it had deposited collectively an additional \$2.0 billion into the escrow account. As a result, we re-evaluated our liability recorded relating to this litigation and reduced our liability by \$24 million during 2009 and 2010. In 2011, Visa again exercised its rights to sell shares of existing Class B shareholders and funded an additional \$2.0 billion into the escrow account and we reduced our liability by \$9 million. At September 30, 2012, there was no liability recorded.

Clearinghouses and exchanges We are a member of various exchanges and clearinghouses that trade and clear securities and/or futures contracts. As a member, we may be required to pay a proportionate share of the financial obligations of another member who defaults on its obligations to the exchange or the clearinghouse. Our guarantee obligations would arise only if the exchange or clearinghouse had exhausted its resources. Any potential contingent liability under these membership agreements cannot be estimated. However, we believe that any potential requirement to make payments under these agreements is remote.

Pledged Assets Pledged assets included in the consolidated balance sheet are summarized in the following table.

	September 30, 2012	December 31, 2011
	(in millions)	
Interest bearing deposits with banks	\$ 917	\$ 4,426
Trading assets ⁽¹⁾	5,384	1,640
Securities available-for-sale ⁽²⁾	18,481	23,347
Securities held to maturity	346	476
Loans ⁽³⁾	1,736	2,113
Other assets ⁽⁴⁾	2,476	3,688
Total	<u>\$29,340</u>	<u>\$35,690</u>

⁽¹⁾ Trading assets are primarily pledged against liabilities associated with consolidated variable interest entities.

⁽²⁾ Securities available-for-sale are primarily pledged against public fund deposits and various short-term and long term borrowings, as well as providing capacity for potential secured borrowings from the Federal Home Loan Bank and the Federal Reserve Bank.

⁽³⁾ Loans are primarily residential mortgage loans pledged against long-term borrowings from the Federal Home Loan Bank.

⁽⁴⁾ Other assets represent cash on deposit with non-banks related to derivative collateral support agreements.

21. *Litigation and Regulatory Matters*

In addition to the matters described below, in the ordinary course of business, we are routinely named as defendants in, or as parties to, various legal actions and proceedings relating to activities of our current and/or former operations. These legal actions and proceedings may include claims for substantial or indeterminate compensatory or punitive damages, or for injunctive relief. In the ordinary course of business, we also are subject to governmental and regulatory examinations, information-gathering requests, investigations and proceedings (both formal and informal), certain of which may result in adverse judgments, settlements, fines, penalties, injunctions or other relief. In connection with formal and informal inquiries by these regulators, we receive numerous requests, subpoenas and orders seeking documents, testimony and other information in connection with various aspects of our regulated activities.

In view of the inherent unpredictability of litigation and regulatory matters, particularly where the damages sought are substantial or indeterminate or when the proceedings or investigations are in the early stages, we cannot determine with any degree of certainty the timing or ultimate resolution of litigation and regulatory matters or the eventual loss, fines, penalties or business impact, if any, that may result. We establish reserves for litigation and regulatory matters when those matters present loss contingencies that are both probable and can be

reasonably estimated. The actual costs of resolving litigation and regulatory matters, however, may be substantially higher than the amounts reserved for those matters.

Given the substantial or indeterminate amounts sought in certain of these matters, and the inherent unpredictability of such matters, an adverse outcome in certain of these matters could have a material adverse effect on our consolidated financial statements in particular quarterly or annual periods.

Litigation

Credit Card Litigation Since June 2005, HSBC Bank USA, HSBC Finance Corporation, HSBC North America and HSBC, as well as other banks and Visa Inc. and MasterCard Incorporated, have been named as defendants in four class actions filed in Connecticut and the Eastern District of New York: *Photos Etc. Corp. et al v. Visa U.S.A., Inc., et al.* (D. Conn. No. 3:05-CV-01007 (WWE)); *National Association of Convenience Stores, et al. v. Visa U.S.A., Inc., et al.* (E.D.N.Y. No. 05-CV 4520 (JG)); *Jethro Holdings, Inc., et al. v. Visa U.S.A., Inc. et al.* (E.D.N.Y. No. 05-CV-4521(JG)); and *American Booksellers Asps' v. Visa U.S.A., Inc. et al.* (E.D.N.Y. No. 05-CV-5391 (JG)). Numerous other complaints containing similar allegations (in which no HSBC entity is named) were filed across the country against Visa Inc., MasterCard Incorporated and other banks. These actions principally allege that the imposition of a no-surcharge rule by the associations and/or the establishment of the interchange fee charged for credit card transactions causes the merchant discount fee paid by retailers to be set at supracompetitive levels in violation of the Federal antitrust laws. These suits have been consolidated and transferred to the Eastern District of New York. The consolidated case is: *In re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation*, MDL 1720, E.D.N.Y. ("MDL 1720"). A consolidated, amended complaint was filed by the plaintiffs on April 24, 2006 and a second consolidated amended complaint was filed on January 29, 2009. On February 7, 2011, MasterCard Incorporated, Visa Inc., the other defendants, including HSBC Bank USA, and certain affiliates of the defendants entered into settlement and judgment sharing agreements (the "Agreements") that provide for the apportionment of certain defined costs and liabilities that the defendants, including HSBC Bank USA and our affiliates, may incur, jointly and/or severally, in the event of an adverse judgment or global settlement of one or all of these actions. The Agreements also cover any other potential or future actions that are transferred for coordinated pre-trial proceedings with MDL 1720.

The parties engaged in a mediation process at the direction of the District Court. In July 2012, MasterCard Incorporated, Visa Inc. and the other defendants, including the HSBC defendants, entered into a Memorandum of Understanding ("MOU") to settle the class litigations consolidated into MDL 1720. On October 22, 2012, a settlement agreement with the individual merchant plaintiffs became effective. In the fourth quarter of 2011, we increased our litigation reserves to an amount equal to our estimated portion of the settlement of this matter. In connection with the execution of the MOU, we increased our litigation reserves by an immaterial amount in anticipation of a related short-term reduction in interchange fees.

Account Overdraft Litigation In February 2011, an action captioned *Ofra Levin et al v. HSBC Bank USA, N.A. et al* (E.D.N.Y. 11-CV-0701) was filed in the Eastern District of New York against HSBC Bank USA, HSBC USA and HSBC North America on behalf of a putative nationwide class and New York sub-class of customers who allegedly incurred overdraft fees due to the posting of debit card transactions to deposit accounts in high-to-low order. *Levin* asserts claims for breach of contract and the implied covenant of good faith and fair dealing, conversion, unjust enrichment, and violation of the New York deceptive acts and practices statute. The plaintiffs dismissed the Federal court action after the case was transferred to the multi-district litigation pending in Miami, Florida, and re-filed the case in New York state court on March 1, 2011. The action, captioned *Ofra Levin et al v. HSBC Bank USA, N.A. et al.* (N.Y. Sup. Ct. 650562/11), alleges a variety of common law claims and violations on behalf of a New York class, including breach of contract and implied covenant of good faith and fair dealing, conversion, unjust enrichment and a violation of the New York deceptive acts and practices statute. We filed a motion to dismiss the complaint in May 2011. In June 2012, the court denied in part and granted in part the

motion to dismiss, granting plaintiffs leave to amend their complaint with regard to plaintiffs' claims for conversion and unjust enrichment. On October 11, 2012, the parties attended a hearing before the Court at which time plaintiff's counsel sought to withdraw as counsel for the named plaintiff in the matter and to amend the complaint to, among other things, substitute a new named plaintiff. The Court granted the motion to amend, but found the motion to withdraw procedurally defective. The Court will permit plaintiff's counsel to re-file a motion to withdraw, and the parties await further proceedings in the case.

Lender-Placed Insurance Matters Lender-placed insurance involves a lender obtaining a hazard insurance policy on a mortgaged property when the borrower fails to maintain their own policy. The cost of the lender-placed insurance is then passed on to the borrower. Industry practices with respect to lender-placed insurance are receiving heightened regulatory scrutiny. The Consumer Financial Protection Bureau recently announced that lender-placed insurance is an important issue and is expected to publish related regulations sometime in 2012. In October 2011, a number of mortgage servicers and insurers, including our affiliate, HSBC Insurance (USA) Inc., received subpoenas from the New York Department of Financial Services (the "NYDFS") with respect to lender-placed insurance activities dating back to September 2005. We have and will continue to provide documentation and information to the NYDFS that is responsive to the subpoena.

Between June 2011 and March 2012, several putative class actions related to lender-placed insurance were filed against various HSBC U.S. entities, including actions against us and our subsidiaries captioned *Montanez et al v. HSBC Mortgage Corporation (USA) et al.* (E.D. Pa. No. 11-CV-4074); *Maxwell et al v. HSBC Mortgage Corporation (USA) et al.* (S.D.N.Y. No. 12-CV-1699); *West et al. v. HSBC Mortgage Corporation (USA) et al.* (South Carolina Court of Common Pleas, 14th Circuit No. 12-CP-00687). These actions relate primarily to industry-wide regulatory concerns, and include allegations regarding the relationships and potential conflicts of interest between the various entities that place the insurance, the value and cost of the insurance that is placed, back-dating policies to the date the borrower allowed it to lapse, self-dealing and insufficient disclosure.

Madoff Litigation In December 2008, Bernard L. Madoff ("Madoff") was arrested for running a Ponzi scheme and a trustee was appointed for the liquidation of his firm, Bernard L. Madoff Investment Securities LLC ("Madoff Securities"), an SEC-registered broker-dealer and investment adviser. Various non-U.S. HSBC companies provided custodial, administration and similar services to a number of funds incorporated outside the United States whose assets were invested with Madoff Securities. Plaintiffs (including funds, funds investors and the Madoff Securities trustee, as described below) have commenced Madoff-related proceedings against numerous defendants in a multitude of jurisdictions. Various HSBC companies have been named as defendants in suits in the United States, Ireland, Luxembourg and other jurisdictions. Certain suits (which include U.S. putative class actions) allege that the HSBC defendants knew or should have known of Madoff's fraud and breached various duties to the funds and fund investors.

In November 2011, the District Court judge overseeing three related putative class actions in the Southern District of New York, captioned *In re Herald, Primeo and Thema Funds Securities Litigation* (S.D.N.Y. Nos. 09-CV-0289 (RMB), 09-CV-2558 (RMB)), dismissed all claims against the HSBC defendants on *forum non conveniens* grounds, but temporarily stayed this ruling as to one of the actions against the HSBC defendants – the claims of investors in Thema International Fund plc – in light of a proposed amended settlement agreement between the lead plaintiff in that action and the relevant HSBC defendants (including, subject to the granting of leave to effect a proposed pleading amendment, HSBC Bank USA). In December 2011, the District Court lifted this temporary stay and dismissed all remaining claims against the HSBC defendants, and declined to consider preliminary approval of the settlement. In light of the District Court's decisions, HSBC has terminated the settlement agreement. The Thema plaintiff contests HSBC's right to terminate. Plaintiffs in all three actions filed notices of appeal to the U.S. Circuit Court of Appeals for the Second Circuit, where the actions are captioned *In re Herald, Primeo and Thema Funds Securities Litigation* (2nd Cir, Nos. 12-156, 12-184, 12-162). Briefing in these appeals was completed in September 2012, and oral argument has not yet been scheduled.

In December 2010, the Madoff Securities trustee commenced suits against various HSBC companies in the U.S. Bankruptcy Court and in the English High Court. The U.S. action, captioned *Picard v. HSBC et al* (Bankr. S.D.N.Y. No. 09-01364), which also names certain funds, investment managers, and other entities and individuals, sought \$9 billion in damages and additional recoveries from HSBC Bank USA, certain of our foreign affiliates and the various other codefendants. It sought damages against the HSBC defendants for allegedly aiding and abetting Madoff's fraud and breach of fiduciary duty. In July 2011, after withdrawing the case from the Bankruptcy Court in order to decide certain threshold issues, the District Court dismissed the trustee's various common law claims on the grounds that the trustee lacks standing to assert them. In December 2011, the trustee filed a notice of appeal to the U.S. Court of Appeals for the Second Circuit, where the action is captioned *Picard v. HSBC Bank plc et al.* (2nd Cir., No. 11-5207). Briefing in that appeal was completed in April 2012, and oral argument has been scheduled for November 2012. The District Court returned the remaining claims to the Bankruptcy Court for further proceedings. Those claims seek, pursuant to U.S. bankruptcy law, recovery of unspecified amounts received by the HSBC defendants from funds invested with Madoff, including amounts that the HSBC defendants received when they redeemed units held in the various funds. The HSBC defendants acquired those fund units in connection with financing transactions the HSBC defendants had entered into with various clients. The trustee's U.S. bankruptcy law claims also seek recovery of fees earned by the HSBC defendants for providing custodial, administration and similar services to the funds. Between September 2011 and April 2012, the HSBC defendants and certain other defendants moved again to withdraw the case from the Bankruptcy Court. The District Court granted those withdrawal motions as to certain issues and is considering the motions as to other issues. Briefing on the merits of the withdrawn issues is ongoing. The trustee's English action, which names HSBC Bank USA and other HSBC entities as defendants, seeks recovery of unspecified transfers of money from Madoff Securities to or through HSBC on the ground that the HSBC defendants actually or constructively knew of Madoff's fraud. HSBC has not been served with the trustee's English action.

Between October 2009 and April 2012, Fairfield Sentry Limited, Fairfield Sigma Limited and Fairfield Lambda Limited ("Fairfield"), funds whose assets were directly or indirectly invested with Madoff Securities, commenced multiple suits in the British Virgin Islands and the United States against numerous fund shareholders, including various HSBC companies that acted as nominees for clients of HSBC's private banking business and other clients who invested in the Fairfield funds. The Fairfield actions, including an action captioned *Fairfield Sentry Ltd. v. Zurich Capital Markets et al.* (Bankr. S.D.N.Y. No. 10-03634), in which HSBC Bank USA is a defendant, seek restitution of amounts paid to the defendants in connection with share redemptions, on the ground that such payments were made by mistake, based on inflated values resulting from Madoff's fraud. Some of these actions also seek recovery of the share redemptions under British Virgin Islands insolvency law. The British Virgin Islands actions have been dismissed, and those dismissals affirmed on appeal. The U.S. actions are stayed pending developments in related appellate litigation in the British Virgin Islands.

HSBC Bank USA was also a defendant in an action filed in July 2011, captioned *Wailea Partners, LP v. HSBC Bank USA, N.A.* (N.D. Ca. No. 11-CV-3544), arising from derivatives transactions between Wailea Partners, LP and HSBC Bank USA that were linked to the performance of a fund that placed its assets with Madoff Securities pursuant to a specified investment strategy. The plaintiff alleged, among other things, that HSBC Bank USA knew or should have known that the fund's assets would not be invested as contemplated. The plaintiff also alleged that HSBC Bank USA marketed, sold and entered into the derivatives transactions on the basis of materially misleading statements and omissions in violation of California law. The plaintiff sought rescission of the transactions and return of amounts paid to HSBC Bank USA in connection with the transactions, together with interest, fees, expenses and disbursements. In December 2011, the District Court granted HSBC's motion to dismiss the complaint with prejudice, and the plaintiff appealed to the U.S. Court of Appeals for the Ninth Circuit, where the action is captioned *Wailea Partners, LP v. HSBC Bank USA, N.A.*, (9th Cir., No. 11-18041). Briefing on that appeal was completed in May 2012, and oral argument has not yet been scheduled.

Greenwich Sentry LP v. HSBC USA Inc. (Del. Ch. No. 6829) was filed in September 2011 in the Delaware Court of Chancery. The complaint seeks the return of specified redemption payments made to HSBC USA as a limited partner in Greenwich Sentry LP, a fund whose assets were invested with Madoff Securities, and asserts claims of

unjust enrichment, mistaken payment, and constructive trust. HSBC USA was served with a copy of the complaint in December 2011. In May 2012, the Court of Chancery granted an unopposed motion by the Madoff Securities trustee to substitute itself for Greenwich Sentry LP as plaintiff in this action. HSBC USA filed a motion to dismiss the complaint in June 2012.

There are many factors that may affect the range of possible outcomes, and the resulting financial impact, of the various Madoff-related proceedings including, but not limited to, the circumstances of the fraud, the multiple jurisdictions in which proceeding have been brought and the number of different plaintiffs and defendants in such proceedings. For these reasons, among others, we are unable to reasonably estimate the aggregate liability or ranges of liability that might arise as a result of these claims but they could be significant. In any event, we consider that we have good defenses to these claims and will continue to defend them vigorously.

Knox Family Trust Litigation. HSBC Bank USA, N.A. is the defendant in seven separate proceedings collectively described as Matter of Knox (N.Y. Surrogate's Court, Erie County, File Nos. DO-0659, DO-0663, DO-0664, DO-0665, DO-0666, 1996-2486/B, and 1996-2486/D), concerning seven trusts for which HSBC Bank USA served as trustee that were established by Seymour Knox II and his descendants for various members of the Knox family. In these proceedings, the beneficiaries of the various trusts objected to HSBC Bank USA's final accountings and claimed that HSBC Bank USA mismanaged certain assets and investments. In November 2010, the court awarded the plaintiffs in the seven proceedings damages totaling approximately \$26 million plus interest and attorneys' fees to be determined. In May 2011, the court entered final judgments totaling approximately \$25 million in two of the seven proceedings (DO-0659 and 1996-2486/B). HSBC Bank USA appealed the judgments and secured the judgments in order to suspend execution of the judgments while the appeals are ongoing by depositing cash in the amount of the judgments in an interest-bearing escrow account. In May 2011, HSBC Bank USA agreed to settle three of the other proceedings (DO-0664, DO-0665 and DO-0666) for an immaterial amount. HSBC Bank USA also filed appeals of the two other proceedings. In August 2011, HSBC Bank USA agreed in principle to settle one proceeding on appeal (1996-2486/B) for an immaterial amount. On June 19, 2012 the N.Y. Appellate Division, 4th Department issued rulings on HSBC Bank USA's three pending appeals modifying the Surrogate Court's decisions by vacating all its determinations of liability (except for an appellate finding in DO-0659 to the extent that HSBC Bank USA held certain stock in F.W. Woolworth Co. after March 1, 1995, which leaves potential liability in an immaterial amount), and as modified, affirming them. The Appellate Division then remitted the three matters to the Surrogate Court for further proceedings. Plaintiffs have thirty days within which to seek permission to appeal. Prior to the Appellate Division's decision, the parties largely had agreed in principle to a consensual resolution of the remaining issues in DO-0659, and the Surrogate Court has approved a resolution of the claims for an immaterial amount. Several beneficiaries have attempted to pursue further appeals of the Appellate Division's decision, which HSBC Bank USA views as procedurally and substantively without merit. In September 2012, those beneficiaries' motions for reargument or leave to appeal to the New York Court of Appeals were denied by the Appellate Division.

Governmental and Regulatory Matters

Foreclosure Practices In April 2011, HSBC Bank USA entered into a consent cease and desist order with the OCC (the "OCC Servicing Consent Order") and our affiliate, HSBC Finance Corporation, and our common indirect parent, HSBC North America, entered into a similar consent order with the Federal Reserve (together with the OCC Servicing Consent Order, the "Servicing Consent Orders") following completion of a broad horizontal review of industry foreclosure practices. The OCC Servicing Consent Order requires HSBC Bank USA to take prescribed actions to address the deficiencies noted in the joint examination and described in the consent order. We are committed to full compliance with the terms of the Servicing Consent Orders, as initially described in our Form 10-Q for the quarter ended March 31, 2011. We continue to work with the OCC and the Federal Reserve to align our processes with the requirements of the Servicing Consent Orders and are implementing operational changes as required.

The Servicing Consent Orders require an independent review of foreclosures (the "Foreclosure Review") pending or completed between January 2009 and December 2010 (the "Foreclosure Review Period") to determine if any

borrower was financially injured as a result of an error in the foreclosure process. Consistent with the industry, and as required by the Servicing Consent Orders, an independent consultant has been retained to conduct that review, and remediation, including restitution, may be required if a borrower is found to have been financially injured as a result of servicer errors. In conjunction with the foreclosure review, a communication and outreach plan has been developed and implemented to contact borrowers with foreclosures pending or completed during the Foreclosure Review Period. We will conduct the outreach efforts in collaboration with other mortgage loan servicers and independent consultants in order to present a uniform, coherent and user-friendly complaint process. Written communications have been sent to borrowers who were subject to foreclosure proceedings during the Foreclosure Review Period notifying them of the foreclosure complaint review process and providing them with forms that can be used to request a review of their foreclosure proceeding. The outreach plan currently includes a staggered mailing to borrowers, which began on November 1, 2011, industry media advertising, which began in January 2012 and a website at which a borrower can request a review. In June 2012, the Federal Reserve and the OCC released a financial remediation framework for use by the independent consultants to recommend remediation for financial injury identified during the Foreclosure Review. Pursuant to this framework, remediation available to a borrower who is found to have been financially injured as a result of servicer errors could include suspension of a pending foreclosure, loan modification, or a lump sum payment ranging from \$500 to \$125,000 plus equity in the most egregious cases. Any borrower who receives remediation will not be precluded from pursuing litigation concerning foreclosure or other mortgage servicing practices. We expect the costs associated with the Servicing Consent Orders, including the Foreclosure Review, customer outreach plan and complaint process will continue to result in significant increases in our operating expenses in future periods. Any resulting remediation could result in further increased costs.

The Servicing Consent Orders do not preclude additional enforcement actions against HSBC Bank USA or our affiliates by bank regulatory, governmental or law enforcement agencies, such as the Department of Justice and State Attorneys General, which could include the imposition of civil money penalties and other sanctions relating to the activities that are the subject of the Servicing Consent Orders. We may also see an increase in private litigation concerning foreclosure and other mortgage servicing practices.

On February 9, 2012, the U.S. Department of Justice, the U.S. Department of Housing and Urban Development and State Attorneys General of 49 states announced a settlement with the five largest U.S. mortgage servicers with respect to foreclosure and other mortgage servicing practices. HSBC North America, HSBC Finance Corporation and HSBC Bank USA have had preliminary discussions with U.S. bank regulators and other governmental agencies regarding a potential resolution, although the timing of any settlement is not presently known. Based on discussions to date, an accrual was determined based on the total projected impact at HSBC North America associated with a proposed settlement of this matter. We recorded an accrual of \$38 million in the fourth quarter of 2011 which reflects the portion of the HSBC North America accrual that we currently believe is allocable to HSBC Bank USA. As this matter progresses and more information becomes available, we will continue to evaluate our portion of the HSBC North America liability which may result in a change to our current estimate. Any such settlement, however, may not completely preclude other enforcement actions by state or federal agencies, regulators or law enforcement agencies related to foreclosure and other mortgage servicing practices, including, but not limited to, matters relating to the securitization of mortgages for investors, including the imposition of civil money penalties, criminal fines or other sanctions. In addition, such a settlement would not preclude private litigation concerning these practices.

Anti-Money Laundering, Bank Secrecy Act and Office of Foreign Assets Control Investigations. In October 2010, HSBC Bank USA entered into a consent cease and desist order with the OCC, and our indirect parent, HSBC North America, entered into a consent cease and desist order with the Federal Reserve (together, the “AML/BSA Consent Orders”). These actions require improvements for an effective compliance risk management program across our U.S. businesses, including various issues relating to BSA and Anti-Money Laundering (“AML”) compliance. Steps continue to be taken to address the requirements of the AML/BSA Consent Orders to ensure compliance, and that effective policies and procedures are maintained.

The AML/BSA Consent Orders do not preclude additional enforcement actions against HSBC Bank USA or HSBC North America by U.S. bank regulatory or law enforcement agencies, including the imposition of civil money penalties, criminal fines and other sanctions relating to activities that are the subject of the AML/BSA Consent Orders. We continue to cooperate in ongoing investigations by the U.S. Department of Justice, the Federal Reserve, the OCC and the U.S. Department of Treasury's Financial Crimes Enforcement Network in connection with AML/BSA compliance, including cross-border transactions involving our cash handling business in Mexico and banknotes business in the U.S.

We continue to cooperate in ongoing investigations by the U.S. Department of Justice, the New York County District Attorney's Office, the Office of Foreign Assets Control ("OFAC"), the Federal Reserve and the OCC regarding historical transactions involving Iranian parties and other parties subject to OFAC economic sanctions. Our affiliate, HSBC Securities (USA) Inc. ("HSI"), continues to cooperate in a review of its AML/BSA compliance program by the Financial Industry Regulatory Authority and a similar examination by the SEC, both of which were initiated in the third quarter of 2012.

In July 2012, the U.S. Senate Permanent Subcommittee on Investigations held a hearing and released a report that was critical of, among other things, HSBC's AML/BSA compliance and compliance with OFAC sanctions.

In each of these regulatory and law enforcement matters, we have received Grand Jury subpoenas or other requests for information from U.S. Government or other agencies, and are cooperating fully and engaging in efforts to resolve matters through ongoing discussions with relevant authorities regarding a possible resolution, including potential fines, penalties and monetary forfeitures, although no agreement has been reached with respect to the imposition of fines, penalties and monetary forfeitures or the amounts that ultimately may have to be paid. The resolution of at least some of these matters is likely to involve the filing of corporate criminal as well as civil charges and the imposition of significant fines, penalties and/or monetary forfeitures. The prosecution of corporate criminal charges in these types of cases has most often been deferred through an agreement with the relevant authorities; however, the U.S. authorities have substantial discretion, and prior settlements can provide no assurance as to how the U.S. authorities will proceed in these matters. Fines, penalties and/or monetary forfeitures are assessed separately by each agency investigating these matters, and the amounts paid to one agency may or may not offset amounts payable to other agencies. It is not practicable at this time for us to know the terms on which a resolution of the ongoing investigations could be achieved or the form or timing of any such resolution. Based on the facts currently known, including our ongoing discussions with relevant authorities, we have recorded an accrual of \$1.5 billion. There is a high degree of uncertainty in making this estimate and it is reasonably possible that the amounts when finally determined could be higher, possibly significantly higher.

Other Regulatory and Law Enforcement Investigations. In April 2011, HSBC Bank USA received a "John Doe" summons from the Internal Revenue Service (the "IRS") directing us to produce records with respect to U.S.-based clients of an HSBC Group company in India. We have cooperated fully by providing responsive documents in our possession in the U.S. to the IRS, and engaging in efforts to resolve these matters.

We continue to cooperate in ongoing investigations by the U.S. Department of Justice and the IRS regarding whether certain HSBC Group companies acted appropriately in relation to certain customers who had U.S. tax reporting requirements.

In April 2011, HSBC Bank USA received a subpoena from the SEC directing HSBC Bank USA to produce records in the United States related to, among other things, HSBC Private Bank Suisse SA's cross-border policies and procedures and adherence to U.S. broker-dealer and investment adviser rules and regulations when dealing with U.S. resident clients. HSBC Bank USA continues to cooperate with the SEC.

Based on the facts currently known, in respect of each of these investigations, it is not practicable at this time for us to determine the terms on which these ongoing investigations will be resolved or the timing of such resolution

or for us to estimate reliably the amounts, or range of possible amounts, of any fines and/or penalties. As matters progress, it is possible that any fines and/or penalties could be significant.

Mortgage Securitization Activity In addition to the repurchase risk described in Note 20, “Guarantee Arrangements and Pledged Assets,” we have also been involved as a sponsor/seller of loans used to facilitate whole loan securitizations underwritten by HSI. In this regard, beginning in 2005 we began acquiring residential mortgage loans, the vast majority of which were originated by non-HSBC entities, that were warehoused on our balance sheet with the intent of selling them to HSI to facilitate HSI’s whole loan securitization program which was discontinued in the second half of 2007. During 2005-2007, we purchased and sold \$24 billion of such loans to HSI which were subsequently securitized and sold by HSI to third parties. The outstanding principal balance on these loans was approximately \$7.7 billion and \$8.5 billion at September 30, 2012 and December 31, 2011, respectively. Based on the specifics of these transactions, the obligation to repurchase loans in the event of a breach of loan level representations and warranties resides predominantly with the organization that originated the loan. Certain of these originators, however, are or may become financially impaired and, therefore, unable to fulfill their repurchase obligations.

Participants in the U.S. mortgage securitization market that purchased and repackaged whole loans have been the subject of lawsuits and governmental and regulatory investigations and inquiries, which have been directed at groups within the U.S. mortgage market, such as servicers, originators, underwriters, trustees or sponsors of securitizations, and at particular participants within these groups. As the industry’s residential mortgage foreclosure issues continue, HSBC Bank USA has taken title to an increasing number of foreclosed homes as trustee on behalf of various securitization trusts. As nominal record owner of these properties, HSBC Bank USA has been sued by municipalities and tenants alleging various violations of law, including laws regarding property upkeep and tenants’ rights. While we believe and continue to maintain that the obligations at issue and any related liability are properly those of the servicer of each trust, we continue to receive significant and adverse publicity in connection with these and similar matters, including foreclosures that are serviced by others in the name of “HSBC, as trustee.”

HSBC Bank USA and certain of our affiliates have been named as defendants in a number of actions in connection with residential mortgage-backed securities (“RMBS”) offerings, which generally allege that the offering documents for securities issued by securitization trusts contained material misstatements and omissions, including statements regarding the underwriting standards governing the underlying mortgage loans. In September 2011, the Federal Housing Finance Agency (the “FHFA”), acting in its capacity as conservator for the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”), filed an action in the U.S. District Court for the Southern District of New York against HSBC Bank USA, HSBC USA, HSBC North America, HSI, HSI Asset Securitization Corporation (“HASCO”) and five former and current officers and directors of HASCO seeking damages or rescission of mortgage-backed securities purchased by Fannie Mae and Freddie Mac that were either underwritten or sponsored by HSBC entities. The aggregate unpaid principal balance of the securities was approximately \$1.8 billion at September 30, 2012. This action, captioned *Federal Housing Finance Agency, as Conservator for the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation v. HSBC North America Holdings Inc. et al.* (S.D.N.Y. No. CV 11-6189-LAK), is one of a series of similar actions filed against 17 financial institutions alleging violations of federal and state securities laws in connection with the sale of private-label RMBS purchased by Fannie Mae and Freddie Mac, primarily from 2005 to 2008. This action, along with all of the similar FHFA RMBS actions that were filed in the U.S. District Court for the Southern District of New York, were transferred to a single judge, who directed the defendant in the first-filed matter, UBS, to file a motion to dismiss. In May 4, 2012, the District Court filed its decision on UBS’ motion denying the motion to dismiss FHFA’s securities law claims and granting the motion to dismiss FHFA’s negligent misrepresentation claims. The District Court’s ruling will form the basis for rulings on the other matters, including the action filed against HSBC Bank USA and our affiliates. Subsequently, UBS sought leave to appeal to the U.S. Court of Appeals for the Second Circuit on certain issues raised in the motion to dismiss. The District Court and the Court of Appeals

granted the request for leave to appeal, and this appeal is pending before the Court of Appeals. This action is at a very early stage. At this time we are unable to reasonably estimate the liability, if any, that might arise as a result of this action.

In January 2012, Deutsche Zentral-Genossenschaftsbank (“DZ Bank”) filed a summons with notice in New York County Supreme Court, State of New York, naming as defendants HSBC North America, HSBC USA, HSBC Bank USA, HSBC Markets (USA) Inc., HASCO and HSI in connection with DZ Bank’s alleged purchase of \$122.4 million in RMBS from the HSBC defendants. In February 2012, HSH Nordbank AG (“HSH”) filed a summons with notice in New York County Supreme Court, State of New York, naming as defendants HSBC Holdings plc, HSBC North America Holdings Inc., HSBC USA, HSBC Bank USA, HSBC Markets (USA) Inc., HASCO, and two Blaylock entities alleging HSH purchases of \$41.3 million in RMBS from the HSBC and Blaylock defendants. In May 2012, HSBC removed both the DZ Bank and HSH cases to the United States District Court for the Southern District of New York. The cases were consolidated in an action captioned *Deutsche Zentral-Genossenschaftsbank AG, New York Branch v. HSBC North America Holdings Inc. et al* (S.D.N.Y. No. 12-CV-4025) following removal. In September 2012, DZ Bank and HSH filed a consolidated complaint against all defendants named in their prior summonses other than HSBC Holdings plc. The consolidated complaint seeks recovery on fraud and other common law theories.

In February 2012, Sealink Funding Ltd. (“Sealink”) filed a summons with notice in New York County Supreme Court, State of New York, naming as defendants 49 entities, including HSBC North America, HSBC USA, HSBC Markets (USA) Inc. and HSI. The summons alleges that Sealink purchased \$948.8 million in RMBS from the defendants and has sustained unspecified damages as a result of material misrepresentations and omissions contained in the offering documents. The claims against the HSBC entities, who are named as underwriters of the related RMBS, are for (i) aiding and abetting fraud, (ii) negligent misrepresentation; (iii) breach of contract; and (iv) mutual mistake. Sealink has 120 days to serve the defendants with a complaint. In May 2012, Sealink filed a notice of discontinuance as to 43 of the defendants, including the HSBC entities.

In December 2010 and February 2011, we received subpoenas from the SEC seeking production of documents and information relating to our involvement, and the involvement of our affiliates, in specified private-label RMBS transactions as an issuer, sponsor, underwriter, depositor, trustee or custodian as well as our involvement as a servicer. We have also had preliminary contacts with other governmental authorities exploring the role of trustees in private-label RMBS transactions. In February 2011, we also received a subpoena from the U.S. Department of Justice (U.S. Attorney’s Office, Southern District of New York) seeking production of documents and information relating to loss mitigation efforts with respect to HUD-insured mortgages on residential properties located in the State of New York. In January 2012, our affiliate, HSI, was served with a Civil Investigative Demand by the Massachusetts State Attorney General seeking documents, information and testimony related to the sale of RMBS to public and private customers in the State of Massachusetts from January 2005 to the present. We expect this level of focus will continue and, potentially, intensify, so long as the U.S. real estate markets continue to be distressed. As a result, we may be subject to additional claims, litigation and governmental and regulatory scrutiny related to our participation in the U.S. mortgage securitization market, either individually or as a member of a group. We are unable to reasonably estimate the financial effect of any action or litigation relating to these matters. As situations develop, it is possible that any related claims could be significant.

22. Fair Value Measurements

Accounting principles related to fair value measurements provide a framework for measuring fair value and focus on an exit price that would be received to sell an asset or paid to transfer a liability in the principal market (or in the absence of the principal market, the most advantageous market) accessible in an orderly transaction between willing market participants (the “Fair Value Framework”). Where required by the applicable accounting standards, assets and liabilities are measured at fair value using the “highest and best use” valuation premise. Amendments to the fair value measurement guidance, which became effective in 2012 clarifies that financial instruments do not have alternative uses and, as such, the fair value of financial instruments should be determined on an individual instrument basis using an “in-exchange” valuation premise. However, the fair value

measurement literature provides a valuation exception and permits an entity to measure the fair value of a group of financial assets and financial liabilities with offsetting credit risks and/or market risks based on the exit price it would receive or pay to transfer the net risk exposure of a group of assets or liabilities if certain conditions are met. We elected to make fair value adjustments to a group of derivative instruments with offsetting credit risks and market risks, which include, but are not limited to, interest rate, foreign currency, equity and debt price, and commodity price risks as of the reporting date.

Fair Value Adjustments The best evidence of fair value is quoted market price in an actively traded market, where available. In the event listed price or market quotes are not available, valuation techniques that incorporate relevant transaction data and market parameters reflecting the attributes of the asset or liability under consideration are applied. Where applicable, fair value adjustments are made to ensure the financial instruments are appropriately recorded at fair value. The fair value adjustments reflect the risks associated with the products, contractual terms of the transactions, and the liquidity of the markets in which the transactions occur. The fair value adjustments are broadly categorized by the following types:

Credit risk adjustment – The credit risk adjustment is an adjustment to a group of financial assets and financial liabilities, predominantly derivative assets and derivative liabilities, to reflect the credit quality of the parties to the transaction in arriving at fair value. A credit valuation adjustment to a financial asset is required to reflect the default risk of the counterparty. A debit valuation adjustment to a financial liability is recorded to reflect the default risk of HUSI. Where applicable, we take into consideration the credit risk mitigating arrangements including collateral agreements and master netting arrangements in estimating the credit risk adjustments.

Liquidity risk adjustment – The liquidity risk adjustment reflects, among other things, (a) the cost that would be incurred to close out the market risks by hedging, disposing or unwinding the actual position (i.e., a bid-offer adjustment), and (b) the illiquid nature, other than the size of the risk position, of a financial instrument.

Input valuation adjustment – Where fair value measurements are determined using internal valuation model based on unobservable inputs, certain valuation inputs may be less readily determinable. There may be a range of possible valuation inputs that market participants may assume in determining the fair value measurement. The resultant fair value measurement has inherent measurement risk if one or more significant parameters are unobservable and must be estimated. An input valuation adjustment is necessary to reflect the likelihood that market participants may use different input parameters, and to mitigate the possibility of measurement error.

Fair Value Hierarchy The Fair Value Framework establishes a three-tiered fair value hierarchy as follows:

Level 1 quoted market price – Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2 valuation technique using observable inputs – Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are inactive, and measurements determined using valuation models where all significant inputs are observable, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 valuation technique with significant unobservable inputs – Level 3 inputs are unobservable inputs for the asset or liability and include situations where fair values are measured using valuation techniques based on one or more significant unobservable input.

Classification within the fair value hierarchy is based on whether the lowest level input that is significant to the fair value measurement is observable. As such, the classification within the fair value hierarchy is dynamic and can be transferred to other hierarchy levels in each reporting period. Transfers between leveling categories are assessed, determined and recognized at the end of each reporting period.

Valuation Control Framework We have established a control framework which is designed to ensure that fair values are either determined or validated by a function independent of the risk-taker. To that end, the ultimate

responsibility for the determination of fair values rests with Finance. Finance has established an independent price validation process to ensure that the assets and liabilities measured at fair value are properly stated.

A valuation committee, chaired by the Head of Business Finance of Global Banking and Markets, meets monthly to review, monitor and discuss significant valuation matters arising from credit and market risks. The committee is responsible for establishing valuation policies and procedures, approving the internal valuation techniques and models developed by the Quantitative Risk and Valuation Group (“QRVG”), reviewing and approving valuation adjustments pertaining to, among other things, unobservable inputs, market liquidity, selection of valuation model and counterparty credit risk. Significant valuation risks identified in business activities are corroborated and addressed by the committee members and, where applicable, are escalated to the Chief Financial Officer of HUSI and the Audit Committee of the Board of Directors.

Where fair value measurements are determined based on information obtained from independent pricing services or brokers, Finance applies appropriate validation procedures to substantiate fair value. For price validation purposes, quotations from at least two independent pricing sources are obtained for each financial instrument, where possible.

The following factors are considered in determining fair values:

- similarities between the asset or the liability under consideration and the asset or liability for which quotation is received;
- collaboration of pricing by referencing to other independent market data such as market transactions and relevant benchmark indices
- consistency among different pricing sources;
- the valuation approach and the methodologies used by the independent pricing sources in determining fair value;
- the elapsed time between the date to which the market data relates and the measurement date; and
- the source of the fair value information.

Greater weight is given to quotations of instruments with recent market transactions, pricing quotes from dealers who stand ready to transact, quotations provided by market-makers who structured such instrument and market consensus pricing based on inputs from a large number of survey participants. Any significant discrepancies among the external quotations are reviewed and adjustments to fair values are recorded where appropriate. Where the transaction volume of a specific instrument has been reduced and the fair value measurement becomes less transparent, Finance will apply more detailed procedures to understand and challenge the appropriateness of the unobservable inputs and the valuation techniques used by the independent pricing service. Where applicable, Finance will develop a fair value estimate using its own pricing model inputs to test reasonableness. Where fair value measurements are determined using internal valuation models, Finance will validate the fair value measurement by either developing unobservable inputs based on the industry consensus pricing surveys in which we participate or back testing by observing the actual settlements occurring soon after the measurement date. Any significant valuation adjustments are reported to and discussed with the valuation committee.

Fair Value of Financial Instruments The fair value estimates, methods and assumptions set forth below for our financial instruments, including those financial instruments carried at cost, are made solely to comply with disclosures required by generally accepted accounting principles in the United States and should be read in conjunction with the financial statements and notes included in this quarterly report.

The following table summarizes the carrying value and estimated fair value of our financial instruments at September 30, 2012 and December 31, 2011.

	September 30, 2012					December 31, 2011	
	Carrying Value	Fair Value	Level 1	Level 2	Level 3	Carrying Value	Fair Value
	(in millions)						
Financial assets:							
Short-term financial assets	\$ 17,203	\$ 17,203	\$ 1,385	\$ 15,313	\$ 505	\$ 27,534	\$ 27,534
Federal funds sold and securities purchased under resale agreements	11,678	11,678	-	11,678	-	3,109	3,104
Non-derivative trading assets	29,243	29,243	2,283	23,928	3,032	30,028	30,028
Derivatives	10,699	10,699	14	10,496	189	9,826	9,826
Securities	64,273	64,509	38,004	26,505	-	55,316	55,579
Commercial loans, net of allowance for credit losses	42,221	42,897	-	-	42,987	33,207	33,535
Commercial loans designated under fair value option and held for sale	424	424	-	424	-	378	378
Commercial loans held for sale	19	19	-	-	19	587	587
Consumer loans, net of allowance for credit losses	18,594	14,606	-	-	14,606	17,917	14,301
Consumer loans held for sale:							
Residential mortgages	548	568	-	-	568	2,058	2,071
Credit cards	-	-	-	-	-	416	416
Other consumer	65	65	-	-	65	231	231
Financial liabilities:							
Short-term financial liabilities	\$ 14,605	\$ 14,605	\$ -	\$ 14,605	\$ -	\$ 18,497	\$ 18,497
Deposits:							
Without fixed maturities	107,721	107,721	-	107,721	-	123,720	122,710
Fixed maturities	4,252	4,261	-	4,261	-	6,210	6,232
Deposits designated under fair value option	9,362	9,362	-	6,482	2,880	9,799	9,799
Non-derivative trading liabilities	7,214	7,214	323	6,891	-	7,342	7,342
Derivatives	15,125	15,125	41	14,871	213	8,440	8,440
Long-term debt	13,267	14,099	-	14,099	-	11,666	11,653
Long-term debt designated under fair value option	7,696	7,696	-	7,375	321	5,043	5,043

Loan values presented in the table above were determined using the Fair Value Framework for measuring fair value, which is based on our best estimate of the amount within a range of value we believe would be received in a sale as of the balance sheet date (i.e. exit price). The secondary market demand and estimated value for our loans has been heavily influenced by the prevailing economic conditions during the past few years, including house price depreciation, rising unemployment, changes in consumer behavior, and changes in discount rates. Many investors are non-bank financial institutions or hedge funds with high equity levels and a high cost of debt. For certain consumer loans, investors incorporate numerous assumptions in predicting cash flows, such as higher charge-off levels and/or slower voluntary prepayment speeds than we, as the servicer of these loans, believe will ultimately be the case. The investor discount rates reflect this difference in overall cost of capital as well as the potential volatility in the underlying cash flow assumptions, the combination of which may yield a significant pricing discount from our intrinsic value. The estimated fair values at September 30, 2012 and December 31, 2011 reflect these market conditions.

Assets and Liabilities Recorded at Fair Value on a Recurring Basis The following table presents information about our assets and liabilities measured at fair value on a recurring basis as of September 30, 2012 and December 31, 2011, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value.

	Fair Value Measurements on a Recurring Basis					
	Level 1	Level 2	Level 3	Gross Balance	Netting ⁽¹⁾	Net Balance
	(in millions)					
September 30, 2012:						
Assets:						
Trading securities, excluding derivatives:						
U.S. Treasury, U.S. Government agencies and sponsored enterprises	\$ 2,283	\$ 523	\$ -	\$ 2,806	\$ -	\$ 2,806
Collateralized debt obligations	-	-	678	678	-	678
Asset-backed securities:						
Residential mortgages	-	309	-	309	-	309
Corporate and other domestic debt securities	-	1,874	1,618	3,492	-	3,492
Debt securities issued by foreign entities:						
Corporate	-	5	724	729	-	729
Government	-	5,415	-	5,415	-	5,415
Equity securities	-	25	12	37	-	37
Precious metals trading	-	15,777	-	15,777	-	15,777
Derivatives ⁽²⁾ :						
Interest rate contracts	120	74,936	15	75,071	-	75,071
Foreign exchange contracts	12	13,982	186	14,180	-	14,180
Equity contracts	-	1,396	220	1,616	-	1,616
Precious metals contracts	1	759	11	771	-	771
Credit contracts	-	6,885	1,334	8,219	-	8,219
Other contracts	-	-	-	-	-	-
Derivatives netting	-	-	-	-	(89,158)	(89,158)
Total derivatives	133	97,958	1,766	99,857	(89,158)	10,699
Securities available-for-sale:						
U.S. Treasury, U.S. Government agencies and sponsored enterprises	37,962	17,496	-	55,458	-	55,458
Obligations of U.S. states and political subdivisions	-	815	-	815	-	815
Asset-backed securities:						
Residential mortgages	-	2	-	2	-	2
Commercial mortgages	-	264	-	264	-	264
Home equity	-	242	-	242	-	242
Student loans	-	-	-	-	-	-
Other	-	85	-	85	-	85
Corporate and other domestic debt securities	-	43	-	43	-	43
Debt securities issued by foreign entities:						
Corporate	-	839	-	839	-	839
Government	42	4,567	-	4,609	-	4,609
Equity securities	-	175	-	175	-	175
Loans ⁽³⁾	-	424	-	424	-	424
Intangible ⁽⁴⁾	-	-	173	173	-	173
Total assets	<u>\$40,420</u>	<u>\$146,838</u>	<u>\$4,971</u>	<u>\$192,229</u>	<u>\$(89,158)</u>	<u>\$103,071</u>
Liabilities:						
Deposits in domestic offices ⁽⁵⁾	\$ -	\$ 6,482	\$2,880	\$ 9,362	\$ -	\$ 9,362
Trading liabilities, excluding derivatives	323	6,891	-	7,214	-	7,214
Derivatives ⁽²⁾ :						
Interest rate contracts	88	75,296	1	75,385	-	75,385
Foreign exchange contracts	5	13,520	183	13,708	-	13,708
Equity contracts	-	985	189	1,174	-	1,174
Precious metals contracts	183	1,717	10	1,910	-	1,910
Credit contracts	-	7,458	1,033	8,491	-	8,491
Other	-	-	-	-	-	-
Derivatives netting	-	-	-	-	(85,543)	(85,543)
Total derivatives	276	98,976	1,416	100,668	(85,543)	15,125
Long-term debt ⁽⁶⁾	-	7,375	321	7,696	-	7,696
Total liabilities	<u>\$ 599</u>	<u>\$119,724</u>	<u>\$4,617</u>	<u>\$124,940</u>	<u>\$(85,543)</u>	<u>\$ 39,397</u>

	Fair Value Measurements on a Recurring Basis					
	Level 1	Level 2	Level 3	Gross Balance	Netting ⁽¹⁾	Net Balance
	(in millions)					
December 31, 2011:						
Assets:						
Trading securities, excluding derivatives:						
U.S. Treasury, U.S. Government agencies and sponsored enterprises	\$ 259	\$ 38	\$ -	\$ 297	\$ -	\$ 297
Collateralized debt obligations	-	52	703	755	-	755
Asset-backed securities:						
Residential mortgages	-	274	-	274	-	274
Home equity	-	1	-	1	-	1
Student loans	-	2	-	2	-	2
Corporate and other domestic debt securities	-	226	1,679	1,905	-	1,905
Debt securities issued by foreign entities:						
Corporate	-	1,958	253	2,211	-	2,211
Government	-	7,461	-	7,461	-	7,461
Equity securities	-	27	13	40	-	40
Precious metals trading	-	17,082	-	17,082	-	17,082
Derivatives ⁽²⁾ :						
Interest rate contracts	135	61,565	9	61,709	-	61,709
Foreign exchange contracts	4	15,440	221	15,665	-	15,665
Equity contracts	-	1,047	169	1,216	-	1,216
Precious metals contracts	171	1,641	30	1,842	-	1,842
Credit contracts	-	12,297	2,093	14,390	-	14,390
Derivatives netting	-	-	-	-	(84,996)	(84,996)
Total derivatives	310	91,990	2,522	94,822	(84,996)	9,826
Securities available-for-sale:						
U.S. Treasury, U.S. Government agencies and sponsored enterprises	22,467	22,142	-	44,609	-	44,609
Obligations of U.S. states and political subdivisions	-	600	-	600	-	600
Asset-backed securities:						
Residential mortgages	-	5	-	5	-	5
Commercial mortgages	-	451	-	451	-	451
Home equity	-	270	-	270	-	270
Student loans	-	12	-	12	-	12
Other	-	80	-	80	-	80
Corporate and other domestic debt securities	-	544	-	544	-	544
Debt securities issued by foreign entities:						
Corporate	-	1,235	-	1,235	-	1,235
Government	40	5,295	-	5,335	-	5,335
Equity securities	-	140	-	140	-	140
Loans ⁽³⁾	-	367	11	378	-	378
Intangible ⁽⁴⁾	-	-	220	220	-	220
Total assets	\$23,076	\$150,252	\$5,401	\$178,729	\$(84,996)	\$ 93,733
Liabilities:						
Deposits in domestic offices ⁽⁵⁾	\$ -	\$ 6,932	\$2,867	\$ 9,799	\$ -	\$ 9,799
Trading liabilities, excluding derivatives	321	7,021	-	7,342	-	7,342
Derivatives ⁽²⁾ :						
Interest rate contracts	66	62,702	-	62,768	-	62,768
Foreign exchange contracts	13	15,191	222	15,426	-	15,426
Equity contracts	-	999	252	1,251	-	1,251
Precious metals contracts	32	1,186	30	1,248	-	1,248
Credit contracts	-	13,553	740	14,293	-	14,293
Derivatives netting	-	-	-	-	(86,546)	(86,546)
Total derivatives	111	93,631	1,244	94,986	(86,546)	8,440
Long-term debt ⁽⁶⁾	-	4,957	86	5,043	-	5,043
Total liabilities	\$ 432	\$112,541	\$4,197	\$117,170	\$(86,546)	\$ 30,624

(1) Represents counterparty and cash collateral netting which allow the offsetting of amounts relating to certain contracts if certain conditions are met.

(2) Includes trading derivative assets of \$9.1 billion and \$8.8 billion and trading derivative liabilities of \$13.7 billion and \$6.8 billion as of September 30, 2012 and December 31, 2011, respectively, as well as derivatives held for hedging and commitments accounted for as derivatives.

(3) Includes leveraged acquisition finance and other commercial loans held for sale or risk-managed on a fair value basis for which we have elected to apply the fair value option. See Note 8, "Loans Held for Sale," for further information.

(4) Represents residential mortgage servicing rights. See Note 9, "Intangible Assets," for further information on residential mortgage servicing rights.

(5) Represents structured deposits risk-managed on a fair value basis for which we have elected to apply the fair value option.

(6) Includes structured notes and own debt issuances which we have elected to measure on a fair value basis.

Transfers between leveling categories are recognized at the end of each reporting period.

Transfers into/out of Levels 1 and 2 During the three and nine months ended September 30, 2012 and 2011, there were no transfers between Level 1 and Level 2 measurements.

Information on Level 3 assets and liabilities The following table summarizes additional information about changes in the fair value of Level 3 assets and liabilities during three and nine months ended September 30, 2012 and 2011. As a risk management practice, we may risk manage the Level 3 assets and liabilities, in whole or in part, using securities and derivative positions that are classified as Level 1 or Level 2 measurements within the fair value hierarchy. Since those Level 1 and Level 2 risk management positions are not included in the table below, the information provided does not reflect the effect of such risk management activities related to the Level 3 assets and liabilities.

	Total Gains and (Losses) Included in ⁽¹⁾							Transfers Into Level 3	Transfers Out of Level 3	Sep. 30, 2012	Current Period Unrealized Gains (Losses)
	Jul. 1, 2012	Trading Revenue (Loss)	Other Revenue	Other Comprehensive Income	Purch- ases	Issua- nces	Settle- ments				
(in millions)											
Assets:											
Trading assets, excluding derivatives:											
Collateralized debt obligations	\$ 658	\$ 44	\$ -	\$-	\$20	\$ -	\$(84)	\$ 40	\$ -	\$ 678	\$ 30
Corporate and other domestic debt securities	1,599	24	-	-	-	-	(5)	-	-	1,618	24
Corporate debt securities issued by foreign entities	688	41	-	-	(1)	-	(4)	-	-	724	35
Equity securities	12	1	-	-	-	-	(1)	-	-	12	1
Derivatives ⁽²⁾ :											
Interest rate contracts	12	-	2	-	-	-	-	-	-	14	1
Foreign exchange contracts	(25)	(12)	-	-	-	(1)	9	-	32	3	20
Equity contracts	(46)	84	-	-	-	-	(6)	1	(2)	31	71
Precious metals contracts	-	1	-	-	-	-	-	-	-	1	1
Credit contracts	921	(227)	-	-	-	-	(7)	(16)	(370)	301	(250)
Loans ⁽³⁾	-	-	-	-	-	-	-	-	-	-	-
Mortgage servicing rights ⁽⁴⁾	187	-	(20)	-	-	6	-	-	-	173	(19)
Total assets	<u>\$ 4,006</u>	<u>\$ (44)</u>	<u>\$(18)</u>	<u>\$-</u>	<u>\$19</u>	<u>\$ 5</u>	<u>\$(98)</u>	<u>\$ 25</u>	<u>\$(340)</u>	<u>\$ 3,555</u>	<u>\$ (86)</u>
Liabilities:											
Deposits in domestic offices	\$(2,908)	\$ (81)	\$ -	\$-	\$ -	\$(119)	\$ 94	\$ 2	\$ 132	\$(2,880)	\$ (79)
Long-term debt	(287)	(22)	-	-	-	(59)	2	-	45	(321)	(20)
Total liabilities	<u>\$(3,195)</u>	<u>\$(103)</u>	<u>\$ -</u>	<u>\$-</u>	<u>\$ -</u>	<u>\$(178)</u>	<u>\$ 96</u>	<u>\$ 2</u>	<u>\$ 177</u>	<u>\$(3,201)</u>	<u>\$ (99)</u>

	Total Gains and (Losses) Included in ⁽¹⁾							Transfers Into Level 3	Transfers Out of Level 3	Sep. 30, 2012	Current Period Unrealized Gains (Losses)
	Jan. 1, 2012	Trading Revenue (Loss)	Other Revenue	Other Comprehensive Income	Purch- ases	Issua- nces	Settle- ments				
(in millions)											
Assets:											
Trading assets, excluding derivatives:											
Collateralized debt obligations	\$ 703	\$ 101	\$ -	\$-	\$ 45	\$ -	\$(211)	\$ 40	\$ -	\$ 678	\$ 79
Corporate and other domestic debt securities	1,679	42	-	-	101	-	(204)	-	-	1,618	32
Corporate debt securities issued by foreign entities	253	107	-	-	388	-	(24)	-	-	724	101
Equity securities	13	-	-	-	-	-	(1)	-	-	12	-
Derivatives ⁽²⁾ :											
Interest rate contracts	9	-	5	-	-	-	-	-	-	14	4
Foreign exchange contracts	(1)	(31)	-	-	-	(6)	11	(3)	33	3	1
Equity contracts	(83)	147	-	-	-	-	(35)	-	2	31	93
Precious metals contracts	-	1	-	-	-	-	-	-	-	1	1
Credit contracts	1,353	(615)	-	-	-	-	(51)	(16)	(370)	301	(605)
Loans ⁽³⁾	11	-	-	-	-	-	-	-	(11)	-	(12)
Mortgage servicing rights ⁽⁴⁾	220	-	(67)	-	-	20	-	-	-	173	(66)
Total assets	<u>\$ 4,157</u>	<u>\$(248)</u>	<u>\$(62)</u>	<u>\$-</u>	<u>\$534</u>	<u>\$ 14</u>	<u>\$(515)</u>	<u>\$ 21</u>	<u>\$(346)</u>	<u>\$ 3,555</u>	<u>\$(372)</u>
Liabilities:											
Deposits in domestic offices	\$(2,867)	\$(158)	\$ -	\$-	\$ -	\$(675)	\$ 254	\$(41)	\$ 607	\$(2,880)	\$(129)
Long-term debt	(86)	(13)	-	-	-	(280)	7	(7)	58	(321)	(16)
Total liabilities	<u>\$(2,953)</u>	<u>\$(171)</u>	<u>\$ -</u>	<u>\$-</u>	<u>\$ -</u>	<u>\$(955)</u>	<u>\$ 261</u>	<u>\$(48)</u>	<u>\$ 665</u>	<u>\$(3,201)</u>	<u>\$(145)</u>

	Total Gains and (Losses) Included in ⁽¹⁾							Transfers Into Level 3	Transfers Out of Level 3	Sep. 30, 2011	Current Period Unrealized Gains (Losses)
	Jul. 1, 2011	Trading Revenue (Loss)	Other Revenue	Other Comprehensive Income	Purch- ases	Issua- nces	Settle- ments				
(in millions)											
Assets:											
Trading assets, excluding derivatives:											
Collateralized debt obligations	\$ 770	\$ (41)	\$ -	\$-	\$ 7	\$ -	\$(29)	\$ -	\$ -	\$ 707	\$ (48)
Corporate and other domestic debt securities	1,615	5	-	-	22	-	-	-	-	1,642	(5)
Corporate debt securities issued by foreign entities	271	(34)	-	-	-	-	-	-	-	237	(33)
Equity securities	16	(2)	-	-	-	-	(2)	-	-	12	(1)
Derivatives ⁽²⁾ :											
Interest rate contracts	3	-	9	-	-	-	-	-	-	12	9
Foreign exchange contracts	1	(2)	-	-	-	-	-	-	-	(1)	(1)
Equity contracts	(29)	(173)	-	-	-	-	(30)	(18)	94	(156)	(33)
Credit contracts	1,069	613	-	-	-	-	(13)	-	-	1,669	598
Loans ⁽³⁾	11	-	-	-	-	-	-	-	-	11	-
Mortgage servicing rights ⁽⁴⁾	363	-	(134)	-	-	-	8	-	-	237	(133)
Total assets	<u>\$ 4,090</u>	<u>\$ 366</u>	<u>\$(125)</u>	<u>\$-</u>	<u>\$29</u>	<u>\$ -</u>	<u>\$(66)</u>	<u>\$(18)</u>	<u>\$ 94</u>	<u>\$ 4,370</u>	<u>\$ 353</u>
Liabilities:											
Deposits in domestic offices	\$(4,719)	\$ 62	\$ -	\$-	\$ -	\$(588)	\$107	\$ -	\$207	\$(4,931)	\$ 68
Long-term debt	(685)	113	-	-	-	(22)	46	-	435	(113)	10
Total liabilities	<u>\$(5,404)</u>	<u>\$ 175</u>	<u>\$ -</u>	<u>\$-</u>	<u>\$ -</u>	<u>\$(610)</u>	<u>\$153</u>	<u>\$ -</u>	<u>\$642</u>	<u>\$(5,044)</u>	<u>\$ 78</u>

	Total Gains and (Losses) Included in ⁽¹⁾							Transfers Into Level 3	Transfers Out of Level 3	Sep. 30, 2011	Current Period Unrealized Gains (Losses)
	Jan. 1, 2011	Trading Revenue (Loss)	Other Revenue	Other Comprehensive Income	Purch- ases	Issua- nces	Settle- ments				
(in millions)											
Assets:											
Trading assets, excluding derivatives:											
Collateralized debt obligations . . .	\$ 793	\$(14)	\$ -	\$-	\$100	\$ -	\$(172)	\$ -	\$ -	\$ 707	\$(31)
Corporate and other domestic debt securities	833	-	-	-	814	-	(5)	-	-	1,642	-
Corporate debt securities issued by foreign entities	243	(6)	-	-	-	-	-	-	-	237	(6)
Equity securities	17	(2)	-	-	-	-	(3)	-	-	12	(2)
Derivatives ⁽²⁾ :											
Interest rate contracts	(1)	-	13	-	-	-	-	-	-	12	13
Foreign exchange contracts	(4)	3	-	-	-	-	-	-	-	(1)	3
Equity contracts	12	(93)	-	-	-	-	(188)	33	80	(156)	(109)
Credit contracts	1,202	562	-	-	-	-	(157)	-	62	1,669	441
Loans ⁽³⁾	11	-	-	-	-	-	-	-	-	11	-
Mortgage servicing rights ⁽⁴⁾	394	-	(189)	-	-	-	32	-	-	237	(189)
Total assets . . .	<u>\$ 3,500</u>	<u>\$450</u>	<u>\$(176)</u>	<u>\$-</u>	<u>\$914</u>	<u>\$ -</u>	<u>\$(493)</u>	<u>\$ 33</u>	<u>\$142</u>	<u>\$ 4,370</u>	<u>\$ 120</u>
Liabilities:											
Deposits in domestic offices	\$(3,612)	\$(29)	\$ -	\$-	\$ -	\$(1,865)	\$ 348	\$(25)	\$252	\$(4,931)	\$ 67
Long-term debt	(301)	101	-	-	-	(621)	189	(3)	521	(114)	12
Total liabilities . . .	<u>\$(3,913)</u>	<u>\$ 72</u>	<u>\$ -</u>	<u>\$-</u>	<u>\$ -</u>	<u>\$(2,486)</u>	<u>\$ 537</u>	<u>\$(28)</u>	<u>\$773</u>	<u>\$(5,045)</u>	<u>\$ 79</u>

(1) Includes realized and unrealized gains and losses.

(2) Level 3 net derivatives included derivative assets of \$1.8 billion and \$2.8 billion and derivative liabilities of \$1.4 billion and \$1.3 billion as of September 30, 2012 and 2011, respectively.

(3) Includes Level 3 corporate lending activities risk-managed on a fair value basis for which we have elected the fair value option.

(4) See Note 9, "Intangible Assets," for additional information.

The following table presents quantitative information about recurring fair value measurement of assets and liabilities classified as Level 3 fair value measurements as of September 30, 2012.

Financial Instrument Type	Fair Value (in millions)	Valuation Technique(s)	Significant Unobservable Inputs	Range of Inputs
Collateralized debt obligations	\$ 678	Broker quotes or consensus pricing and, where applicable, discounted cash flows	Prepayment rates	0% - 6%
			Constant default rates	4% - 14%
			Loss severity rates	50% - 100%
Corporate and other domestic debt securities	1,618	Option adjusted discounted cash flows	Option adjusted spread	446 basis points
		Discounted cash flows	Spread volatility on collateral assets	1.54% - 4.17%
			Correlation between insurance claim shortfall and collateral value	80%
Corporate debt securities issued by foreign entities	724	Discounted cash flows	Correlations of default among a portfolio of credit names of embedded credit derivatives	29.0% - 29.2%
Equity securities (investments in hedge funds)	12	Net asset value of hedge funds	Range of fair value adjustments to reflect restrictions on timing and amount of redemption and realization risks	0% - 90%
Interest rate derivative contracts	14	Market comparable adjusted for probability to fund	Probability to fund for rate lock commitments	NM ⁽¹⁾
Foreign exchange derivative contracts ⁽⁴⁾	3	Option pricing model	Foreign exchange volatility and correlation of a basket of currencies	NM ⁽²⁾⁽³⁾
Equity derivative contracts ⁽⁴⁾	31	Option pricing model	Price volatility of underlying equity and correlations of equities with a basket or index	NM ⁽²⁾⁽³⁾
Precious metals contracts	1	Option pricing model	Precious metals price volatility and correlation of a basket of precious metals	NM ⁽²⁾⁽³⁾
Credit derivative contracts	301	Option pricing model	Correlation of defaults of a portfolio of reference credit names	40.4% - 43.4%
			Industry by industry correlation of defaults	48% - 75%
Mortgage servicing rights	173	Option adjusted discounted cash flow	Constant prepayment rates	8.3% - 48.2%
			Option adjusted spread	8.07% - 19.07%
			Estimated annualized costs to service	\$98 - \$263 per account
Deposits in domestic offices (Structured deposits)	(2,880)	Option adjusted discounted cash flows	Foreign exchange volatility and correlations of a currency basket within the embedded derivative feature	NM ⁽³⁾
			Equity price volatility and correlations of equity baskets or index within the embedded derivative feature	
Long-term debt (Structured notes)	(321)	Option adjusted discounted cash flows	Foreign exchange volatility and correlations of a currency basket within the embedded derivative feature	NM ⁽³⁾
			Equity price volatility and correlations of equity baskets or index within the embedded derivative feature	

⁽¹⁾ Insignificant Level 3 measurement. Disclosure is not meaningful to users.

- (2) We are the client-facing entity and we enter into identical but opposite derivatives to transfer the resultant risks to our affiliates. With the exception of counterparty credit risks, we are market neutral. As a result, the range of significant unobservable inputs is not meaningful as the net risk positions are not significant.
- (3) The structured notes and structured deposits contain embedded equity or foreign currency derivatives. For financial reporting purposes, we measure the financial instruments at fair value in entirety with changes in fair value recorded in the income statement. For the presentation of this table, we have separated the embedded derivatives from the financial instruments and included them in the equity derivative, foreign currency derivative and precious metals derivatives categories to reflect the underlying risks are managed through identical but offsetting derivatives with affiliates (also see note (2) above).
- (4) Excludes Level 3 inputs for a partially funded total return swap with a third party investor for which we fully hedge the market risks by holding the underlying foreign currency denominated security.

Sensitivity of Level 3 Inputs to Fair Value Measurements

Collateralized Debt Obligations – Probability of default, prepayment speed and loss severity rate are significant unobservable inputs. Significant increase (decrease) in these inputs will result in a lower (higher) fair value measurement of a collateralized debt obligation. A change in assumption for default probability is often accompanied by a directionally similar change in loss severity, and a directionally opposite change in prepayment speed.

Corporate and Domestic Debt Securities – The fair value measurements of certain corporate debt securities are affected by the fair value of the underlying portfolios of investments used as collateral and the make-whole guarantee provided by third party guarantors. The probability that the collateral fair value declines below the collateral call threshold concurrent with the guarantors failure to perform its make whole obligation is unobservable. The increase (decrease) in the probability the collateral value falls below the collateral call threshold is often accompanied by a directionally similar change in default probability of the guarantor.

Credit derivatives – Correlation of default among a basket of reference credit names is a significant unobservable input if the credit attributes of the portfolio are not within the parameters of relevant standardized CDS indices. Significant increase (decrease) in the unobservable input will result in a lower (higher) fair value measurement of the credit derivative. A change in assumption for default correlation is often accompanied by a directionally similar change in default probability and loss rates of other credit names in the basket.

Equity and foreign currency derivatives – The fair value measurement of a structured equity or foreign currency derivative is primarily affected by the implied volatility of the underlying equity price or exchange rate of the paired foreign currencies. The implied volatility is not observable. Significant increase (decrease) in the implied volatility will result in a higher (lower) fair value of a long position in the derivative contract.

Material Additions to and Transfers Into (Out of) Level 3 Measurements During both the three and nine months ended September 30, 2012, we transferred \$370 million of credit derivatives from Level 3 to Level 2 as a result of a qualitative analysis of the foreign exchange and credit correlation attributes of our model used for certain credit default swaps. In addition, during the three and nine months ended September 30, 2012, we transferred \$132 million and \$607 million, respectively, of deposits in domestic offices, which we have elected to carry at fair value, from Level 3 to Level 2 as a result of the embedded derivative no longer being unobservable as the derivative option is closer to maturity and there is more observability in short term volatility.

During the nine months ended September 30, 2011, we transferred \$62 million of credit derivatives from Level 3 to Level 2 as a result of a qualitative analysis of the foreign exchange and credit correlation attributes of our model used for certain credit default swaps. There were no significant transfers of derivatives during the three months ended September 30, 2011. In addition, during the three and nine months ended September 30, 2011, we transferred \$435 million and \$521 million, respectively, of long-term debt from Level 3 to Level 2. The long-term debt relates to medium term debt issuances where the embedded derivative is no longer unobservable as the derivative option is closer in maturity and there is more observability in short term volatility.

Assets and Liabilities Recorded at Fair Value on a Non-recurring Basis Certain financial and non-financial assets are measured at fair value on a non-recurring basis and therefore, are not included in the tables above. These assets include (a) mortgage and consumer loans classified as held for sale reported at the lower of amortized cost or fair value and (b) impaired loans or assets that are written down to fair value based on the valuation of underlying collateral during the period. These instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustment in certain circumstances (e.g., impairment). The following table presents the fair value hierarchy level within which the fair value of the financial and non-financial assets has been recorded as of September 30, 2012 and 2011. The gains (losses) during the three and nine months ended September 30, 2012 and 2011 are also included.

	Non-Recurring Fair Value Measurements as of September 30, 2012				Total Gains (Losses) For the Three Months Ended September 30, 2012	Total Gains (Losses) For the Nine Months Ended September 30, 2012
	Level 1	Level 2	Level 3	Total		
(in millions)						
Residential mortgage loans held for sale ⁽¹⁾	\$-	\$ -	\$108	\$108	\$ 3	\$ (4)
Other consumer loans held for sale ⁽¹⁾	-	-	65	65	-	-
Impaired loans ⁽²⁾	-	-	309	309	(4)	(27)
Real estate owned ⁽³⁾	-	18	-	18	1	3
Commercial loans held for sale	-	19	-	19	-	-
Total assets at fair value on a non-recurring basis	<u>\$-</u>	<u>\$37</u>	<u>\$482</u>	<u>\$519</u>	<u>\$ -</u>	<u>\$(28)</u>
(in millions)						
	Non-Recurring Fair Value Measurements as of September 30, 2011				Total Gains (Losses) For the Three Months Ended September 30, 2011	Total Gains (Losses) For the Nine Months Ended September 30, 2011
	Level 1	Level 2	Level 3	Total		
(in millions)						
Residential mortgage loans held for sale ⁽¹⁾	\$-	\$ 5	\$228	\$233	\$(10)	\$(16)
Other consumer loans held for sale ⁽¹⁾	-	-	71	71	-	-
Impaired loans ⁽²⁾	-	-	415	415	(8)	44
Real estate owned ⁽³⁾	-	28	-	28	(1)	(4)
Commercial loans held for sale	-	32	-	32	-	-
Impairment of certain previously capitalized software development costs ⁽⁴⁾	-	-	-	-	-	(94)
Building held for sale	-	-	-	-	-	(5)
Total assets at fair value on a non-recurring basis	<u>\$-</u>	<u>\$65</u>	<u>\$714</u>	<u>\$779</u>	<u>\$(19)</u>	<u>\$(75)</u>

⁽¹⁾ As of September 30, 2012 and 2011, the fair value of the loans held for sale was below cost. Certain residential mortgage loans held for sale have been classified as a Level 3 fair value measurement within the fair value hierarchy as the underlying real estate properties which determine fair value are illiquid assets as a result of market conditions and significant inputs in estimating fair value were unobservable. Additionally, the fair value of these properties is affected by, among other things, the location, the payment history and the completeness of the loan documentation.

⁽²⁾ Represents impaired commercial loans. Certain commercial loans have undergone troubled debt restructurings and are considered impaired. As a matter of practical expedient, we measure the credit impairment of a collateral-dependent loan based on the fair value of the collateral. The collateral often involves real estate properties that are illiquid due to market conditions. As a result, these commercial loans are classified as a Level 3 fair value measurement within the fair value hierarchy.

⁽³⁾ Real estate owned are required to be reported on the balance sheet net of transactions costs. The real estate owned amounts in the table above reflect the fair value unadjusted for transaction costs.

⁽⁴⁾ In the first quarter of 2011 it was determined that certain previously capitalized software development costs were no longer realizable as a result of the decision to cancel certain projects and, therefore, we recorded an impairment charge of \$78 million representing the full amount of the developed software capitalized associated with these projects. The impairment charge was recorded in other expenses in our consolidated statement of income (loss) and is included in the results of our RBWM and CMB segment. During the second quarter of

2011, HSBC completed a comprehensive review of all platforms currently under development which resulted in additional projects being cancelled. As a result, we recorded an additional charge of \$16 million relating to the impairment of certain previously capitalized software development costs relating to these projects which were determined to be no longer realizable. The impairment charges were recorded in other expenses in our consolidated statement of income (loss) and are included in the results of our segments principally in RBWM and CMB.

The following table presents quantitative information about non-recurring fair value measurements of assets and liabilities classified with Level 3 of the fair value hierarchy as of September 30, 2012.

Financial Instrument Type	Fair Value (in millions)	Valuation Technique(s)	Significant Unobservable Inputs	Range of Inputs
Residential mortgage loans held for sale	\$108	Valuation of third party appraisal on underlying collateral	Loss severity rates	-% - 90%
Impaired loans	309	Valuation by third party appraisal on underlying collateral	Loss severity rates	2% - 61%

Valuation Techniques Following is a description of valuation methodologies used for assets and liabilities recorded at fair value and for estimating fair value for those financial instruments not recorded at fair value for which fair value disclosure is required.

Short-term financial assets and liabilities – The carrying amount of certain financial assets and liabilities recorded at cost is considered to approximate fair value because they are short-term in nature, bear interest rates that approximate market rates, and generally have negligible credit risk. These items include cash and due from banks, interest bearing deposits with banks, accrued interest receivable, customer acceptance assets and liabilities and short-term borrowings.

Federal funds sold and purchased and securities purchased and sold under resale and repurchase agreements – Federal funds sold and purchased and securities purchased and sold under resale and repurchase agreements are recorded at cost. A significant majority of these transactions are short-term in nature and, as such, the recorded amounts approximate fair value. For transactions with long-dated maturities, fair value is based on dealer quotes for instruments with similar terms and collateral.

Loans – Except for leveraged loans, selected residential mortgage loans and certain foreign currency denominated commercial loans, we do not record loans at fair value on a recurring basis. From time to time, we record on a non-recurring negative basis adjustment to loans. The write-downs can be based on observable market price of the loan or the underlying collateral value. In addition, fair value estimates are determined based on the product type, financial characteristics, pricing features and maturity.

- **Mortgage Loans Held for Sale** – Certain residential mortgage loans are classified as held for sale and are recorded at the lower of amortized cost or fair value. The fair value of these mortgage loans is determined based on the valuation information observed in alternative exit markets, such as the whole loan market, adjusted for portfolio specific factors. These factors include the location of the collateral, the loan-to-value ratio, the estimated rate and timing of default, the probability of default or foreclosure and loss severity if foreclosure does occur.
- **Leveraged Loans** – We record leveraged loans and revolvers held for sale at fair value. Where available, market consensus pricing obtained from independent sources is used to estimate the fair value of the leveraged loans and revolvers. In determining the fair value, we take into consideration the number of participants submitting pricing information, the range of pricing information and distribution, the methodology applied by the pricing services to cleanse the data and market liquidity. Where consensus pricing information is not available, fair value is estimated using observable market prices of similar instruments or inputs, including

bonds, credit derivatives, and loans with similar characteristics. Where observable market parameters are not available, fair value is determined based on contractual cash flows, adjusted for the probability of default and estimated recoveries where applicable, discounted at the rate demanded by market participants under current market conditions. In those cases, we also consider the loan specific attributes and inherent credit risk and risk mitigating factors such as collateral arrangements in determining fair value.

- Commercial Loans – Commercial loans and commercial real estate loans are valued by discounting the contractual cash flows, adjusted for prepayments and the borrower’s credit risk, using a discount rate that reflects the current rates offered to borrowers of similar credit standing for the remaining term to maturity and our own estimate of liquidity premium.
- Commercial impaired loans – Fair value is determined primarily by an analysis of discounted expected cash flows with a reference to independent valuations of underlying loan collateral and considering secondary market prices for distressed debt, where applicable.
- Consumer Loans – The estimated fair value of our consumer loans were determined by developing an approximate range of value from a mix of various sources as appropriate for the respective pool of assets. These sources included, among other things, value estimates from an HSBC affiliate which reflect over-the-counter trading activity, forward looking discounted cash flow models using assumptions we believe are consistent with those which would be used by market participants in valuing such receivables; trading input from other market participants which includes observed primary and secondary trades; where appropriate, the impact of current estimated rating agency credit tranching levels with the associated benchmark credit spreads; and general discussions held directly with potential investors. For revolving products, the estimated fair value excludes future draws on the available credit line as well as other items and, therefore, does not include the fair value of the entire relationship.

Valuation inputs include estimates of future interest rates, prepayment speeds, default and loss curves, estimated collateral value and market discount rates reflecting management’s estimate of the rate that would be required by investors in the current market given the specific characteristics and inherent credit risk of the receivables. Some of these inputs are influenced by collateral value changes and unemployment rates. To the extent available, such inputs are derived principally from or corroborated by observable market data by correlation and other means. We perform analytical reviews of fair value changes on a quarterly basis and periodically validate our valuation methodologies and assumptions based on the results of actual sales of such receivables. In addition, from time to time, we may engage a third party valuation specialist to measure the fair value of a pool of receivables. Portfolio risk management personnel provide further validation through discussions with third party brokers and other market participants. Since an active market for these receivables does not exist, the fair value measurement process uses unobservable significant inputs specific to the performance characteristics of the various receivable portfolios.

Lending-related commitments – The fair value of commitments to extend credit, standby letters of credit and financial guarantees are not included in the table. The majority of the lending related commitments are not carried at fair value on a recurring basis nor are they actively traded. These instruments generate fees, which approximate those currently charged to originate similar commitments, which are recognized over the term of the commitment period. Deferred fees on commitments and standby letters of credit totaled \$43 million and \$44 million at September 30, 2012 and December 31, 2011, respectively.

Precious metals trading – Precious metals trading primarily include physical inventory which are valued using spot prices.

Securities – Where available, debt and equity securities are valued based on quoted market prices. If a quoted market price for the identical security is not available, the security is valued based on quotes from similar securities, where possible. For certain securities, internally developed valuation models are used to determine fair values or validate quotes obtained from pricing services. The following summarizes the valuation methodology used for our major security classes:

- U.S. Treasury, U.S. Government agency issued or guaranteed and Obligations of U.S. state and political subdivisions – As these securities transact in an active market, fair value measurements are based on quoted prices for the identical security or quoted prices for similar securities with adjustments as necessary made using observable inputs which are market corroborated.
- U.S. Government sponsored enterprises – For certain government sponsored mortgage-backed securities which transact in an active market, fair value measurements are based on quoted prices for the identical security or quoted prices for similar securities with adjustments as necessary made using observable inputs which are market corroborated. For government sponsored mortgage-backed securities which do not transact in an active market, fair value is determined primarily based on pricing information obtained from pricing services and is verified by internal review processes.
- Asset-backed securities, including collateralized debt obligations – Fair value is primarily determined based on pricing information obtained from independent pricing services adjusted for the characteristics and the performance of the underlying collateral.

Additional information relating to asset-backed securities and collateralized debt obligations is presented in the following tables:

Trading asset-backed securities and related collateral:

Rating of Securities:	Collateral Type:	Prime		Alt-A		Sub-prime		Total
		Level 2	Level 3	Level 2	Level 3	Level 2	Level 3	
(in millions)								
AAA -A	Residential mortgages	\$-	\$-	\$68	\$-	\$178	\$-	\$246
	Home equity	-	-	-	-	-	-	-
	Student loans	-	-	-	-	-	-	-
	Other	-	-	-	-	-	-	-
	Total AAA -A	-	-	<u>68</u>	-	<u>178</u>	-	<u>246</u>
BBB -B	Residential mortgages	-	-	-	-	-	-	-
	Home equity	-	-	-	-	-	-	-
	Total BBB -B	-	-	-	-	-	-	-
CCC-Unrated	Residential mortgages	-	-	-	-	4	-	4
	Home equity	-	-	-	-	-	-	-
	Other	-	-	-	-	-	-	-
	Total CCC -Unrated	-	-	-	-	<u>4</u>	-	<u>4</u>
		<u>\$-</u>	<u>\$-</u>	<u>\$68</u>	<u>\$-</u>	<u>\$182</u>	<u>\$-</u>	<u>\$250</u>

Trading collateralized debt obligations and related collateral:

Rating of Securities:	Collateral Type:	Level 2	Level 3
	(in millions)		
AAA -A	Commercial mortgages	\$ -	\$ -
	Residential mortgages	-	-
	Student loans	58	-
	Other	-	-
	Total AAA -A	58	-
BBB -B	Commercial mortgages	-	122
	Corporate loans	-	330
	Other	-	162
	Total BBB -B	-	614
CCC -Unrated	Commercial mortgages	-	65
	Corporate loans	-	-
	Other	-	-
	Total CCC -Unrated	-	65
		<u>\$58</u>	<u>\$679</u>

Available-for-sale securities backed by collateral:

Rating of Securities:	Collateral Type:	Commercial Mortgages		Prime		Alt-A		Sub-prime		Total
		Level 2	Level 3	Level 2	Level 3	Level 2	Level 3	Level 2	Level 3	
		(in millions)								
AAA -A	Residential mortgages	\$ -	\$-	\$-	\$-	\$ -	\$-	\$-	\$-	\$ -
	Commercial mortgages	264	-	-	-	-	-	-	-	264
	Home equity	-	-	-	-	104	-	-	-	104
	Student loans	-	-	-	-	-	-	-	-	-
	Other	-	-	-	-	85	-	-	-	85
	Total AAA -A	264	-	-	-	189	-	-	-	453
BBB -B	Residential mortgages	-	-	-	-	-	-	-	-	-
	Home equity	-	-	-	-	77	-	-	-	77
	Total BBB -B	-	-	-	-	77	-	-	-	77
CCC -Unrated	Residential mortgages	-	-	-	-	2	-	-	-	2
	Home equity	-	-	-	-	62	-	-	-	62
	Total CCC -Unrated	-	-	-	-	64	-	-	-	64
		<u>\$264</u>	<u>\$-</u>	<u>\$-</u>	<u>\$-</u>	<u>\$330</u>	<u>\$-</u>	<u>\$</u>	<u>\$-</u>	<u>\$594</u>

- Other domestic debt and foreign debt securities (corporate and government) – Except for certain structured securities, substantially all of the domestic and foreign securities are classified as Level 3 measurements. For non-callable corporate securities, a credit spread scale is created for each issuer. These spreads are then added to the equivalent maturity U.S. Treasury yield to determine current pricing. Credit spreads are obtained from the new market, secondary trading levels and dealer quotes. For securities with early redemption features, an option adjusted spread (“OAS”) model is incorporated to adjust the spreads determined above. Additionally, we survey the broker/dealer community to obtain relevant trade data including benchmark quotes and updated spreads.

- Equity securities – Except for those legacy investments in hedge funds, since most of our securities are transacted in active markets, fair value measurements are determined based on quoted prices for the identical security. For mutual fund investments, we receive monthly statements from the investment manager with the estimated fair value.

Derivatives – Derivatives are recorded at fair value. Asset and liability positions in individual derivatives that are covered by legally enforceable master netting agreements, including cash collateral are offset and presented net in accordance with accounting principles which allow the offsetting of amounts relating to certain contracts.

Derivatives traded on an exchange are valued using quoted prices. OTC derivatives, which comprise a majority of derivative contract positions, are valued using valuation techniques. The fair value for the majority of our derivative instruments are determined based on internally developed models that utilize independently corroborated market parameters, including interest rate yield curves, option volatilities, and currency rates. For complex or long-dated derivative products where market data is not available, fair value may be affected by the choice of valuation model and the underlying assumptions about, among other things, the timing of cash flows and credit spreads. The fair values of certain structured derivative products are sensitive to unobservable inputs such as default correlations of the referenced credit and volatilities of embedded options. These estimates are susceptible to significant change in future periods as market conditions change.

Significant inputs related to derivative classes are broken down as follows:

- Credit Derivatives – Use credit default curves and recovery rates which are generally provided by broker quotes and various pricing services. Certain credit derivatives may also use correlation inputs in their model valuation. Correlation is derived using market quotes from brokers and various pricing services.
- Interest Rate Derivatives – Swaps use interest rate curves based on currency that are actively quoted by brokers and other pricing services. Options will also use volatility inputs which are also quoted in the broker market. We use the Overnight Indexed Swap (OIS) curves as inputs to measure the fair value of certain collateralized interest rate derivatives.
- Foreign Exchange (“FX”) Derivatives – FX transactions use spot and forward FX rates which are quoted in the broker market.
- Equity Derivatives – Use listed equity security pricing and implied volatilities from equity traded options position.
- Precious Metal Derivative – Use spot and forward metal rates which are quoted in the broker market.

We may adjust valuations derived using the methods described above in order to ensure that those values represent appropriate estimates of fair value. These adjustments, which are applied consistently over time, are generally required to reflect factors such as bid-ask spreads and counterparty credit risk that can affect prices in arms-length transactions with unrelated third parties. Such adjustments are based on management judgment and may not be observable.

Real estate owned – Fair value is determined based on third party appraisals obtained at the time we take title to the property and, if less than the carrying amount of the loan, the carrying amount of the loan is adjusted to the fair value. The carrying amount of the property is further reduced, if necessary, not less than once every 45 days to reflect observable local market data including local area sales data.

Mortgage servicing rights – We elected to measure residential mortgage servicing rights, which are classified as intangible assets, at fair value. The fair value for the residential mortgage servicing rights is determined based on an option adjusted approach which involves discounting servicing cash flows under various interest rate projections at risk-adjusted rates. The valuation model also incorporates our best estimate of the prepayment

speed of the mortgage loans, current cost to service and discount rates which are unobservable. As changes in interest rates is a key factor affecting the prepayment speed and hence the fair value of the mortgage servicing rights, we use various interest rate derivatives and forward purchase contracts of mortgage-backed securities to risk-manage the mortgage servicing rights.

Structured notes – Certain structured notes were elected to be measured at fair value in their entirety under fair value option accounting principles. As a result, derivative features embedded in the structured notes are included in the valuation of fair value. The valuation of embedded derivatives may include significant unobservable inputs such as correlation of the referenced credit names or volatility of the embedded option. Other significant inputs include interest rates (yield curve), time to maturity, expected loss and loss severity.

Cash flows of the funded notes are discounted at the appropriate rate for the applicable duration of the instrument adjusted for our own credit spreads. The credit spreads applied to these instruments are derived from the spreads at which institutions of similar credit standing would offer for issuing similar structured instruments as of the measurement date. The market spreads for structured notes are generally lower than the credit spreads observed for plain vanilla debt or in the credit default swap market.

Long-term debt – We elected to apply fair value option to certain own debt issuances for which fair value hedge accounting otherwise would have been applied. These own debt issuances elected under FVO are traded in secondary markets and, as such, the fair value is determined based on observed prices for the specific instrument. The observed market price of these instruments reflects the effect of our own credit spreads. The credit spreads applied to these instruments were derived from the spreads recognized in the secondary market for similar debt as of the measurement date.

For long-term debt recorded at cost, fair value is determined based on quoted market prices where available. If quoted market prices are not available, fair value is based on dealer quotes, quoted prices of similar instruments, or internally developed valuation models adjusted for own credit risks.

Deposits – For fair value disclosure purposes, the carrying amount of deposits with no stated maturity (e.g., demand, savings, and certain money market deposits), which represents the amount payable upon demand, is considered to generally approximate fair value. For deposits with fixed maturities, fair value is estimated by discounting cash flows using market interest rates currently offered on deposits with similar characteristics and maturities.

23. New Accounting Pronouncements

Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts In October 2010, the FASB issued guidance which amends the accounting rules that define which costs associated with acquiring or renewing insurance contracts qualify as deferrable acquisition costs by insurance entities. We adopted the new guidance effective January 1, 2012. The adoption of this guidance did not have a material impact on our financial position or results of operations.

Repurchase Agreements In April 2011, the FASB issued a new Accounting Standards Update related to repurchase agreements. This new guidance removes the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and the related collateral maintenance guidance from the assessment of effective control. As a result, an entity is no longer required to consider the sufficiency of the collateral exchanged but will evaluate the transferor's contractual rights and obligations to determine whether it maintains effective control over the transferred assets. The new guidance is required to be applied prospectively for all transactions that occur on or after January 1, 2012. Adoption did not have a material impact on our financial position or results of operations.

Fair Value Measurements and Disclosures In May 2011, the FASB issued an Accounting Standards Update to converge with newly issued IFRS 13, Fair Value Measurement. The new guidance clarifies that the application of

the highest and best use and valuation premise concepts are not relevant when measuring the fair value of financial assets or liabilities. This Accounting Standards Update also requires new and enhanced disclosures on the quantification and valuation processes for significant unobservable inputs, transfers between Levels 1 and 2, and the categorization of all fair value measurements into the fair value hierarchy, even where those measurements are only for disclosure purposes. We adopted the new disclosure requirements effective January 1, 2012. See Note 22, "Fair Value Measurement," in these consolidated financial statements.

Presentation of Comprehensive Income In June 2011, the FASB issued a new Accounting Standards Update on the presentation of other comprehensive income. This Update requires entities to present net income and other comprehensive income in either a single continuous statement or in two separate, but consecutive, statements of net income and other comprehensive income. The option to present items of other comprehensive income in the statement of changes in equity is eliminated. We adopted the new guidance effective January 1, 2012. See the Consolidated Statement of Comprehensive Income (Loss) and Note 14, "Accumulated Other Comprehensive Income," in these consolidated financial statements.

Goodwill In September 2011, the FASB issued an Accounting Standards Update which simplifies goodwill impairment testing. The new guidance provides entities with the option to first assess goodwill qualitatively to determine whether it is necessary to perform the required two-step quantitative goodwill impairment test. If it is determined that it is not more-likely-than-not that the fair value of the reporting unit is less than its carrying amount, then the two-step quantitative impairment test would not be required. An entity may, however, choose to bypass the qualitative assessment for any reporting unit in any period and move directly to the two-step impairment test. The guidance is effective for annual and interim goodwill impairment tests performed after January 1, 2012. Adoption of this guidance did not have a significant impact on our process for determining goodwill impairment.

Balance Sheet Offsetting In December 2011, the FASB issued an Accounting Standards Update that requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. Entities will be required to disclose both gross information and net information about instruments and transactions eligible for offset in the statement of financial position and those which are subject to an agreement similar to master netting arrangement. The new guidance is effective for all annual and interim periods beginning January 1, 2013. Additionally, entities will be required to provide the disclosures required by the new guidance retrospectively for all comparative periods. The adoption of this guidance will not have an impact on our financial position or results of operations.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with the consolidated financial statements, notes and tables included elsewhere in this report and with our Annual Report on Form 10-K for the year ended December 31, 2011 (the "2011 Form 10-K"). MD&A may contain certain statements that may be forward-looking in nature within the meaning of the Private Securities Litigation Reform Act of 1995. In addition, we may make or approve certain statements in future filings with the SEC, in press releases, or oral or written presentations by representatives of HSBC USA Inc. ("HSBC USA") that are not statements of historical fact and may also constitute forward-looking statements. Words such as "may," "will," "should," "would," "could," "appears," "believe," "intends," "expects," "estimates," "targeted," "plans," "anticipates," "goal" and similar expressions are intended to identify forward-looking statements but should not be considered as the only means through which these statements may be made. These matters or statements will relate to our future financial condition, economic forecast, results of operations, plans, objectives, performance or business developments and will involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from that which were expressed or implied by such forward-looking statements. Forward-looking statements are based on our current views and assumptions and speak only as of the date they are made. HSBC USA Inc. undertakes no obligation to update any forward-looking statement to reflect subsequent circumstances or events.

Executive Overview

HSBC USA Inc. is an indirect wholly owned subsidiary of HSBC Holdings plc ("HSBC"). HSBC USA Inc. and its subsidiaries may also be referred to in MD&A as "we," "us," or "our".

The following discussion of our financial condition and results of operations excludes the results of our discontinued operations from all periods presented unless otherwise noted. See Note 2, "Discontinued Operations," in the accompanying consolidated financial statements for further discussion of these operations.

Current Environment The U.S. economy continued its overall weak recovery during the third quarter of 2012. GDP is now expected to expand about 1.6% for the year, well below the economy's potential growth rate and markedly less than forecasts earlier in the year. Uncertainty remains an issue as businesses and markets look for clarity on Europe, the health of the U.S. economy and the future course of fiscal policy. The Conference Board's measure of consumer confidence reached its lowest point of the year in August before improving somewhat in September as sovereign debt fears in Europe and domestic fiscal uncertainties continue to play a role in diminishing sentiment and continue to impact interest rates and spreads. Weak consumer fundamentals including declines in wage income and a difficult job market also continue to influence consumer confidence. Serious threats to economic growth remain, including high energy costs, continued pressure on housing prices and elevated unemployment levels. Businesses continue to be cautious about the underlying strength of demand over the remainder of 2012 and are hesitant about ramping up their non-seasonal hiring activity. In September, Federal Reserve policy makers initiated a new round of quantitative easing designed to stimulate economic activity and announced that economic conditions are likely to warrant exceptionally low levels for the Federal funds rate at least through the middle of 2015. The prolonged period of low Federal funds rates continues to put pressure on spreads earned on our deposit base. While the housing markets in general began to rebound during the third quarter with overall home prices beginning to move higher as demand increased while the supply of homes for sale declined, housing prices will continue to remain under pressure in many markets as servicers resume foreclosure activities and the underlying properties are listed for sale.

While the economy continued to add jobs in the third quarter of 2012, the pace of new job creation continues to be slower than needed to meaningfully reduce unemployment. As a result, there continues to be uncertainty as to

how pronounced the economic recovery will be and whether it can be sustained. U.S. unemployment rates, which have been a major factor in the deterioration of credit quality in the U.S., remained high based on historical standards at 7.8 percent in September 2012. Also, a significant number of U.S. residents are no longer looking for work and, therefore, are not reflected in the U.S. unemployment rates. Unemployment has continued to have an impact on the provision for credit losses in our loan portfolio and in loan portfolios across the industry. Concerns about the future of the U.S. economy, including the pace and magnitude of recovery from the recent economic recession, consumer confidence, volatility in energy prices, credit market volatility, including the ability to permanently resolve the European sovereign debt crisis and trends in corporate earnings will continue to influence the U.S. economic recovery and the capital markets. In particular, continued improvement in unemployment rates, a sustained recovery of the housing markets and stabilization in energy prices remain critical components of a broader U.S. economic recovery. These conditions in combination with the impact of recent regulatory changes, including the continued implementation of the “Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010” (“Dodd-Frank”), will continue to impact our results in 2012 and beyond, the degree of which is largely dependent upon the pace and extent of the economic recovery.

Due to the significant slow-down in foreclosure processing which began in the second half of 2008, and in some instances the prior cessation of all foreclosure processing by numerous loan servicers in late 2010, there has been a reduction in the number of properties being marketed following foreclosure. This reduction has contributed to an increase in demand for properties currently on the market resulting in a general improvement in home prices in recent months but has also resulted in a larger number of vacant properties still pending foreclosure in certain communities. As servicers begin to increase foreclosure activities and market properties in large numbers, an over-supply of housing inventory could occur, creating downward pressure on property values and tempering any future home price improvement.

In addition, certain courts and state legislatures have issued new rules or statutes relating to foreclosures. Scrutiny of foreclosure documentation has increased in some courts. Also, in some areas, officials are requiring additional verification of information filed prior to the foreclosure proceeding. The combination of these factors has led to a significant backlog of foreclosures which will take time to resolve. If these trends continue, there could be additional delays in the processing of foreclosures, which could have an adverse impact upon housing prices.

Growing government indebtedness and a large budget deficit have resulted in a downgrade in the U.S. sovereign debt rating by one major rating agency and two major rating agencies having U.S. sovereign debt on a negative watch. There is an underlying risk that lower growth, fiscal challenges and a general lack of political consensus will result in continued scrutiny of the U.S. credit standing over the longer term. While the potential effects of the U.S. downgrade are broad and impossible to accurately predict, they could over time include a widening of sovereign and corporate credit spreads, devaluation of the U.S. dollar and a general market move away from riskier assets.

Performance, Developments and Trends Income (loss) from continuing operations was a loss of \$782 million and \$1.3 billion during the three and nine months ended September 30, 2012, respectively, compared to income of \$172 million and \$433 million during the three and nine months ended September 30, 2011, respectively. Income (loss) from continuing operations before income tax expense was a loss of \$794 million and \$938 million during the three and nine months ended September 30, 2012, respectively, compared to income of \$289 million and \$671 million during the three and nine months ended September 30, 2011, respectively. Income (loss) from continuing operations before income tax expense decreased during the three and nine months ended September 30, 2012 as compared to the prior year periods driven by higher operating expenses, lower net interest income, lower other revenue and a higher provision for credit losses. Other revenues in the three and nine months ended September 30, 2012 includes gains of \$103 million and \$433 million, respectively, from the sale of certain retail branches to First Niagara Bank, N.A. (“First Niagara”) and operating expenses in the three and nine months ended September 30, 2012 includes an expense accrual related to certain regulatory matters of \$800 million and \$1.5 billion, respectively. Also, both 2011 periods include a non-recurring impairment of leasehold

improvements associated with certain branch closures and in the nine month period ended September 30, 2011, a non-recurring impairment of software development costs. In addition, our results in all periods were also impacted by the change in the fair value of our own debt and the related derivatives for which we have elected fair value option. These items collectively distort the ability of investors to compare the underlying performance trends of our business. In order to better understand the underlying performance of our business, the following table summarizes the collective impact of these items on our income from continuing operations before income tax for all periods presented:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Income (loss) from continuing operations before income tax, as reported	\$(794)	\$ 289	\$ (938)	\$ 671
(Gain) loss in value of our own fair value option debt and related derivatives	171	(417)	243	(456)
Gain on sale of branches	(103)	-	(433)	-
Expense accrual related to certain regulatory matters ⁽¹⁾	800	-	1,500	-
Impairment of branch leasehold improvements	-	11	-	11
Impairment of software development costs	-	-	-	94
Income (loss) from continuing operations before income tax, excluding above items ⁽²⁾	<u>\$ 74</u>	<u>\$(117)</u>	<u>\$ 372</u>	<u>\$ 320</u>

⁽¹⁾ For additional discussion regarding expense accrual related to certain regulatory matters, see Note 21, "Litigation and Regulatory Matters," in the accompanying consolidated financial statements.

⁽²⁾ Represents a non-U.S. GAAP financial measure.

Excluding the collective impact of the items in the table above, our income from continuing operations before tax for the three and nine months ended September 30, 2012 improved compared to the prior year periods as higher other revenues and lower operating expenses were partially offset by lower net interest income and a higher provision for credit losses.

During the nine months ended September 30, 2012, we continued to reduce certain risk positions, largely related to legacy structured credit products in our Global Banking and Markets business, as opportunities arose. Improved market conditions and reduced outstanding exposure have resulted in an improvement in valuation adjustments recorded. A summary of the significant valuation adjustments that impacted revenue for the three and nine months ended September 30, 2012 and 2011 are presented in the following table.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Gains (Losses)				
Insurance monoline structured credit products ⁽¹⁾	\$16	\$ (16)	\$ 6	\$ 16
Other structured credit products ⁽¹⁾	49	(86)	123	39
Mortgage whole loans held for sale (predominantly subprime) ⁽²⁾	(9)	(8)	(12)	(22)
Leverage acquisition finance loans held for sale ⁽⁴⁾	14	(44)	48	(27)
Total gains (losses)	<u>\$70</u>	<u>\$(154)</u>	<u>\$165</u>	<u>\$ 6</u>

⁽¹⁾ Reflected in Trading revenue in the consolidated statement of income (loss).

⁽²⁾ Reflected in Other income in the consolidated statement of income (loss).

⁽³⁾ Reflected in Gain (loss) on instruments designated at fair value and related derivatives in the consolidated statement of income (loss).

As discussed above, other revenues in the three and nine months ended September 30, 2012 includes a gain from the sale of certain retail branches to First Niagara and in all periods reflects the impact of changes in value of our own debt and related derivatives for which we elected fair value option. Excluding the impact of these items, other revenues increased \$215 million and \$103 million during the three and nine months ended September 30, 2012, respectively, due primarily to higher trading revenue, higher other income and in the year-to-date period, higher securities gains, partially offset by lower other fees and commissions, lower credit card fees and lower mortgage banking revenue. The higher trading revenue was driven by improved credit market conditions which led to higher derivative trading revenue, as well as improvements in valuations associated with our legacy global markets businesses. The increase in other income reflects higher miscellaneous income driven by higher income associated with fair value hedge ineffectiveness, partially offset by lower earnings from equity investments. Securities gains were higher due to sales associated with a re-balancing of the portfolio for risk management purposes based on the low interest rate environment. Lower other fees and commissions were driven by lower debit card fees, while the lower credit card fees reflect lower outstanding balances driven by the sale of a portion of the portfolio to First Niagara. The lower mortgage banking revenue was largely driven by higher provisions for mortgage repurchase exposure on previously sold loans. See “Results of Operations” for a more detailed discussion of other revenues.

Net interest income was \$510 million and \$1.6 billion during the three and nine months ended September 30, 2012 compared to \$621 million and \$1.8 billion during the year-ago periods. The decrease in both periods reflects the impact of lower interest income on securities due to lower interest rates, partially offset by higher interest income on loans, driven by higher average balances on commercial loans due to new business volume. Also partially offsetting the decrease in the year-to-date period was lower interest charges related to estimated tax exposures. See “Results of Operations” for a more detailed discussion of net interest income.

Our provision for credit losses was \$84 million and \$173 million during the three and nine months ended September 30, 2012, respectively, compared to \$78 million and \$171 million during the three and nine months ended September 30, 2011, respectively. In our consumer loan portfolio, the provision for credit losses decreased in both periods primarily due to lower provisions in our residential mortgage loan portfolio driven by continued improvements in economic and credit conditions, including lower dollars of delinquency and improvements in loan delinquency roll rates, partially offset by higher charge-offs in our home equity mortgage portfolio due to an increased volume of loans where we have decided not to pursue foreclosure. In our commercial portfolio, the provision for credit losses was higher in both periods driven largely by increased levels of reserves for risk factors associated with expansion activities in the U.S. and in the nine month period, Latin America. In addition, the prior year periods reflect the benefit of a partial recovery on a previously charged-off loan relating to a single client relationship. See “Results of Operations” for a more detailed discussion of our provision for credit losses.

Operating expenses totaled \$1.6 billion and \$4.0 billion during the three and nine months ended September 30, 2012, respectively, an increase of 76 percent and 47 percent, respectively, compared to the year-ago periods. Operating expenses in the three and nine month periods ended September 30, 2012 reflects an expense accrual related to certain regulatory matters of \$800 million and \$1.5 billion, respectively and in the prior year-to-date period, an impairment of certain previously capitalized software development costs which totaled \$94 million. In addition, occupancy expense in both 2011 periods includes an \$11 million impairment of leasehold improvements associated with branch closure activity. Excluding the impact of these items, operating expenses decreased 10 percent and 4 percent, respectively, compared to the year-ago periods as lower salaries and benefits, lower occupancy costs, lower marketing costs, lower professional fees and, in the year-to-date period, lower FDIC assessment fees were partially offset in the year-to-date period by higher compliance costs. Compliance costs were a significant component of our cost base in 2012, totaling \$92 million and \$300 million in the three and nine months ended September 30, 2012, respectively, compared to \$116 million and \$211 million in the year-ago periods, largely attributable to investment in BSA/AML process enhancements and infrastructure. While we continue to focus attention on cost mitigation efforts in order to continue realization of optimal cost efficiencies, we expect compliance remediation related costs will remain elevated into 2013 as we continue to address the requirements of the regulatory consent agreements. See “Results of Operations” for a more detailed discussion of our operating expenses.

Our efficiency ratio from continuing operations was 178.28 percent during the three months ended September 30, 2012 compared to 71.51 percent during the year-ago quarter. Our efficiency ratio from continuing operations was 123.47 percent during the nine months ended September 30, 2012 compared to 76.51 percent during the year-ago period. Our efficiency ratio was impacted in all periods by the change in the fair value of our own debt and related derivatives for which we have elected fair value option accounting. Also impacting the efficiency ratio in both 2012 periods was the gain from the sale of certain non-strategic retail branches to First Niagara as well as an expense accrual related to certain regulatory matters and, in the prior year-to-date period, the impairment of certain software development costs and in both 2011 periods, the impairment of leasehold improvements associated with branch closure activity as discussed above. Excluding the impact of these items, our efficiency ratio improved to 83.79 percent and 82.24 percent in the three and nine months ended September 30, 2012, respectively, compared to 104.48 percent and 84.30 percent in the corresponding three and nine months ended September 30, 2011 as other revenues increased while operating expenses declined. While operating expenses adjusted for the items discussed above declined in both periods, driven by the impact of our retail branch divestitures and cost mitigation efforts, they continue to reflect elevated levels of compliance costs.

We continue to focus on cost optimization efforts to ensure realization of cost efficiencies. In an effort to create a more sustainable cost structure, a formal review was initiated in 2011 to identify areas where we may be able to streamline or redesign operations within certain functions to reduce or eliminate costs. To date, we have identified various opportunities to reduce costs through organizational structure redesign, vendor spending, discretionary spending and other general efficiency initiatives. Workforce reductions, some of which relate to organizational structure redesign, have resulted in total legal entity full-time equivalent employees being reduced by 25 percent since September 30, 2011 and 30 percent since December 21, 2010. Workforce reductions are also occurring in certain non-compliance shared services functions, which we expect will result in additional reductions to future allocated costs for these functions. The review is continuing and, as a result, we may incur restructuring charges in future periods, the amount of which will depend upon the actions that ultimately are implemented.

Our effective tax rate was (1.5) percent for the three months ended September 30, 2012 compared to 40.5 percent in the prior year quarter. Our effective tax rate was 38.1 percent for the nine months ended September 30, 2012 compared to 35.5 percent in the prior year period. The effective tax rate for the three and nine months ended September 30, 2012 reflects non-deductible goodwill related to the branches sold to First Niagara, a non-deductible expense accrual related to certain regulatory matters, prior period adjustments to the current liability account, including the reversal of an accrued foreign tax expense related to Brazilian withholding taxes corrected in the current year, changes in the uncertain tax reserve accrual, the utilization of low income housing credits and the impact of state taxes. The effective tax rate for the nine months ended September 30, 2012 also reflects the effect of a change in state rates used to value deferred taxes. The effective tax rate for the three and nine months ended September 30, 2011 primarily reflects the impact of foreign operations, the utilization of low income housing and other tax credits, the impact of state taxes, changes in uncertain tax positions and, as it relates to the nine month period, the release of valuation allowance reserves previously established on foreign tax credits.

In the third quarter of 2012, we added \$186 million of loans discharged under Chapter 7 bankruptcy and not re-affirmed to our residential mortgage TDR Loan balances, consistent with recently issued regulatory guidance. The impact on the allowance for credit losses was insignificant. These loans will be written down to the lower of amortized cost or fair value of the collateral less cost to sell during the fourth quarter of 2012.

We estimate probable losses for consumer loans and certain small balance commercial loans which do not qualify as troubled debt restructures using a roll rate migration analysis that estimates the likelihood that a loan will progress through the various stages of delinquency and ultimately charge-off. This has historically resulted in the identification of a loss emergence period for these loans collectively evaluated for impairment using a roll rate migration analysis which approximates less than 12 months of loss coverage in the allowance for credit losses for certain loan products. A loss coverage of 12 months in our allowance for credit losses would be more

aligned with U.S. bank industry practice. Our regulators have indicated they would like us to more closely align our loss coverage period with industry practice. During the fourth quarter of 2012, we will review our estimate of loss emergence to determine what changes should be made to our credit loss estimate which could result in an increase to our allowance for credit losses in the fourth quarter of 2012 in an amount that is not expected to exceed 15 percent of our total allowance for credit losses at September 30, 2012.

On May 1, 2012, HSBC, through its wholly-owned subsidiaries HSBC Finance Corporation, HSBC USA Inc. and other wholly-owned affiliates, completed the sale of its Card and Retail Services business to Capital One Financial Corporation (“Capital One”). The sale included our General Motors and Union Plus credit card receivables as well as our private label credit card and closed-end receivables, all of which were purchased from HSBC Finance. Prior to completing the transaction, we recorded cumulative lower of amortized cost or fair value adjustments on these receivables which were classified as held for sale on our balance sheet as a component of assets of discontinued operations totaling \$1.0 billion, of which \$440 million was recorded in the nine months ended September 30, 2012 and \$159 million was recorded in the three and nine months ended September 30, 2011, respectively. These fair value adjustments were largely offset by held for sale accounting adjustments in which loan impairment charges and premium amortization are no longer recorded. The total final cash consideration allocated to us was approximately \$19.2 billion, which did not result in the recognition of a gain or loss upon completion of the sale as the receivables were recorded at fair value.

In May 2012, we completed the sale of 138 branches to First Niagara and recognized an after-tax gain, net of allocated non-deductible goodwill, of \$71 million. Since the premium received of \$886 million was calculated based on the total amount of outstanding deposit balances for all branches being sold, a pro-rata portion of the premium related to the deposit balances associated with the branches that were not sold in the amount of \$209 million was deferred as unearned revenue to be recognized in the third quarter when the remaining branches and related deposit amounts were sold. In the third quarter of 2012, we completed the sale of the remaining 57 branches and recognized an additional after-tax gain net of allocated non-deductible goodwill, of \$23 million.

In April 2012, we completed the de-recognition of our 452 Fifth Avenue headquarters building which was sold in April 2010. The building was not able to be de-recognized at the time of sale due to a profit sharing arrangement with the purchaser relating to any future sale of the building which expired in April. The deferred gain of \$117 million is being amortized over the remaining life of the lease at the time of de-recognition which was eight years.

We previously announced to employees that we are considering strategic options for our mortgage operations, with the objective of recommending the future course of our prime mortgage lending and mortgage servicing platforms. On May 7, 2012, we announced that we have entered into a strategic relationship with PHH Mortgage to manage our mortgage processing and servicing operations. The conversion of these operations is expected to be completed in the first quarter of 2013. Under the terms of the agreement, PHH Mortgage will provide us with mortgage origination processing services as well as sub-servicing of our portfolio of owned and serviced mortgages totaling \$51.0 billion as of September 30, 2012. We will continue to own both the mortgages on our balance sheet and the mortgage servicing rights associated with these loans. We will sell our agency eligible originations to PHH Mortgage on a servicing released basis which will result in no additional mortgage servicing rights being recognized going forward. As a result of this agreement, many of our mortgage servicing employees will be given the opportunity to transfer to PHH Mortgage. No significant one-time restructuring costs have been or are expected to be incurred as a result of this transaction. We plan to continue originating mortgages for our customers with particular emphasis on Premier relationships.

We continue to evaluate our overall operations as we seek to optimize our risk profile and cost efficiencies as well as our liquidity, capital and funding requirements. This could result in further strategic actions that may

include changes to our legal structure, asset levels, cost structure or product offerings in support of HSBC's strategic priorities.

The financial information set forth below summarizes selected financial highlights of HSBC USA Inc. as of September 30, 2012 and December 31, 2011 and for the three and nine months ended September 30, 2012 and 2011.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(dollars are in millions)			
Income (loss) from continuing operations	<u>\$ (782)</u>	<u>\$ 172</u>	<u>\$ (1,295)</u>	<u>\$ 433</u>
Rate of return on average:				
Total assets	(1.61)%	.38%	(.90)%	.33%
Total common shareholder's equity	(20.19)	2.88	(10.60)	3.18
Net interest margin to average earning assets	1.22	1.47	1.31	1.45
Efficiency ratio ⁽²⁾	178.28	71.51	123.47	76.51
Commercial loan net charge-off ratio ⁽¹⁾	.12	(.13)	.35	.23
Consumer loan net charge-off ratio ⁽¹⁾	1.14	1.18	1.31	1.32
			September 30, 2012	December 31, 2011
			(dollars are in millions)	
Loans:				
Commercial loans			\$42,568	\$33,649
Consumer loans			18,884	18,218
Total loans			<u>\$61,452</u>	<u>\$51,867</u>
Loans held for sale			<u>\$ 1,056</u>	<u>\$ 3,670</u>
Allowance for credit losses as a percent of loans ⁽¹⁾			1.04%	1.43%
Consumer two-months-and-over contractual delinquency			6.25	6.01
Loan-to-deposits ratio ⁽³⁾			70.62	53.33
Total shareholders' equity to total assets			8.65	9.80
Total capital to risk weighted assets			19.20	18.39
Tier 1 capital to risk weighted assets			13.25	12.74
Tier 1 common equity to risk weighted assets			10.97	10.72

⁽¹⁾ Excludes loans held for sale.

⁽²⁾ Total operating expenses, reduced by minority interests, expressed as a percentage of the sum of net interest income and other revenues.

⁽³⁾ Represents period end loans, net of loss reserves, as a percentage of domestic deposits less certificate of deposits equal to or less than \$100 thousand. Excluding the deposits and loans held for sale to First Niagara, the ratio was 59.60 percent at December 31, 2011.

Loans Loans, excluding loans held for sale, were \$61.5 billion at September 30, 2012 compared to \$51.9 billion at December 31, 2011. The increase in loans as compared to December 31, 2011 was driven by an increase in commercial loans of \$8.9 billion due to new business activity, particularly in global banking as well as in business banking and middle market enterprises, partially offset by paydowns and managed reductions in certain exposures. Consumer loans increased modestly, driven by higher levels of residential mortgage loans largely associated with originations targeted at our Premier customer relationships. We continue to sell a substantial portion of new mortgage loan originations to government sponsored enterprises. See "Balance Sheet Review" for a more detailed discussion of the changes in loan balances.

Credit Performance Our allowance for credit losses as a percentage of total loans decreased to 1.04 percent at September 30, 2012 as compared to 1.43 percent at December 31, 2011. The decrease in our allowance ratio reflects a lower allowance for credit losses in most of our loan portfolios due to improved credit quality,

including lower dollars of delinquency, reductions in commercial loan exposures including the charge-off of certain specific global banking client relationships and continuing improvements in economic conditions.

Our consumer two-months-and-over contractual delinquency as a percentage of loans and loans held for sale (“delinquency ratio”) increased to 6.25 percent at September 30, 2012 as compared to 6.01 percent at December 31, 2011 driven largely by lower overall receivable balances in our residential mortgage loan portfolio due to lower levels of residential mortgages loans held for sale, a substantial majority of which were less than 60 days contractually delinquent, partially offset by improved delinquency levels. See “Credit Quality” for a more detailed discussion of the increase in our delinquency ratios.

Net charge-offs as a percentage of average loans (“net charge-off ratio”) for the three months ended September 30, 2012 increased 8 basis points compared to the prior year quarter due to higher commercial loan charge-offs as the prior year quarter included a partial recovery of a previously charged-off loan related to a single client relationship, while our consumer loan net charge-off dollars and ratio declined modestly. See “Credit Quality” for a more detailed discussion of our trends in net charge-off.

Funding and Capital Capital amounts and ratios are calculated in accordance with current banking regulations. Our Tier 1 capital ratio was 13.25 percent and 12.74 percent at September 30, 2012 and December 31, 2011, respectively. Our capital levels remain well above levels established by current banking regulations as “well capitalized”. We did not receive any cash capital contributions from our immediate parent, HSBC North America Inc. (“HNAI”) during the first nine months of 2012.

As part of the regulatory approvals with respect to the affiliate receivable purchases completed in January 2009, HSBC Bank USA and HSBC made certain additional capital commitments to ensure that HSBC Bank USA holds sufficient capital with respect to the purchased receivables that are or may become “low-quality assets,” as defined by the Federal Reserve Act. These capital requirements, which require a risk-based capital charge of 100 percent for each “low-quality asset” transferred or arising in the purchased portfolios rather than a typical eight percent capital charge applied to similar assets that are not part of the transferred portfolios, are applied both for purposes of satisfying the terms of the commitments and for purposes of measuring and reporting HSBC Bank USA’s risk-based capital and related ratios. This treatment applies as long as the low-quality assets are owned by HSBC Bank USA. In 2011, HSBC Bank USA sold low-quality credit card receivables with a net carrying value of approximately \$266 million to a non-bank subsidiary of HSBC USA Inc. to reduce the capital requirement associated with these assets. The remaining purchased receivables subject to this requirement were sold to Capital One as part of the previously discussed sale which was completed on May 1, 2012. We exceeded the minimum capital ratios required at September 30, 2012 and December 31, 2011.

As discussed in previous filings, HSBC North America is required to implement Basel II provisions in accordance with current regulatory timelines. While HSBC USA will not report separately under the new rules, HSBC Bank USA will report under the new rules on a stand-alone basis. Adoption of Basel II requires the approval of U.S. regulators and encompasses enhancements to a number of risk policies, processes and systems to align HSBC Bank USA with the Basel II final rule requirements. We are uncertain as to when we will receive approval to adopt Basel II from the Federal Reserve Board, HSBC North America’s primary regulator. We have integrated Basel II metrics into our management reporting and decision making process. As a result of Dodd-Frank, a banking organization that has formally implemented Basel II must calculate its capital requirements under Basel I and Basel II, compare the two results, and then use the lower of such ratios for purposes of determining compliance with its minimum Tier 1 capital and total risk-based capital requirements. On June 7, 2012, the U.S. regulators issued three joint Notices of Proposed Rulemaking which include the proposed changes to the regulatory capital adequacy framework required to implement Basel III in the U.S. If implemented as proposed, the rules would be effective as of January 1, 2013 with phase-in periods for certain provisions.

Income Before Income Tax Expense – Significant Trends Income from continuing operations before income tax expense, and various trends and activity affecting operations, are summarized in the following table.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Income from continuing operations before income tax from prior year	\$ 289	\$ 408	\$ 671	\$1,310
Increase (decrease) in income from continuing operations before income tax attributable to:				
Balance sheet management activities excluding gains (losses) on security sales ⁽¹⁾	78	(118)	87	(117)
Trading revenue ⁽²⁾	201	(210)	121	(95)
Gains (losses) on security sales	1	12	40	46
Loans held for sale ⁽³⁾	(3)	(4)	13	(84)
Residential mortgage banking related revenue (loss) ⁽⁴⁾	(44)	31	(46)	169
Gain on the sale of branches	103	-	433	-
Gain (loss) on own debt designated at fair value and related derivatives ⁽⁵⁾	(588)	363	(699)	164
Gain (loss) on instruments at fair value and related derivatives, excluding own debt ⁽⁵⁾	22	(73)	1	(41)
Provision for credit losses ⁽⁶⁾	(6)	(68)	(2)	(178)
Expense accrual related to certain regulatory matters ⁽⁷⁾	(800)	-	(1,500)	-
Interest expense on certain tax exposures	(2)	(12)	69	(96)
Impairment of software development costs	-	-	94	(94)
All other activity ⁽⁸⁾	(45)	(40)	(220)	(313)
Income (loss) from continuing operations before income tax for current period	<u>\$ (794)</u>	<u>\$ 289</u>	<u>\$ (938)</u>	<u>\$ 671</u>

⁽¹⁾ Balance sheet management activities are comprised primarily of net interest income from management of interest rate risk associated with the repricing characteristics of balance sheet assets and liabilities. For additional discussion regarding Global Banking and Markets net interest income, trading revenues, and the Global Banking and Markets business segment see the caption “Business Segments” section in this MD&A.

⁽²⁾ For additional discussion regarding trading revenue, see the caption “Results of Operations” in this MD&A.

⁽³⁾ For additional discussion regarding loans held for sale, see the caption “Balance Sheet Revenue” in this MD&A.

⁽⁴⁾ For additional discussion regarding residential mortgage banking revenue, see the caption “Results of Operations” in this MD&A.

⁽⁵⁾ For additional discussion regarding fair value option and fair value measurement, see Note 12, “Fair Value Option,” in the accompanying consolidated financial statements.

⁽⁶⁾ For additional discussion regarding provision for credit losses, see the caption “Results of Operations” in this MD&A.

⁽⁷⁾ For additional discussion regarding expense accrual related to certain regulatory matters, see Note 21, “Litigation and Regulatory Matters,” in the accompanying consolidated financial statements.

⁽⁸⁾ Represents other banking activities, including revenue and expense items not specifically identified above.

Basis of Reporting

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”). Unless noted, the discussion of our financial condition and results of operations included in MD&A are presented on a continuing operations basis of reporting. Certain reclassifications have been made to prior year amounts to conform to the current year presentation.

In addition to the U.S. GAAP financial results reported in our consolidated financial statements, MD&A includes reference to the following information which is presented on a non-U.S. GAAP basis:

International Financial Reporting Standards (“IFRSs”) Because HSBC reports results in accordance with IFRSs and IFRSs results are used in measuring and rewarding performance of employees, our management also separately monitors net income under IFRSs (a non-U.S. GAAP financial measure). The following table reconciles our net income on a U.S. GAAP basis to net income on an IFRSs basis.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(in millions)			
Net income (loss) – U.S. GAAP basis	\$(782)	\$ 312	\$(1,092)	\$ 873
Adjustments, net of tax:				
IFRS reclassification of fair value measured financial assets during 2008	(17)	39	(59)	14
Securities	(3)	(1)	(4)	9
Derivatives	3	3	1	7
Loan impairment	(2)	4	8	7
Property	(7)	(5)	(16)	(21)
Pension costs	(11)	14	(3)	13
Purchased loan portfolios	-	5	-	(16)
Transfer of credit card receivables to held for sale and subsequent sale	-	-	(31)	-
Servicing assets	1	4	1	2
Gain on the sale of branches	22	-	92	-
Tax valuation allowances	-	(13)	-	13
Litigation accrual	(13)	4	(10)	4
Other	12	(14)	20	(9)
Net profit (loss) – IFRSs basis	(797)	352	(1,093)	896
Tax provision (benefit) – IFRSs basis	34	(211)	(390)	(480)
Profit (loss) before tax – IFRSs basis	\$(831)	\$ 563	\$ (703)	\$1,376

A summary of the significant differences between U.S. GAAP and IFRSs as they impact our results are presented below:

IFRS reclassification of fair value measured financial assets during 2008 – Certain securities were reclassified from “trading assets” to “loans and receivables” under IFRSs as of July 1, 2008 pursuant to an amendment to IAS 39, “Financial Instruments: Recognition and Measurement” (“IAS 39”), and are no longer marked to market under IFRSs. In November 2008, additional securities were similarly transferred to loans and receivables. These securities continue to be classified as “trading assets” under U.S. GAAP.

Additionally, certain Leverage Acquisition Finance (“LAF”) loans were classified as “Trading Assets” for IFRSs and to be consistent, an irrevocable fair value option was elected on these loans under U.S. GAAP on January 1, 2008. These loans were reclassified to “loans and advances” as of July 1, 2008 pursuant to the IAS 39

amendment discussed above. Under U.S. GAAP, these loans are classified as “held for sale” and carried at fair value due to the irrevocable nature of the fair value option.

Securities – Under U.S. GAAP, the credit loss component of an other-than-temporary impairment of a debt security is recognized in earnings while the remaining portion of the impairment loss is recognized in accumulated other comprehensive income (loss) provided we have concluded we do not intend to sell the security and it is more-likely-than-not that we will not have to sell the security prior to recovery. Under IFRSs, there is no bifurcation of other-than-temporary impairment and the entire amount is recognized in earnings. Also under IFRSs, recoveries in other-than-temporary impairment related to improvement in the underlying credit characteristics of the investment are recognized immediately in earnings while under U.S. GAAP, they are amortized to income over the remaining life of the security. There are also less significant differences in measuring other-than-temporary impairment under IFRSs versus U.S. GAAP.

Under IFRSs, securities include HSBC shares held for stock plans at fair value. These shares held for stock plans are measured at fair value through other comprehensive income. If it is determined these shares have become impaired, the unrealized loss in accumulated other comprehensive income is reclassified to profit or loss. There is no similar requirement under U.S. GAAP.

Derivatives – Effective January 1, 2008, U.S. GAAP removed the observability requirement of valuation inputs to allow up-front recognition of the difference between transaction price and fair value in the consolidated statement of income (loss). Under IFRSs, recognition is permissible only if the inputs used in calculating fair value are based on observable inputs. If the inputs are not observable, profit and loss is deferred and is recognized (1) over the period of contract, (2) when the data becomes observable, or (3) when the contract is settled.

Loan impairment – IFRSs requires a discounted cash flow methodology for estimating impairment on pools of homogeneous customer loans which requires the discounting of cash flows including recovery estimates at the original effective interest rate of the pool of customer loans. The amount of impairment relating to the discounting of future cash flows unwinds with the passage of time, and is recognized in interest income. Also under IFRSs, if the recognition of a write-down to fair value on secure loans decreases because collateral values have improved and the improvement can be related objectively to an event occurring after recognition of the write-down, such write-down can be reversed, which is not permitted under U.S. GAAP. Additionally under IFRSs, future recoveries on charged-off loans or loans written down to fair value less cost to obtain title and sell are accrued for on a discounted basis and a recovery asset is recorded. Subsequent recoveries are recorded to earnings under U.S. GAAP, but are adjusted against the recovery asset under IFRSs. Under IFRSs, interest on impaired loans is recorded at the effective interest rate on the customer loan balance net of impairment allowances, and therefore reflects the collectibility of the loans.

Property – The sale of our 452 Fifth Avenue property, including the 1 W. 39th Street building in April 2010, resulted in the recognition of a gain under IFRSs while under U.S. GAAP, such gain is deferred and recognized over eight years due to our continuing involvement.

Pension costs – Pension expense under U.S. GAAP is generally higher than under IFRSs as a result of the amortization of the amount by which actuarial losses exceeded the higher of 10 percent of the projected benefit obligation or fair value of the plan assets (the “corridor.”) In 2012, amounts include a higher pension curtailment benefit under US GAAP as a result of the decision in the third quarter to cease all future benefit accruals under the Cash Balance formula of the HSBC North America Pension Plan and freeze the plan effective January 1, 2013. Under IFRSs, these losses are recorded directly in other comprehensive income. In 2011, amounts reflect a pension curtailment gain relating to the branch sales as under IFRSs recognition occurs when “demonstrably committed to the transaction” as compared to U.S. GAAP when recognition occurs when the transaction is completed. Furthermore, in 2010, changes to future accruals for legacy participants under the HSBC North America Pension Plan were accounted for as a plan curtailment under IFRSs, which resulted in immediate income recognition. Under U.S. GAAP, these changes were considered to be a negative plan amendment which resulted in no immediate income recognition.

Purchased loan portfolios – Under U.S. GAAP, purchased loans for which there has been evidence of credit deterioration at the time of acquisition are recorded at an amount based on the net cash flows expected to be collected. This generally results in only a portion of the loans in the acquired portfolio being recorded at fair value. Under IFRSs, the entire purchased portfolio is recorded at fair value. When recording purchased loans at fair value, the difference between all estimated future cash collections and the purchase price paid is recognized into income using the effective interest method. An allowance for loan loss is not established unless the original estimate of expected future cash collections declines.

Transfer of credit card receivables to held for sale and subsequent sale – For receivables transferred to held for sale subsequent to origination, IFRSs requires these receivables to be reported separately on the balance sheet but does not change the recognition and measurement criteria. Accordingly for IFRSs purposes, such loans continue to be accounted for in accordance with IAS 39, with any gain or loss recognized at the time of sale. U.S. GAAP requires loans that meet the held for sale classification requirements be transferred to a held for sale category at the lower of amortized cost or fair value. As a result, any loss is recorded prior to sale.

Servicing Assets – Under IAS 38, servicing assets are initially recorded on the balance sheet at cost and amortized over the projected life of the assets. Servicing assets are periodically tested for impairment with impairment adjustments charged against current earnings. Under U.S. GAAP, we generally record servicing assets on the balance sheet at fair value. Subsequent adjustments to fair value are generally reflected in current period earnings.

Gain on sale of branches – Under U.S. GAAP, the amount of goodwill allocated to the retail branch disposal group is higher as goodwill amortization ceased under U.S. GAAP in 2002 while under IFRS, goodwill was amortized until 2005. This resulted in a lower gain under U.S. GAAP

Tax valuation allowances – Reflects differences in the timing of amounts of deferred tax assets that can be realized between U.S. GAAP and IFRSs.

Litigation accrual – Under U.S. GAAP, litigation accruals are recorded when it is probable a liability has been incurred and the amount is reasonably estimable. Under IFRSs, a present obligation must exist for an accrual to be recorded. In certain cases, this creates differences in the timing of accrual recognition between IFRSs and U.S. GAAP.

Other – Other includes the net impact of certain adjustments which represent differences between U.S. GAAP and IFRSs that were not individually material, including deferred loan origination costs and fees, interest recognition, restructuring costs, depreciation expense, share based payments and loans held for sale.

Balance Sheet Review

We utilize deposits and borrowings from various sources to provide liquidity, fund balance sheet growth, meet cash and capital needs, and fund investments in subsidiaries. Balance sheet totals at September 30, 2012 and increases (decreases) over prior periods, including continuing and discontinuing operations, are summarized in the table below.

	September 30, 2012	Increase (Decrease) from			
		June 30, 2012		December 31, 2011	
		Amount	%	Amount	%
(dollars are in millions)					
Period end assets:					
Short-term investments	\$ 28,376	\$(5,627)	(16.5)%	\$ (1,803)	(6.0)%
Loans, net	60,815	5,370	9.7	9,691	19.0
Loans held for sale	1,056	(926)	(46.7)	(2,614)	(71.2)
Trading assets	38,322	2,544	7.1	(478)	(1.2)
Securities	64,273	1,926	3.1	8,957	16.2
Other assets	10,290	(582)	(5.4)	(20,901)	(67.0)
	<u>\$203,132</u>	<u>\$ 2,705</u>	<u>1.3%</u>	<u>\$ (7,148)</u>	<u>(3.4)%</u>
Funding sources:					
Total deposits	\$121,335	\$(1,892)	(1.5)%	\$(18,394)	(13.2)%
Trading liabilities	20,875	655	3.2	6,689	47.2
Short-term borrowings	14,113	3,382	31.5	(1,896)	(11.8)
All other liabilities	8,277	295	3.7	3,132	60.9
Long-term debt	20,963	949	4.7	4,254	25.5
Shareholders' equity	17,569	(684)	(3.7)	(933)	(5.0)
	<u>\$203,132</u>	<u>\$ 2,705</u>	<u>1.3%</u>	<u>\$ (7,148)</u>	<u>(3.4)%</u>

Short-Term Investments Short-term investments include cash and due from banks, interest bearing deposits with banks, federal funds sold and securities purchased under agreements to resell. Balances will fluctuate between periods depending upon our liquidity position at the time.

Loans, Net Loan balances at September 30, 2012 and increases (decreases) from prior periods are summarized in the table below:

	September 30, 2012	Increase (Decrease) from			
		June 30, 2012		December 31, 2011	
		Amount	%	Amount	%
(dollars are in millions)					
Commercial loans:					
Construction and other real estate	\$ 7,920	\$ (57)	(.7)%	\$ 60	.8%
Business banking and middle market enterprises ...	12,497	1,241	11.0	2,272	22.2
Global banking ⁽¹⁾	19,011	3,969	26.4	6,353	50.2
Other commercial loans	3,140	(2)	(.1)	234	8.1
Total commercial loans	42,568	5,151	13.8	8,919	26.5
Consumer loans:					
Residential mortgages, excluding home equity mortgages	15,086	328	2.2	973	6.9
Home equity mortgages	2,387	(68)	(2.8)	(176)	(6.9)
Total residential mortgages	17,473	260	1.5	797	4.8
Credit Card	796	13	1.7	(32)	(3.9)
Other consumer	615	(36)	(5.5)	(99)	(13.9)
Total consumer loans	18,884	237	1.3	666	3.7
Total loans	61,452	5,388	9.6	9,585	18.5
Allowance for credit losses	637	18	2.9	(106)	(14.3)
Loans, net	\$60,815	\$5,370	9.7%	\$9,691	19.0%

⁽¹⁾ Represents large multinational firms including globally focused U.S. corporate and financial institutions and USD lending to selected high quality Latin American and other multinational customers managed by HSBC on a global basis.

Commercial loan balances increased compared to both June 30, 2012 and December 31, 2011, driven by new business activity, particularly in global banking as well as in business banking and middle market enterprises. These increases were partially offset by paydowns and managed reductions in certain exposures.

Residential mortgage loans increased since June 30, 2012 and December 31, 2011. The balances reflect increases to the portfolio associated with originations targeted at our Premier customer relationships and compared with December 31, 2011, the transfer in the first quarter of 2012 of \$140 million of FHA/VA loans from held for sale that were no longer part of the loan sale to First Niagara. As a result of balance sheet initiatives to manage interest rate risk and improve the structural liquidity of HSBC Bank USA, we continue to sell a substantial portion of our new residential loan originations through the secondary markets.

Over the past several years, real estate markets in a large portion of the United States have been affected by stagnation or declines in property values and in many cases, the loan-to-value (“LTV”) ratios for our mortgage loan portfolio has declined since origination. Refreshed loan-to-value ratios for our mortgage loan portfolio, excluding subprime residential mortgage loans held for sale, are presented in the table below.

	Refreshed LTVs ⁽¹⁾⁽²⁾ at September 30, 2012		Refreshed LTVs ⁽¹⁾⁽²⁾ at December 31, 2011	
	First Lien	Second Lien	First Lien	Second Lien
LTV < 80%	76.6%	58.0%	75.4%	62.2%
80% ≤ LTV < 90%	9.8	13.4	11.0	13.7
90% ≤ LTV < 100%	6.2	11.7	6.5	10.2
LTV ≥ 100%	7.4	16.9	7.2	13.8
Average LTV for portfolio	68.0%	73.2%	67.7%	71.2%

- (1) Refreshed LTVs for first liens are calculated using the loan balance as of the reporting date. Refreshed LTVs for second liens are calculated using the loan balance as of the reporting date plus the senior lien amount at origination. Current estimated property values are derived from the property's appraised value at the time of loan origination updated by the change in the Federal Housing Finance Agency's (formerly known as the Office of Federal Housing Enterprise Oversight) house pricing index ("HPI") at either a Core Based Statistical Area ("CBSA") or state level. The estimated value of the homes could vary from actual fair values due to changes in condition of the underlying property, variations in housing price changes within metropolitan statistical areas and other factors. As a result, actual property values associated with loans that end in foreclosure may be significantly lower than the estimates used for purposes of this disclosure.
- (2) Current property values are calculated using the most current HPI's available and applied on an individual loan basis, which results in an approximately three month delay in the production of reportable statistics. Therefore, the information in the table above reflects current estimated property values using HPIs as of June 30, 2012 and September 30, 2011, respectively.

Credit card receivable balances which represents our legacy HSBC Bank USA credit card portfolio, remained relatively flat from June 30, 2012 but decreased compared to December 31, 2011, driven by a continued focus by customers to reduce outstanding credit card debt and seasonal improvements in our collection activities during the first quarter of the year as some customers use their tax refunds to make payments.

Other consumer loans have decreased primarily due to the discontinuation of originations of student loans and run-off of our installment loan portfolio.

Loans Held for Sale Loans held for sale at September 30, 2012 and decreases from prior periods are summarized in the table below.

	September 30, 2012	Increase (Decrease) from			
		June 30, 2012		December 31, 2011	
		Amount	%	Amount	%
(dollars are in millions)					
Total commercial loans	\$ 443	\$(432)	(49.4)%	\$ (522)	(54.1)%
Consumer loans:					
Residential mortgages	548	(355)	(39.3)	(1,510)	(73.4)
Credit card receivables	-	(94)	(100.0)	(416)	(100.0)
Other consumer	65	(45)	(40.9)	(166)	(71.9)
Total consumer loans	613	(494)	(44.6)	(2,092)	(77.3)
Total loans held for sale	<u>\$1,056</u>	<u>\$(926)</u>	<u>(46.7)%</u>	<u>\$(2,614)</u>	<u>(71.2)%</u>

Loans held for sale at June 30, 2012 include \$531 million of loans that were subsequently sold as part of our agreement to sell certain retail branches, including \$115 million of commercial loans, \$279 million of residential mortgages, \$94 million of credit card receivables and \$43 million of other consumer loans. Loans held for sale at December 31, 2011 include \$2.5 billion on loans that were subsequently sold as part of our agreement to sell certain retail branches, including \$521 million of commercial loans, \$1.4 billion of residential mortgages, \$416 million of credit card receivables and \$161 million of other consumer loans. The decrease in loans held for sale from both June 30, 2012 and December 31, 2011 was driven primarily by the completion of the sale of 195 branches to First Niagara, including 57 which were sold in the third quarter of 2012.

We originate commercial loans in connection with our participation in a number of leveraged acquisition finance syndicates. A substantial majority of these loans were originated with the intent of selling them to unaffiliated third parties and are classified as commercial loans held for sale. Commercial loans held for sale under this program were \$424 million, \$411 million and \$377 million at September 30, 2012, June 30, 2012 and December 31, 2011, respectively, all of which are recorded at fair value as we have elected to designate these loans under fair value option. Commercial loans held for sale also includes commercial real estate loans of \$19 million, \$313 million and \$55 million at September 30, 2012, June 30, 2012 and December 31, 2011, respectively, which are originated with the intent to sell to government sponsored enterprises.

In addition to the residential mortgage loans held for sale to First Niagara at June 30, 2012 and December 31, 2011, residential mortgage loans held for sale include subprime residential mortgage loans of \$94 million, \$164 million and \$181 million at September 30, 2012, June 30, 2012 and December 31, 2011, respectively, which were acquired from unaffiliated third parties and from HSBC Finance with the intent of securitizing or selling the loans to third parties. We sold subprime residential mortgage loans with a carrying amount of \$64 million in 2012. Also included in residential mortgage loans held for sale are first mortgage loans originated and held for sale primarily to various government sponsored enterprises. We retained the servicing rights in relation to the mortgages upon sale.

In addition to the other consumer loans held for sale to First Niagara at June 30, 2012 and December 31, 2011 as discussed above, other consumer loans held for sale in all periods also include certain student loans which we no longer originate.

Consumer loans held for sale are recorded at the lower of cost or fair value. The valuation adjustment on loans held for sale was \$169 million and \$251 million at September 30, 2012 and December 31, 2011, respectively.

Trading Assets and Liabilities Trading assets and liabilities balances at September 30, 2012 and increases (decreases) over prior periods, are summarized in the table below.

	September 30, 2012	Increase (Decrease) from			
		June 30, 2012		December 31, 2011	
		Amount	%	Amount	%
(dollars are in millions)					
Trading assets:					
Securities ⁽¹⁾	\$13,466	\$1,957	17.0%	\$ 520	4.0%
Precious metals	15,777	1,318	9.1	(1,305)	(7.6)
Derivatives ⁽²⁾	9,079	(731)	(7.5)	307	3.5
	<u>\$38,322</u>	<u>\$2,544</u>	<u>7.1%</u>	<u>\$ (478)</u>	<u>(1.2)%</u>
Trading liabilities:					
Securities sold, not yet purchased	\$ 361	\$ 45	14.2%	\$ 18	5.2%
Payable for precious metals	6,853	(105)	(1.5)	(146)	(2.1)
Derivatives ⁽³⁾	13,661	715	5.5	6,817	99.6
	<u>\$20,875</u>	<u>\$ 655</u>	<u>3.2%</u>	<u>\$ 6,689</u>	<u>47.2%</u>

⁽¹⁾ Includes U.S. Treasury securities, securities issued by U.S. Government agencies and U.S. Government sponsored enterprises, other asset-backed securities, corporate bonds and debt securities.

⁽²⁾ At September 30, 2012, June 30, 2012 and December 31, 2011, the fair value of derivatives included in trading assets has been reduced by \$5.9 billion, \$6.2 billion and \$4.8 billion, respectively, relating to amounts recognized for the obligation to return cash collateral received under master netting agreements with derivative counterparties.

⁽³⁾ At September 30, 2012, June 30, 2012 and December 31, 2011, the fair value of derivatives included in trading liabilities has been reduced by \$2.3 billion, \$2.5 billion and \$6.3 billion, respectively, relating to amounts recognized for the right to reclaim cash collateral paid under master netting agreements with derivative.

Securities balances increased since June 30, 2012 and December 31, 2011 due to an increase in U.S. Treasury and compared to the prior quarter, corporate and foreign sovereign positions related to hedges for derivative positions in both the interest rate and emerging market trading portfolios. Balances of securities sold, not yet purchased increased since June 30, 2012 and December 31, 2011 due to an increase in short U.S. Treasury positions related to hedges of derivatives in the interest rate trading portfolio.

Precious metals trading assets decreased at September 30, 2012 compared to December 31, 2011, but increased compared to June 30, 2012. The decrease from December 31, 2011 was due to a reduction in unallocated metal balances held for customers, partially offset by gains in spot metal prices. The increase from June 30, 2012 was primarily due to an increase in spot metal prices as unallocated metal balances held for customers increased

modestly. The lower payable for precious metals compared to both June 30, 2012 and December 31, 2011 was due to a decrease in unallocated metal balances held for customers, which was partially offset by an increase in spot metal prices.

Derivative assets balances decreased as compared to June 30, 2012, but increased compared to December 31, 2011. The decrease from June 30, 2012 resulted from a decrease in value of foreign exchange, metals and credit derivatives, as spreads continued to tighten during the quarter, while the increase since December 31, 2011 was mainly from market movements as valuations of interest rate derivatives increased offsetting decreases in value of foreign exchange and credit derivatives. The balances also reflect the continued decrease in credit derivative positions as a number of transaction unwinds and commutations reduced the outstanding market value as we continue to actively reduce exposure. The derivative liability balance increased in both periods due to the increase in cash collateral held as well as the increase in interest rate derivative valuations.

Securities Securities include securities available-for-sale and securities held-to-maturity. Balances will fluctuate between periods depending upon our liquidity position at the time. See Note 5, "Securities," in the accompanying consolidated financial statements for additional information.

Deposits Deposit balances by major depositor categories at September 30, 2012 and increases (decreases) over prior periods, are summarized in the table below.

	September 30, 2012	Increase (Decrease) from			
		June 30, 2012		December 31, 2011	
		Amount	%	Amount	%
(dollars are in millions)					
Individuals, partnerships and corporations	\$ 99,458	\$(1,533)	(1.5)%	\$ (2,211)	(2.2)%
Domestic and foreign banks	20,385	3,130	18.1	(241)	(1.2)
U.S. Government, states and political subdivisions . . .	1,035	258	33.2	200	24.0
Foreign governments and official institutions	457	(114)	(20.0)	(998)	(68.6)
Deposits held for sale ⁽¹⁾	-	(3,633)	(100.0)	(15,144)	(100.0)
Total deposits	<u>\$121,335</u>	<u>\$(1,892)</u>	<u>(1.5)%</u>	<u>\$(18,394)</u>	<u>(13.2)%</u>
Total core deposits ⁽²⁾	<u>\$ 88,509</u>	<u>\$(6,682)</u>	<u>(7.0)%</u>	<u>\$(15,630)</u>	<u>(15.0)%</u>

⁽¹⁾ Represents deposits we have agreed to sell to First Niagara.

⁽²⁾ We monitor "core deposits" as a key measure for assessing results of our core banking network. Core deposits generally include all domestic demand, money market and other savings accounts, as well as time deposits with balances not exceeding \$100,000. Balances at September 30, 2012, June 30, 2012 and December 31, 2011 include deposits held for sale.

Deposits continued to be a significant source of funding during the first nine months of 2012. Deposits at September 30, 2012 decreased compared to June 30, 2012 and December 31, 2011. As compared with December 31, 2011, the decrease was largely driven by the completion of the sale of 195 retail branches which reduced outstanding deposit levels by \$13.2 billion as well as decreases in interest bearing deposits in foreign offices, partially offset by increases in non-interest bearing domestic branch deposits. Compared to June 30, 2012, the decrease in deposits associated with the sale of the remaining 57 retail branches in the third quarter was partially offset by increases in non-interest bearing domestic deposits. Core domestic deposits, which are a substantial source of our core liquidity, decreased during the third quarter and first nine months of 2012 driven by the sale of branches as well as a decrease in institutional transaction account balances.

Our strategy for our core retail banking business is to grow our market share and deepen relationships with existing customers in key internationally connected urban markets with a focus on needs based, relationship led wealth and banking services. This strategy includes various initiatives, such as:

- HSBC Premier, HSBC's global banking service that offers internationally-minded, mass affluent customers unique international services seamlessly delivered through HSBC's global network coupled with a premium local service with a dedicated premier relationship manager. Total Premier deposits have decreased to \$23.2 billion at September 30, 2012 as compared to \$25.4 billion and \$29.9 billion at June 30, 2012 and December 31, 2011, respectively, primarily as a result of the sale of branches to First Niagara,
- Deepening our existing customer relationships by needs-based sales of wealth, banking and mortgage products.

Short-Term Borrowings Balances at September 30, 2012 increased as compared to June 30, 2012 due largely to increased commercial paper issuance and increased levels of securities sold under agreements to repurchase. Compared to December 31, 2011, short term borrowings declined as a result of decreased levels of securities sold under agreements to repurchase.

Long-Term Debt Long-term debt at September 30, 2012 increased as compared to June 30, 2012 and December 31, 2011 due to long-term debt issuances totaling \$0.6 billion and \$5.3 billion in the third quarter and first nine months of 2012, respectively, partially offset by maturities.

Incremental issuances from the \$40 billion HSBC Bank USA Global Bank Note Program totaled \$35 million and \$237 million during the three and nine months ended September 30, 2012, respectively, compared to \$179 million and \$503 million during the year-ago periods. Total debt outstanding under this program was \$4.8 billion at September 30, 2012 and \$4.9 billion at December 31, 2011.

Incremental long-term debt issuances from our shelf registration statement with the Securities and Exchange Commission totaled \$579 million and \$5.1 billion during the three and nine months ended September 30, 2012, respectively, compared to \$504 million and \$1.6 billion during the year-ago periods. Total long-term debt outstanding under this shelf was \$8.0 billion and \$3.8 billion at September 30, 2012 and December 31, 2011, respectively.

Borrowings from the Federal Home Loan Bank of New York ("FHLB") totaled \$1.0 billion at both September 30, 2012 and December 31, 2011. At September 30, 2012, we had the ability to access further borrowings of up to \$4.1 billion based on the amount pledged as collateral with the FHLB.

We have entered into transactions with variable interest entities ("VIEs") organized by HSBC affiliates and unrelated third parties. We are the primary beneficiary of a low income housing limited liability partnership VIE under the applicable accounting literature and, accordingly, we have consolidated the assets and the debt of this VIE. Debt obligations of the VIE totaling \$55 million were included in long-term debt at both September 30, 2012 and December 31, 2011. See Note 19, "Variable Interest Entities," in the accompanying consolidated financial statements for additional information regarding VIE arrangements.

Residential Real Estate Owned

We obtain real estate by taking possession of the collateral pledged as security for residential mortgage loans. REO properties are made available for sale in an orderly fashion with the proceeds used to reduce or repay the outstanding receivable balance. The following table provides quarterly information regarding our REO properties:

	Three Months Ended				
	September 30, 2012	June 30, 2012	March 31, 2012	December 31, 2011	September 30, 2011
Number of REO properties at end of period	203	188	201	206	275
Number of properties added to REO inventory in the period	87	88	106	63	57
Average (gain) loss on sale of REO properties ⁽¹⁾	(.2)%	5.9%	.7%	3.8%	2.3%
Average total loss on foreclosed properties ⁽²⁾ . . .	46.8%	48.7%	55.7%	50.7%	57.5%
Average time to sell REO properties (in days) . .	281	284	378	340	276

⁽¹⁾ Property acquired through foreclosure is initially recognized at the lower of amortized cost or its fair value less estimated costs to sell (“Initial REO Carrying Amount”). The average loss on sale of REO properties is calculated as cash proceeds less the Initial REO Carrying Amount divided by the unpaid loan principal balance prior to write-down (excluding any accrued finance income) plus certain other ancillary disbursements that, by law, are reimbursable from the cash proceeds (e.g., real estate tax advances) and were incurred prior to our taking title to the property. This ratio represents the portion of our total loss on foreclosed properties that occurred after we took title to the property.

⁽²⁾ The average total loss on foreclosed properties sold each quarter includes both the loss on sale of the REO property as discussed above and the cumulative write-downs recognized on the loans up to the time we took title to the property. This calculation of the average total loss on foreclosed properties uses the unpaid loan principal balance prior to write-down (excluding any accrued finance income) plus certain other ancillary disbursements that, by law, are reimbursable from the cash proceeds (e.g., real estate tax advances) and were incurred prior to our taking title to the property.

Our methodology for determining the fair values of the underlying collateral as described in Note 2, “Summary of Significant Accounting Policies and New Accounting Pronouncements” in our 2011 Form 10-K is continuously validated by comparing our net investment in the loan subsequent to charging the loan down to the lower of amortized cost or fair value less cost to sell, or our net investment in the property upon completing the foreclosure process, to the updated broker’s price opinion and once the collateral has been obtained, any adjustments that have been made to lower the expected selling price, which may be lower than the broker’s price opinion. Adjustments in our expectation of the ultimate proceeds that will be collected are recognized as they occur based on market information at that time and consultation with our listing agents for the properties.

As previously reported, beginning in late 2010 we temporarily suspended all new foreclosure proceedings and in early 2011 temporarily suspended foreclosures in process where judgment had not yet been entered while we enhanced foreclosure documentation and processes for foreclosures and re-filed affidavits where necessary. During the first, second and third quarters of 2012, we added 106 properties, 88 properties and 87 properties, respectively, to REO inventory which primarily reflects loans for which we had either accepted the deed to the property in lieu of payment or for which we had received a foreclosure judgment prior to the suspension of foreclosures. We expect the number of REO properties added to inventory will increase during the remainder of 2012 although the number of new REO properties added to inventory will continue to be impacted by our ongoing refinements to our foreclosure processes as well as the extended foreclosure timelines in all states as discussed below.

The number of REO properties at September 30, 2012 increased as compared to June 30, 2012 as the volume of properties added to REO inventory exceeded the sales of REO properties during the third quarter. The number of REO properties at September 30, 2012 decreased as compared to December 31, 2011 as the volume of properties added to REO inventory continues to be slow as a result of the backlog in foreclosure activities driven by the

temporary suspension of foreclosures as discussed above, as well as continuing sales of REO properties during the first nine months of 2012. We have resumed processing suspended foreclosure activities where judgment had not yet been entered in substantially all states, although, certain states have received additional focus. We have also begun initiating new foreclosure activities in substantially all states. It will take time to work through the backlog of loans in each state that have not yet been referred to foreclosure.

In addition, certain courts and state legislatures have issued new rules or statutes relating to foreclosures. Scrutiny of foreclosure documentation has increased in some courts. Also, in some areas, officials are requiring additional verification of information filed prior to the foreclosure proceeding. The combination of these factors has led to a significant backlog of foreclosures which will take time to resolve. If these trends continue, there could be additional delays in the processing of foreclosures, which could have an adverse impact upon housing prices.

Results of Operations

Unless noted otherwise, the following discusses amounts from continuing operations as reported in our consolidated statement of income (loss).

Net Interest Income Net interest income is the total interest income on earning assets less the total interest expense on deposits and borrowed funds. In the discussion that follows, interest income and rates are presented and analyzed on a taxable equivalent basis to permit comparisons of yields on tax-exempt and taxable assets. An analysis of consolidated average balances and interest rates on a taxable equivalent basis is presented in this MD&A under the caption “Consolidated Average Balances and Interest Rates – Continuing Operations.”

In the following table which summarizes the significant components of net interest income, interest expense includes \$50 million for the nine months ended September 30, 2012 and \$54 million and \$170 million for the three and nine months ended September 30, 2011, respectively, that has been allocated to our discontinued operations in accordance with our existing internal transfer pricing policies as external interest expense is unaffected by the transfer of businesses to discontinued operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Yield on total earning assets	1.88%	2.21%	2.00%	2.29%
Rate paid on interest bearing liabilities . . . . .	.91	.85	.84	.92
Interest rate spread . . . . .	.97	1.36	1.16	1.37
Benefit from net non-interest earning or paying funds . . . . .	.25	.11	.15	.08
Net interest margin to earning assets ⁽¹⁾	1.22%	1.47%	1.31%	1.45%

Significant trends affecting the comparability of net interest income and interest rate spread for the three and nine months ended September 30, 2012 are summarized in the following table. Net interest income in the table is presented on a taxable equivalent basis.

	Three Months Ended September 30, 2012		Nine Months Ended September 30, 2012	
	Amount	Interest Rate Spread	Amount	Interest Rate Spread
	(dollars are in millions)			
Net interest income/interest rate spread from prior year	\$572	1.36%	\$1,640	1.37%
Increase (decrease) in net interest income associated with:				
Trading related activities	(29)		(85)	
Balance sheet management activities ⁽¹⁾	(10)		(2)	
Commercial loans	1		(47)	
Deposits	(33)		(55)	
Residential mortgage banking	(14)		(29)	
Interest on estimated tax exposures	(2)		69	
Other activity	30		105	
Net interest income/interest rate spread for current year	<u>\$515</u>	<u>.97%</u>	<u>\$1,596</u>	<u>1.16%</u>

⁽¹⁾ Represents our activities to manage interest rate risk associated with the repricing characteristics of balance sheet assets and liabilities. Interest rate risk, and our approach to manage such risk, are described under the caption "Risk Management" in this Form 10-Q.

Trading related activities Net interest income for trading related activities decreased during the three and nine months ended September 30, 2012 primarily due to lower rates earned on interest earning trading assets.

Balance sheet management activities Lower net interest income from balance sheet management activities during the three and nine months ended September 30, 2012 reflects the impact of the sale of certain securities for risk management purposes in the first nine months of 2012 as well as the lower interest rate environment.

Commercial loans Net interest income on commercial loans decreased during the nine months ended September 30, 2012 primarily due to higher funding costs and a lower yield on loans which was partially offset by higher average loan balances due to new business activity as well as lower levels of nonperforming loans. Net interest income was slightly higher in the three month period as the higher funding costs and lower yields were more than offset by the impact of higher average loan balances.

Deposits Lower net interest income during both periods reflects the impact of lower average balances on interest bearing deposits and improved spreads in the Retail Banking and Wealth Management ("RBWM") and Commercial Banking ("CMB") business segments as deposit pricing has been adjusted to reflect the on-going low interest rate environment. Both segments continue to be impacted however, relative to historical trends, by the current low rate environment.

Residential mortgage banking Lower net interest income during the three and nine months ended September 30, 2012 reflects narrower spreads and lower average balances as well as increased deferred cost amortization in 2012 as a result of higher prepayments. The reduction in residential mortgage average outstanding balances primarily as a result of the sale of branches to First Niagara was partially offset by an increase in residential mortgage loans to our Premier customers.

Interest on estimated tax exposures Higher net interest income during the nine months ended September 30, 2012 resulted from higher interest expense in the prior year periods associated with tax reserves on estimated exposures while during the three month period, interest expense was relatively flat.

Other activity Net interest income on other activity was higher during the third quarter and first nine months of 2012, largely driven by lower unallocated funding costs.

Provision for Credit Losses The provision for credit losses associated with various loan portfolios is summarized in the following table. Amounts in brackets represent recoveries.

Three Months Ended September 30,	2012	2011	Increase (Decrease)	
			Amount	%
(dollars are in millions)				
Commercial:				
Construction and other real estate	\$ (11)	\$ (10)	\$ (1)	(10.0)%
Business banking and middle market enterprises	18	5	13	100+
Global banking	12	28	(16)	(57.1)
Other commercial	-	(23)	23	100+
Total commercial	19	-	19	100+%
Consumer:				
Residential mortgages, excluding home equity mortgages	33	53	(20)	(37.7)
Home equity mortgages	13	8	5	62.5
Credit card receivables ⁽¹⁾	15	12	3	25.0
Other consumer	4	5	(1)	(20.0)
Total consumer	65	78	(13)	(16.7)
Total provision for credit losses	\$ 84	\$ 78	\$ 6	7.7%
(dollars are in millions)				
Nine Months Ended September 30,				
(dollars are in millions)				
Commercial:				
Construction and other real estate	\$ (36)	\$ 11	\$(47)	(100+)%
Business banking and middle market enterprises	39	(4)	43	100+
Global banking	9	22	(13)	(59.1)
Other commercial	(9)	(33)	24	(72.7)
Total commercial	3	(4)	7	100+
Consumer:				
Residential mortgages, excluding home equity mortgages	72	98	(26)	(26.5)
Home equity mortgages	55	31	24	77.4
Credit card receivables ⁽¹⁾	35	32	3	9.4
Other consumer	8	14	(6)	(42.9)
Total consumer	170	175	(5)	(2.9)
Total provision for credit losses	\$173	\$171	\$ 2	1.2%

⁽¹⁾ Related to credit card receivables associated with HSBC Bank USA's legacy credit card program which were not sold to Capital One.

During the three months ended September 30, 2012, we increased our credit loss reserves as the provision for credit losses was \$18 million higher than net charge-offs largely reflecting higher loss estimates in our commercial loan and residential mortgage loan portfolios. During the nine months ended September 30, 2012, we decreased our credit loss reserves as the provision for credit losses was \$106 million lower than net charge-offs largely reflecting lower loss estimates in our commercial loan and residential mortgage loan portfolios.

In our commercial portfolio, the provision for credit losses was higher in both periods as the prior year periods include a partial recovery of a previously charged-off loan relating to a single client relationship which was partially offset by a specific provision associated with a corporate lending relationship and, in the year-to-date

period, a specific provision associated with the downgrade of a specific commercial real estate loan. Excluding these items, our commercial loan provision remained higher in both periods driven largely by increased levels of reserves for risk factors associated with expansion activities in the U.S. and, in the year-to-date period, Latin America. In addition, while we experienced continued improvements in economic and credit conditions including lower nonperforming loans and criticized asset levels in 2012, reductions in higher risk rated loan balances and stabilization in credit downgrades, including managed reductions in certain exposures and improvements in the financial circumstances of certain customer relationships in both years resulted in a higher overall release in loss reserves during the year-ago periods.

The provision for credit losses on residential mortgages including home equity mortgages decreased during the three and nine months ended September 30, 2012 as compared to the year-ago periods, driven by continued improvements in economic and credit conditions including lower dollars of delinquency and improvements in loan delinquency roll rates, partially offset by higher charge-offs in our home equity mortgage portfolio due to an increased volume of loans where we have decided not to pursue foreclosure.

Our methodology and accounting policies related to the allowance for credit losses are presented in “Critical Accounting Policies and Estimates” in MD&A and in Note 2, “Summary of Significant Accounting Policies and New Accounting Pronouncements” in our 2011 Form 10-K. See “Credit Quality” in this MD&A for additional discussion on the allowance for credit losses associated with our various loan portfolios.

Other Revenues The components of other revenues are summarized in the following table.

Three Months Ended September 30,	2012	2011	Increase (Decrease)	
			Amount	%
	(dollars are in millions)			
Credit card fees	\$ 18	\$ 31	\$ (13)	(41.9)%
Other fees and commissions	167	222	(55)	(24.8)
Trust income	22	26	(4)	(15.4)
Trading revenue	113	(107)	220	100+
Other securities gains, net	50	49	1	2.0
HSBC affiliate income:				
Fees and commissions	27	24	3	12.5
Other affiliate income	36	25	11	44.0
Total HSBC affiliate income	63	49	14	28.6
Residential mortgage banking revenue ⁽¹⁾	4	34	(30)	(88.2)
Gain (loss) on instruments at fair value and related derivatives	(187)	379	(566)	(100+)
Gain on sale of branches	103	-	103	100+
Other income:				
Valuation of loans held for sale	(12)	(9)	(3)	(33.3)
Insurance	11	3	8	100+
Earnings from equity investments	-	10	(10)	(100.0)
Miscellaneous income	45	(20)	65	100+
Total other income	44	(16)	60	100+
Total other revenues	\$ 397	\$ 667	\$(270)	(40.5)%

Nine Months Ended September 30,	2012	2011	Increase (Decrease)	
			Amount	%
(dollars are in millions)				
Credit card fees	\$ 70	\$ 95	\$ (25)	(26.3)%
Other fees and commissions	530	605	(75)	(12.4)
Trust income	72	83	(11)	(13.3)
Trading revenue	395	243	152	62.6
Other securities gains, net	145	105	40	38.1
HSBC affiliate income:				
Fees and commissions	81	78	3	3.8
Other affiliate income	84	73	11	15.1
Total HSBC affiliate income	165	151	14	9.3
Residential mortgage banking revenue ⁽¹⁾	31	48	(17)	(35.4)
Gain (loss) on instruments at fair value and related derivatives	(258)	440	(698)	(100+)
Gain on sale of branches	433	-	433	100+
Other income:				
Valuation of loans held for sale	(15)	(28)	13	46.4
Insurance	15	11	4	36.4
Earnings from equity investments	(1)	29	(30)	(100+)
Miscellaneous income	45	8	37	100+
Total other income	44	20	24	100+
Total other revenues	<u>\$1,627</u>	<u>\$1,790</u>	<u>\$(163)</u>	<u>(9.1)%</u>

⁽¹⁾ Includes servicing fees received from HSBC Finance of less than \$1 million and \$3 million during the three and nine months ended September 30, 2012 and \$3 million and \$7 million during the three and nine months ended September 30, 2011.

Credit Card Fees Credit card fees declined in both periods largely due to lower outstanding balances driven by the sale of a portion of the portfolio as part of the sale of 195 retail branches in the second and third quarters of 2012 as well as a trend towards lower late fees due to improved delinquency levels and lower enhancement services revenue.

Other fees and commissions Other fee-based income decreased during the three and nine month period ended September 30, 2012, reflecting the impact of the sale of 195 retail branches as discussed above and the implementation of new legislation in late 2011 which limits fees paid by retailers to banks on debit card purchases.

Trust income Trust income decreased in both periods due to a reduction in fee income associated with the continued decline in money market assets under management, partially offset by an increase in fee income associated with our management of fixed income assets.

Trading revenue Trading revenue is generated by participation in the foreign exchange, rates, credit and precious metals markets. The following table presents trading related revenue by business. The data in the table includes net interest income earned on trading instruments, as well as an allocation of the funding benefit or cost associated with the trading positions. The trading related net interest income component is included in net interest income on the consolidated statement of income (loss). Trading revenues related to the mortgage banking business are included in residential mortgage banking revenue.

Three Months Ended September 30,	2012	2011	Increase (Decrease)	
			Amount	%
(dollars are in millions)				
Trading revenue	\$113	\$(107)	\$220	100+%
Net interest income	(10)	20	(30)	(100+)
Trading related revenue	<u>\$103</u>	<u>\$ (87)</u>	<u>\$190</u>	<u>100+%</u>
Business:				
Derivatives ⁽¹⁾	\$ 57	\$(136)	\$193	100+%
Balance sheet management	(3)	(21)	18	85.7
Foreign exchange	44	55	(11)	(20.0)
Precious metals	11	33	(22)	(66.7)
Global banking	1	(1)	2	100+
Other trading	(7)	(17)	10	58.8
Trading related revenue	<u>\$103</u>	<u>\$ (87)</u>	<u>\$190</u>	<u>100+%</u>
(dollars are in millions)				
Nine Months Ended September 30,				
2012 2011 Amount %				
(dollars are in millions)				
Trading revenue	\$395	\$ 243	\$152	62.6%
Net interest income	(27)	63	(90)	(100+)
Trading related revenue	<u>\$368</u>	<u>\$ 306</u>	<u>\$ 62</u>	<u>20.3%</u>
Business:				
Derivatives ⁽¹⁾	\$146	\$ 134	\$ 12	9.0%
Balance sheet management	(6)	(32)	26	81.3
Foreign exchange	166	150	16	10.7
Precious metals	52	77	(25)	(32.5)
Global banking	3	(1)	4	100+
Other trading	7	(22)	29	100+
Trading related revenue	<u>\$368</u>	<u>\$ 306</u>	<u>\$ 62</u>	<u>20.3%</u>

⁽¹⁾ Includes derivative contracts related to credit default and cross-currency swaps, equities, interest rates and structured credit products.

Trading revenue increased during the three and nine months ended September 30, 2012 as a result of improved credit market conditions which reflected tighter credit spreads and led to higher derivative trading revenue from favorable price variation and reserve releases. Balance sheet management and other trading activities also contributed to higher revenue during both periods. These increases were partially offset by lower revenue from precious metals during both periods due to a decline in trading volumes and, in the three month period, foreign exchange due to lower volatility.

Trading revenue related to derivatives products increased in both periods from tightening credit spreads and significant reserve releases related to counterparty exposures on structured credit products. Partially offsetting

these increases in the nine month period ended September 30, 2012 were losses associated with the termination of certain structured credit exposures in advance of their scheduled maturity dates.

Trading revenue related to balance sheet management activities increased during the three and nine months ended September 30, 2012 primarily as economic hedge positions improved due to changes in rates.

Foreign exchange trading revenue increased during the nine months ended September 30, 2012 from increased trading volumes, but decreased during the three month period due to decreased trading volumes and price volatility.

Precious metals trading revenues decreased during the three and nine months ended September 30, 2012 as a result of lower metals price volatility and a decline in trading volumes.

Global banking trading revenue increased during the three and nine months ended September 30, 2012 mainly from the change in the valuation of credit default swaps.

Other trading revenue improved in both periods from movements in interest rate curves used to value certain instruments and valuation reserve releases.

Other Securities Gains, Net We maintain various securities portfolios as part of our balance sheet diversification and risk management strategies. During the third quarter and first nine months of 2012, we sold \$3.0 billion and \$10.4 billion, respectively, of U.S. Treasury, mortgage-backed and other asset-backed securities as part of a strategy to re-balance the securities portfolio for risk management purposes based on the current interest rate environment and recognized gains of \$59 million and \$260 million and losses of \$9 million and \$115 million, respectively, which is included as a component of other security gains, net above. During the third quarter and first nine months of 2011, we sold \$3.3 billion and \$17.0 billion, respectively, of U.S. Treasury, mortgage-backed and other asset-backed securities as part of a strategy to adjust portfolio risk duration as well as to reduce risk-weighted asset levels and recognized gains of \$73 million and \$213 million and losses of \$24 million and \$108 million, respectively. Gross realized gains and losses from sales of securities are summarized in Note 5, "Securities," in the accompanying consolidated financial statements.

Servicing and other fees from HSBC affiliates increased during the three and nine month periods ended September 30, 2012 due to an increase in payment and cash management fees generated from affiliates.

Residential mortgage banking revenue The following table presents the components of residential mortgage banking revenue. The net interest income component reflected in the table is included in net interest income in the consolidated statement of income (loss) and reflects actual interest earned, net of interest expense and corporate transfer pricing.

Three Months Ended September 30,	2012	2011	Increase (Decrease)		
			Amount	%	
(dollars are in millions)					
Net interest income	\$ 48	\$ 62	\$ (14)	(22.6)%	
Servicing related income:					
Servicing fee income	21	27	(6)	(22.2)	
Changes in fair value of MSR due to:					
Changes in valuation inputs or assumptions used in valuation model	(5)	(110)	105	95.5	
Realization of cash flows	(14)	(23)	9	39.1	
Trading – Derivative instruments used to offset changes in value of MSRs	7	130	(123)	(94.6)	
Total servicing related income	9	24	(15)	(62.5)	
Originations and sales related income (loss):					
Gains on sales of residential mortgages	24	4	20	100+	
Provision for repurchase obligations	(28)	(1)	(27)	(100+)	
Trading and hedging activity	(4)	3	(7)	(100+)	
Total originations and sales related income (loss)	(8)	6	(14)	(100+)	
Other mortgage income	3	4	(1)	(25.0)	
Total residential mortgage banking revenue included in other revenues	4	34	(30)	(88.2)	
Total residential mortgage banking related revenue	\$ 52	\$ 96	\$ (44)	(45.8)%	
(dollars are in millions)					
Nine Months Ended September 30,		2012	2011	Increase (Decrease)	
				Amount	%
(dollars are in millions)					
Net interest income	\$150	\$ 179	\$ (29)	(16.2)%	
Servicing related income:					
Servicing fee income	68	83	(15)	(18.1)	
Changes in fair value of MSR due to:					
Changes in valuation inputs or assumptions used in valuation model	(20)	(132)	112	84.8	
Realization of cash flows	(46)	(57)	11	19.3	
Trading – Derivative instruments used to offset changes in value of MSRs	33	155	(122)	(78.7)	
Total servicing related income	35	49	(14)	(28.6)	
Originations and sales related income (loss):					
Gains on sales of residential mortgages	57	27	30	100+	
Provision for repurchase obligations	(81)	(41)	(40)	(97.6)	
Trading and hedging activity	-	(8)	8	100+	
Total originations and sales related income (loss)	(24)	(22)	(2)	(9.1)	
Other mortgage income	20	21	(1)	(4.8)	
Total residential mortgage banking revenue included in other revenues	31	48	(17)	(35.4)	
Total residential mortgage banking related revenue	\$181	\$ 227	\$ (46)	(20.3)%	

Lower net interest income in both periods reflects narrower spreads as well as increased deferred cost amortization in 2012 as a result of higher prepayments. The reduction in residential mortgage average outstanding balances primarily as a result of the sale of branches to First Niagara was partially offset by an increase in residential mortgage loans to our Premier customers. Consistent with our Premier strategy, additions to the portfolio are comprised largely of Premier relationship products.

Total servicing related income decreased in the three and nine months ended September 30, 2012 driven by lower servicing income as the average serviced loan portfolio decreased and, in the three month period, a decline in net hedged MSR performance.

Originations and sales related income (loss) declined in the three and nine months ended September 30, 2012 driven by higher loss provisions for loan repurchase obligations associated with loans previously sold partially offset by increased gains on individual loan sales. During the three and nine months ended September 30, 2012, we recorded a charge of \$28 million and \$81 million, respectively, due to an increase in our estimated exposure associated with repurchase obligations on loans previously sold compared to a charge of \$1 million and \$41 million recorded in the year-ago periods for such exposure.

Gain (loss) on instruments designated at fair value and related derivatives We have elected to apply fair value option accounting to commercial leveraged acquisition finance loans, unfunded commitments, certain own fixed-rate debt issuances and all structured notes and structured deposits issued after January 1, 2006 that contain embedded derivatives. We also use derivatives to economically hedge the interest rate risk associated with certain financial instruments for which fair value has been elected. See Note 12, "Fair Value Option," in the accompanying consolidated financial statements for additional information including a breakout of these amounts by individual component.

Gain on sale of branches As discussed above, in May 2012, we completed the sale of 138 non-strategic retail branches to First Niagara and recognized a pre-tax gain, net of allocated non-deductible goodwill, of \$330 million. In the third quarter of 2012, we completed the sale of the remaining 57 non-strategic retail branches to First Niagara and recognized an additional pre-tax gain, net of allocated non-deductible goodwill, of \$103 million.

Valuation of loans held for sale Valuation adjustments on loans held for sale improved in the nine month period ended September 30, 2012 due to lower average balances and reduced volatility. During the three month period ended September 30, 2012, valuation adjustments increased slightly due to adjustments to the carrying value based on sale activity in the quarter. Valuations on loans held for sale relate primarily to residential mortgage loans purchased from third parties and HSBC affiliates with the intent of securitization or sale. Included in this portfolio are subprime residential mortgage loans with a fair value of \$94 million and \$181 million as of September 30, 2012 and December 31, 2011, respectively. Loans held for sale are recorded at the lower of their aggregate cost or fair value, with adjustments to fair value being recorded as a valuation allowance. Valuations on residential mortgage loans held for sale that we originate are recorded as a component of residential mortgage banking revenue in the consolidated statement of income (loss).

Other Income Excluding the valuation of loans held for sale as discussed above, other income increased during the three and nine months ended September 30, 2012 due to higher miscellaneous income driven by higher income associated with fair value hedge ineffectiveness, partially offset by lower earnings from equity investments driven by the sale in the fourth quarter of 2011 of our equity investment in a joint venture.

Operating Expenses The components of operating expenses are summarized in the following tables.

Three Months Ended September 30,	2012	2011	Increase (Decrease)	
			Amount	%
(dollars are in millions)				
Salaries and employee benefits:				
Salaries	\$ 143	\$ 164	\$ (21)	(12.8)%
Employee benefits	64	102	(38)	(37.3)
Total salaries and employee benefits	207	266	(59)	(22.2)
Occupancy expense, net	60	73	(13)	(17.8)
Support services from HSBC affiliates:				
Fees paid to HSBC Finance for loan servicing and other administrative support	5	8	(3)	(37.5)
Fees paid to HMUS	81	70	11	15.7
Fees paid to HTSU	237	279	(42)	(15.1)
Fees paid to other HSBC affiliates	39	55	(16)	(29.1)
Total support services from HSBC affiliates	362	412	(50)	(12.1)
Expense accrual related to certain regulatory matters	800	-	800	100+
Other expenses:				
Equipment and software	11	11	-	-
Marketing	12	16	(4)	(25.0)
Outside services	30	19	11	57.9
Professional fees	28	36	(8)	(22.2)
Postage, printing and office supplies	2	3	(1)	(33.3)
Off-balance sheet credit reserves	(7)	(2)	(5)	(100+)
FDIC assessment fee	21	16	5	31.3
Insurance business	2	-	2	100+
Miscellaneous	89	71	18	25.4
Total other expenses	188	170	18	10.6
Total operating expenses	\$ 1,617	\$ 921	\$ 696	75.6%
Personnel – average number	8,168	9,785		
Efficiency ratio	178.28%	71.51%		

Nine Months Ended September 30,	2012	2011	Increase (Decrease)	
			Amount	%
(dollars are in millions)				
Salaries and employee benefits:				
Salaries	\$ 457	\$ 490	\$ (33)	(6.7)%
Employee benefits	276	362	(86)	(23.8)
Total salaries and employee benefits	733	852	(119)	(14.0)
Occupancy expense, net	176	209	(33)	(15.8)
Support services from HSBC affiliates:				
Fees paid to HSBC Finance for loan servicing and other administrative support	22	27	(5)	(18.5)
Fees paid to HMUS	227	192	35	18.2
Fees paid to HTSU	711	725	(14)	(1.9)
Fees paid to other HSBC affiliates	140	148	(8)	(5.4)
Total support services from HSBC affiliates	1,100	1,092	8	.7
Expense accrual related to certain regulatory matters	1,500	-	1,500	100+
Other expenses:				
Equipment and software	33	130	(97)	(74.6)
Marketing	37	53	(16)	(30.2)
Outside services	77	49	28	57.1
Professional fees	89	99	(10)	(10.1)
Postage, printing and office supplies	10	11	(1)	(9.1)
Off-balance sheet credit reserves	(19)	(27)	8	29.6
FDIC assessment fee	75	87	(12)	(13.8)
Insurance business	4	-	4	100+
Miscellaneous	209	187	22	11.8
Total other expenses	515	589	(74)	(12.6)
Total operating expenses	\$ 4,024	\$ 2,742	\$ 1,282	46.8%
Personnel – average number	8,579	9,731		
Efficiency ratio	123.47%	76.51%		

Salaries and employee benefits Salaries and employee benefits expense decreased during both periods driven by the impact of the sale of 195 non-strategic retail branches completed in the second and third quarters of 2012 and continued cost management efforts, partially offset by higher salaries expense relating to expansion activities associated with certain businesses.

Occupancy expense, net Occupancy expense decreased in both periods reflecting lower rent and lower utilities costs, including the impact of the retail branch sales as discussed above, as well as the commencement of the recognition of a \$117 million deferred gain on the sale of our 452 Fifth Avenue headquarters building which began in April 2012 and is being recognized over the eight year remaining life of our lease at the time of commencement. In addition, occupancy expense in both 2011 periods includes \$11 million relating to the write-off of leasehold improvements associated with the consolidation of certain retail branch offices.

Support services from HSBC affiliates includes technology and certain centralized support services, including human resources, corporate affairs and other shared services, legal, compliance, tax and finance charged to us by HTSU. Support services from HSBC affiliates also includes services charged to us by an HSBC affiliate located outside of the United States which provides operational support to our businesses, including among other areas, customer service, systems, risk management, collection and accounting functions as well as servicing fees paid to

HSBC Finance for servicing nonconforming residential mortgage loans and, prior to May 1, 2012, certain credit card receivables. Higher support services from HSBC affiliates in the year-to-date period reflects higher fees paid to HMUS, primarily related to compliance costs, partially offset by lower fees paid to HTSU as increased costs relating to compliance, including costs associated with our AML/BSA and foreclosure remediation activities was more than offset by workforce reductions in certain shared services functions which resulted in lower allocated costs for these functions. Support services from HSBC affiliates declined in the three month period ended September 30, 2012 as lower HTSU charges for non-compliance shared services reflecting the impact of continued cost management efforts as well as lower compliance charges and lower fees paid to HSBC Finance, who no longer services our credit card portfolio, more than offset the higher fees paid to HMUS for compliance. Compliance costs reflected in support services from affiliates totaled \$68 million and \$232 million in the three and nine months ended September 30, 2012 compared to \$79 million and \$156 million in the year-ago periods.

Expense accrual related to certain regulatory matters Included in the three and nine months ended September 30, 2012 is an expense accrual related to certain regulatory matters of \$800 million and \$1.5 billion, respectively. See Note 21, "Litigation and Regulatory Matters" for the additional information.

Marketing expenses Lower marketing and promotional expenses in both periods resulted from continued optimization of marketing spend as a result of general cost saving initiatives.

Other expenses Other expenses (excluding marketing expenses) includes in the year-to-date period, a reduction of \$9 million in estimated costs associated with penalties related to foreclosure delays involving loans serviced for government sponsored enterprises ("GSEs") and other third parties previously accrued and in the year-to-date 2011 period, a charge of \$94 million included within equipment and software relating to the impairment of certain previously capitalized software development costs. Excluding these amounts, other expenses were higher in both periods, largely due to higher outside services fees and higher litigation expenses.

Efficiency ratio Our efficiency ratio from continuing operations was 178.28 percent and 123.47 percent during the three and nine months ended September 30, 2012, respectively, compared to 71.51 percent and 76.51 percent during the year-ago periods. Our efficiency ratio was impacted in each period by the change in the fair value of our own debt and related derivatives for which we have elected fair value option accounting. Also impacting the efficiency ratio in both 2012 periods was the gain from the sale of certain non-strategic retail branches as well as an expense accrual related to certain regulatory matters and, in the prior year-to-date period, the impairment of certain software development costs as well as in both prior year periods, the impairment of leasehold improvements associated with certain branch closures as discussed above. Excluding the impact of these items, our efficiency ratio for the three and nine months ended September 30, 2012 improved to 83.79 percent and 82.24 percent, respectively, compared to 104.48 percent and 84.30 percent in the year-ago periods as other revenues increased while operating expenses declined. While operating expenses adjusted for the items above declined in both periods, driven by the impact of our retail branch divestitures and cost mitigation efforts, they continue to reflect elevated levels of compliance costs.

Segment Results – IFRSs Basis

We have four distinct segments that are utilized for management reporting and analysis purposes. The segments, which are generally based upon global businesses, are described under Item 1, “Business” in our 2011 Form 10-K.

Our segment results are reported on a continuing operations basis. As previously discussed, in the second quarter of 2012 we sold our GM and UP credit card receivables as well as our private label credit card and closed-end receivables to Capital One. Because the credit card and private label receivables sold were classified as held for sale prior to disposition and the operations and cash flows from these receivables will be eliminated from our ongoing operations post-disposition without any significant continuing involvement, we have determined we have met the requirements to report the results of these credit card and private label card and closed-end receivables being sold, as discontinued operations for all periods presented. Prior to being reported as discontinued operations beginning in the third quarter of 2011, these receivables were previously included in our Retail Banking and Wealth Management segment. As discussed in Note 2, “Discontinued Operations,” our wholesale banknotes business (“Banknotes Business”), which was previously reported in our Global Banking and Markets segment, is also reported as discontinued operations and is not included in our segment presentation.

We report to our parent, HSBC, in accordance with its reporting basis, IFRSs. As a result, our segment results are presented on an IFRSs Basis (a non-U.S. GAAP financial measure) as operating results are monitored and reviewed, trends are evaluated and decisions about allocating resources such as employees are made almost exclusively on an IFRSs basis. However, we continue to monitor capital adequacy, establish dividend policy and report to regulatory agencies on a U.S. GAAP basis. The significant differences between U.S. GAAP and IFRSs as they impact our results are summarized in Note 18, “Business Segments,” in the accompanying consolidated financial statements and under the caption “Basis of Reporting” in the MD&A.

Retail Banking and Wealth Management (“RBWM”) Our RBWM segment provides retail banking and wealth products and services, including personal loans, credit cards, deposits, branch services, financial planning products and asset management services such as mutual funds, investments and insurance.

We continued to direct resources towards the growth of wealth services and HSBC Premier, HSBC’s global banking service that offers customers a seamless international service. We remain focused on providing differentiated premium services to internationally-minded, mass affluent and upwardly mobile customers. In order to align our retail network to increase focus on our strategy of internationally minded markets and customers, we announced in August of 2011 the sale of 195 retail branches in our non-strategic upstate New York region, of which 138 were sold in May 2012, and 57 were sold in the third quarter of 2012.

Consistent with our strategy, additions to our residential mortgage portfolio primarily consist of Premier relationship products, while sales of loans consist primarily of conforming loans sold to GSEs. In addition to normal sales activity, at times we have historically sold prime adjustable and fixed rate mortgage loan portfolios to third parties. We retained the servicing rights in relation to the mortgages upon sale.

The following table summarizes the IFRSs Basis results for our RBWM segment:

Three Months Ended September 30,	2012	2011	Increase (Decrease)	
			Amount	%
(dollars are in millions)				
Net interest income	\$209	\$259	\$(50)	(19.3)%
Other operating income	138	148	(10)	(6.8)
Total operating income	347	407	(60)	(14.7)
Loan impairment charges	72	76	(4)	(5.3)
	275	331	(56)	(16.9)
Operating expenses	368	368	-	-
Profit (loss) before tax	<u>\$ (93)</u>	<u>\$ (37)</u>	<u>\$(56)</u>	<u>(100+)%</u>

Nine Months Ended September 30,	2012	2011	Increase (Decrease)	
			Amount	%
(dollars are in millions)				
Net interest income	\$ 653	\$ 756	\$(103)	(13.6)%
Other operating income	497	337	160	47.5
Total operating income	1,150	1,093	57	5.2
Loan impairment charges	174	166	8	4.8
	976	927	49	5.3
Operating expenses	1,010	1,187	(177)	(14.9)
Profit (loss) before tax	<u>\$ (34)</u>	<u>\$ (260)</u>	<u>\$ 226</u>	<u>86.9%</u>

Our RBWM segment reported a higher loss before tax during the three months ended September 30, 2012, reflecting lower net interest income and lower other operating income, partially offset by lower loan impairment charges. Our RBWM segment reported a lower loss before tax during the nine months ended September 30, 2012, reflecting higher other operating income and lower operating expenses, partially offset by lower net interest income and higher loan impairment charges.

Net interest income was lower during the three and nine months ended September 30, 2012 driven by lower deposit margins primarily as a result of lower returns related to deposits held for sale to First Niagara due to their short term nature, lower deposit balances as a result of the sale as well as a continued low interest rate environment. In addition, there were narrower spreads as well as increased deferred cost amortization in 2012 as a result of higher prepayments on lower residential mortgage average balances primarily as a result of the sale of branches to First Niagara which were partially offset by an increase in residential mortgage loans to our Premier customers.

Other operating income included a gain from the sale of certain branches to First Niagara totaling \$59 million and \$238 million in the three and nine months ended September 30, 2012, respectively. Excluding the gain on the sale of certain branches, other operating income decreased in both periods driven by higher provisions for mortgage loan repurchase obligations associated with previously sold loans and a reduction in debit card fee income as a result of the implementation of new legislation which caps fees paid by retailers to banks for debit card purchases. These items were partially offset by improved gains on sales of loans sold to GSEs.

Loan impairment charges increased in the year-to-date period, driven by increased mortgage reserves as a result of increasing foreclosure time frames and higher charge-offs on home equity loans. Loan impairment charges decreased in the three month period ended September 30, 2012 primarily due to slightly lower charge offs.

Operating expenses in the nine month period ended September 30, 2011 included the impairment of previously capitalized software development costs, which resulted in a charge of \$73 million. The three and nine month periods ended September 30, 2012 included a \$44 million litigation charge and in the nine month period a \$9 million reduction in estimated cost associated with penalties related to foreclosure delays involving loans serviced for GSEs. Excluding these amounts, operating expenses remained lower in both periods primarily due to the sale of the 195 branches to First Niagara as well as a decrease in expenses in our retail banking business driven by several cost reduction initiatives primarily optimizing staffing in the branch network and administrative areas as well as reduced marketing spend. In addition, there were lower FDIC assessments beginning in the second quarter of 2011 as assessments are now based on assets rather than deposits. Partially offsetting these improvements in operating expense were transaction costs associated with our announced branch sale as well as increased compliance costs and a \$16 million reduction in the amount of branch costs allocated to Commercial Banking in the third quarter of 2012 based upon an updated cost study.

Commercial Banking (“CMB”) Our Commercial Banking segment serves three client groups, notably Middle Market Enterprises, Business Banking and Commercial Real Estate. CMB’s business strategy is to be the leader in international banking in target markets. In the U.S., CMB strives to execute on that vision and strategy by proactively targeting the growing number of U.S. companies that are increasingly in need of international banking, financial products and services as well as foreign companies in need of U.S. products and services. The products and services provided to these client groups are offered through multiple delivery systems including the branch banking network as well as through cross-selling products of our Global Banking and Markets segment, consistent with our global strategy of cross-sale to other customer groups. In 2012, we continued to invest in this business and focus on expanding our core proposition and proactively target companies with international banking requirements which increased the number of relationship managers in areas with strong international connectivity including the west coast, Midwest, Texas and Florida.

During the first nine months of 2012, interest rate spreads continued to be pressured from a low interest rate environment while loan impairment charges improved. Both an increase in demand for loans as well as new loan originations have resulted in an 20 percent increase in loans outstanding to middle-market customers since December 31, 2011. The business banking loan portfolio has seen a 30 percent decrease in loans outstanding since December 31, 2011 resulting from the sale of 195 branches in the non-strategic upstate New York region. The commercial real estate group is focusing on selective business opportunities and portfolio management, which resulted in a slight increase in outstanding loans for this portfolio since December 31, 2011. Average customer deposit balances across all CMB business lines during the nine months ended September 30, 2012 increased 5 percent compared to the year-ago period with the impact of the branch sale more than offset by underlying growth. Total average loans increased 16 percent as compared to the year-ago period.

The following table summarizes the IFRSs Basis results for our CMB segment:

Three Months Ended September 30,	2012	2011	Increase (Decrease)	
			Amount	%
(dollars are in millions)				
Net interest income	\$168	\$180	\$(12)	(6.7)%
Other operating income	173	114	59	51.8
Total operating income	341	294	47	16.0
Loan impairment charges (recoveries)	6	(5)	11	100+
	335	299	36	12.0
Operating expenses	175	177	(2)	(1.1)
Profit before tax	\$160	\$122	\$ 38	31.1%

Nine Months Ended September 30,	2012	2011	Increase (Decrease)	
			Amount	%
	(dollars are in millions)			
Net interest income	\$ 490	\$527	\$ (37)	(7.0)%
Other operating income	578	325	253	77.8
Total operating income	1,068	852	216	25.4
Loan impairment charges (recoveries)	(3)	7	(10)	(100+)
	1,071	845	226	26.7
Operating expenses	550	553	(3)	(0.5)
Profit before tax	\$ 521	\$292	\$229	78.4%

Our CMB segment reported higher profit before tax during the three and nine months ended September 30, 2012 as higher other operating income and lower operating expenses were partially offset by lower net interest income. Loan impairment charges (recoveries) were higher in the three months period ended September 30, 2012 and were lower in the nine month ended September 30, 2012.

Net interest income in both periods was lower reflecting higher funding costs, partially offset by the favorable impact of higher loans.

Other operating income in the three and nine months ended September 30, 2012 reflects a \$65 million and \$278 million gain, respectively, from the sale of certain branches to First Niagara. Excluding the gain, other operating income was lower in both periods due to lower interchange and deposit service fees.

Loan impairment charges in the prior year-to-date period included a specific provision on an individual commercial real estate loan. Excluding the impact of the specific provision, loan impairment charges increased in both periods due to a lower level of recoveries compared to 2011 on troubled debt restructures in commercial real estate and middle market enterprises.

Operating expense decreased during the three and nine months ended September 30, 2012 as higher expenses relating to staffing increases to support growth as well as higher infrastructure costs such as compliance and technology costs were more than offset by lower branch network charges including a \$16 million reduction in the amount of branch costs allocated from RBWM in the third quarter of 2012 based upon an updated cost study. The prior nine month period also reflect a \$19 million impairment charge associated with previously capitalized as software development costs.

Global Banking and Markets (“GBM”) Our Global Banking and Markets business segment supports HSBC’s global strategy to become the leading international bank for cross-border business. By leveraging HSBC’s international network, driving connectivity between emerging and developed markets and utilizing the strength of our product expertise, we deliver wholesale banking solutions to major corporations and financial institutions.

There are three major lines of business within GBM: Global Banking, Global Markets and Balance Sheet Management. The Global Banking business provides corporate lending and investment banking services and also offers transaction services such as payments and cash management, securities services, trade finance and fund administration and custody services. This unit also manages client relationships across all GBM products. The Global Markets business services the requirements of central banks and financial institutions, corporate and middle market clients and institutional and Private Banking investors through our global trading platforms and distribution capabilities. Balance Sheet Management carries out our treasury functions, including management of liquidity and interest rate risk, funding for business operations and stewardship over surplus funds held in the investment portfolio.

We continue to proactively target U.S. companies with international banking requirements and foreign companies with banking needs in the Americas. Furthermore, we have seen higher average loan balances as well as growth in revenue from the cross-sale of our products to CMB and RBWM customers consistent with our global strategy of cross-sale to other global businesses. Global Banking and Markets segment results during the first nine months of 2012 were affected by improved U.S. credit market conditions, which led to increased income from improved valuations of structured credit products which we no longer offer. Our risk management efforts to improve the credit quality of our corporate lending relationships, as well as increased liquidity costs on unused commitments, has resulted in a slight tightening of average spreads, that was more than offset by higher revenue from growth in loan balances. Revenue improvements in the first nine months of 2012 in payments and cash management and foreign exchange as well as higher gains on sales of investment portfolio securities were partially offset by a decline in revenue from rates and credit derivatives. Additionally, other global markets revenue declined due to fair value adjustments on structure note debt issuances.

The following table summarizes IFRSs Basis results for the GBM segment:

Three Months Ended September 30,	2012	2011	Increase (Decrease)	
			Amount	%
(dollars are in millions)				
Net interest income	\$ 129	\$ 120	\$ 9	7.5%
Other operating income	251	67	184	100+
Total operating income	380	187	193	100+
Loan impairment charges	6	28	(22)	(78.6)
	374	159	215	100+
Operating expenses	249	270	(21)	(7.8)
Profit before tax	\$ 125	\$ (111)	\$236	100+%
(dollars are in millions)				
Nine Months Ended September 30,	2012	2011	Increase (Decrease)	
			Amount	%
(dollars are in millions)				
Net interest income	\$ 439	\$ 382	\$ 57	14.9%
Other operating income	742	756	(14)	(1.9)
Total operating income	1,181	1,138	43	3.8
Loan impairment charges (recoveries)	(2)	1	(3)	(100+)
	1,183	1,137	46	4.0
Operating expenses	744	735	9	1.2
Profit before tax	\$ 439	\$ 402	\$ 37	9.2%

Our GBM segment reported a higher profit before tax during the three months ended September 30, 2012 driven by higher net interest income, higher other operating income, lower loan impairment charges and lower operating expenses. Higher profit before tax during the nine months ended September 30, 2012 was driven by higher net interest income and lower loan impairment charges (recoveries), partially offset by lower other operating income and higher operating expenses.

Net interest income increased during both periods due to higher corporate loan and investment balances, partially offset by lower credit spreads on corporate loans as the business continues to manage down high risk credit exposures and increased cost related to liquidity facilities.

Other operating income increased in the three months ended September 30, 2012 due to an increase in the value of certain structured credit and interest rate derivative exposures, and increased income from payments and cash management generated from services to affiliates. These increases were partially offset by lower revenue from foreign exchange and metals driven by a reduction in metals trading volumes and price volatility, lower gains from the sale of investment portfolio securities and a decrease in other transaction services revenue resulting from the transfer of our fund service business to an affiliate entity. Other operating income decreased in the nine months ended September 30, 2012 due to lower revenue from foreign exchange and metals driven by a reduction in metals trading volumes and price volatility, losses from fair value adjustments on our structured notes liabilities and a decline in other transaction services revenue resulting from the transfer of our fund services business to an affiliate entity. These declines were partially offset by higher income from higher gains on sales of investments portfolio securities and increased income from payments and cash management generated from services to affiliates.

Other operating income reflected gains on structured credit products of \$48 million and \$72 million during the three and nine months ended September 30, 2012 compared to losses of \$80 million and gains of \$62 million during the year-ago periods. Included in structured credit products were exposures to monoline insurance companies that resulted in gains of \$16 million and \$6 million during the three and nine months ended September 30, 2012, respectively, compared to losses of \$16 million and a gains of \$16 million during the year-ago periods, respectively. Valuation losses of \$2 million and \$6 million during the three and nine months ended September 30, 2012, respectively, were recorded against the fair values of sub-prime residential mortgage loans held for sale compared to valuation losses of \$9 million and \$22 million in year-ago periods.

Loan impairment charges decreased during the three and nine month periods due to reductions in higher risk rated loan balances and the stabilization of credit downgrades. In addition, the year-to-date period reflects the impairment of a credit facility in the second quarter of 2012.

Operating expense decreased during the three months ended September 30, 2012 from lower staff costs as a result of lower average headcount levels as well as lower compliance costs. Operating expenses increased during the nine month period driven by higher compliance costs associated with our AML/BSA remediation activities and higher technology expenses, partially offset by decreased staff costs as a result of lower headcount and reduced performance based costs.

The following table summarizes on an IFRSs Basis, the impact of key activities on total operating income of the Global Banking and Markets segment.

Three Months Ended September 30,	2012	2011
	(in millions)	
Foreign exchange and metals	\$ 78	\$ 122
Credit ⁽¹⁾	41	(103)
Rates	20	(13)
Equities	3	5
Other Global Markets	(25)	(23)
Total Global Markets	<u>117</u>	<u>(12)</u>
Financing	48	54
Payments and cash management	93	79
Other transaction services	13	26
Total Global Banking	<u>154</u>	<u>159</u>
Balance sheet management	108	49
Other	1	(9)
Total operating income	<u>\$380</u>	<u>\$ 187</u>
	2012	2011
	(in millions)	
Foreign exchange and metals	\$ 284	\$ 322
Credit ⁽¹⁾	51	51
Rates	117	115
Equities	11	11
Other Global Markets	(66)	(42)
Total Global Markets	<u>397</u>	<u>457</u>
Financing	126	125
Payments and cash management	263	227
Other transaction services	64	84
Total Global Banking	<u>453</u>	<u>436</u>
Balance sheet management	336	243
Other	(5)	2
Total operating income	<u>\$1,181</u>	<u>\$1,138</u>

⁽¹⁾ Credit includes a gain of \$43 million and \$56 million in the three and nine months ended September 30, 2012, respectively, and a loss of \$89 million and a gain of \$54 million in the three and nine months ended September 30, 2011, respectively, of structured credit products which we no longer offer.

Private Banking (“PB”) As part of HSBC’s global network, the PB segment offers integrated domestic and international services to high net worth individuals, their families and their businesses. These services address both resident and non-resident financial needs. During the first nine months of 2012, we continued to dedicate resources to strengthen product and service leadership in the wealth management market. Areas of focus are banking and cash management, investment advice including discretionary portfolio management, investment and structured products, residential mortgages, as well as wealth planning for trusts and estates.

Average client deposit levels increased \$610 million or 5 percent compared to the prior year quarter due to large deposits from domestic and international market customers. Total average loans increased 20 percent compared to the prior year quarter from growth in both commercial lending and tailored mortgage products. Overall period end client assets were higher by \$2.6 billion compared to the prior year quarter mainly due to increases in various

PB wealth management products, investment products and deposits. The benefit from these improvements in 2012 however were offset by lower spread on new loans due to lower risk appetite, lower fees on investment products due to clients moving to more risk adverse investments and lower recoveries on previously charged-off loans.

The following table summarizes IFRSs Basis results for the PB segment.

Three Months Ended September 30,	2012	2011	Increase (Decrease)	
			Amount	%
(dollars are in millions)				
Net interest income	\$ 45	\$ 44	\$ 1	2.3%
Other operating income	26	27	(1)	(3.7)
Total operating income	71	71	-	-
Loan impairment charges (recoveries)	2	(24)	26	100+
	69	95	(26)	(27.4)
Operating expenses	57	65	(8)	(12.3)
Profit before tax	\$ 12	\$ 30	\$(18)	60.0%
(dollars are in millions)				
Nine Months Ended September 30,	2012	2011	Amount	%
(dollars are in millions)				
Net interest income	\$137	\$134	\$ 3	2.2%
Other operating income	83	97	(14)	(14.4)
Total operating income	220	231	(11)	(4.8)
Loan impairment charges (recoveries)	(3)	(34)	31	91.2
	223	265	(42)	(15.8)
Operating expenses	178	194	(16)	(8.2)
Profit before tax	\$ 45	\$ 71	\$(26)	36.6%

Our PB segment reported lower profit before tax during the three and nine months ended September 30, 2012 driven by lower other operating income and lower recoveries of loan impairment charges partially offset by higher net interest income and lower operating expenses.

Net interest income was slightly higher during both periods due to improved volumes of banking and lending as well as improved spreads on products.

Other operating income was lower in both periods reflecting lower fees on managed and structured investment products, funds fees, custody fees and the loss of income due to the sale of our equity interest in Guernsey investments.

Recoveries on loan impairment charges were lower in both periods while continued improved credit conditions and client credit ratings favorably impacted all periods, these factors were more pronounced in the prior periods leading to an overall reduction in recoveries compared to 2012.

Operating expenses decreased during both periods due to lower staff costs and lower support service costs.

Other The other segment primarily includes adjustments made at the corporate level for fair value option accounting related to certain debt issued, the offset to funding credits provided to CMB for holding certain investments, income and expense associated with certain affiliate transactions, adjustments to the fair value on HSBC shares held for stock plans, interest expense associated with certain tax exposures and in both 2012 periods, an expense accrual for certain regulatory matters.

The following table summarizes IFRSs Basis results for the Other segment.

Three Months Ended September 30,	2012	2011	Increase (Decrease)	
			Amount	%
(dollars are in millions)				
Net interest income	\$ (9)	\$ (6)	\$ (3)	(50.0)%
Gain on own debt designated at fair value and related derivatives	(186)	400	(586)	(100+)
Other operating loss	(15)	(20)	5	25.0
Total operating loss	(210)	374	(584)	(100+)
Loan impairment charges	-	-	-	-
	(210)	374	(584)	(100+)
Operating expenses	823	14	809	100+
Profit (loss) before tax	<u>\$(1,033)</u>	<u>\$360</u>	<u>\$(1,393)</u>	<u>(100+)%</u>
(dollars are in millions)				
Nine Months Ended September 30,	2012	2011	Amount	%
(dollars are in millions)				
Net interest income	\$ (19)	\$ (73)	\$ 54	74.0%
Gain (loss) on own debt designated at fair value and related derivatives	(289)	407	(696)	(100+)
Other operating loss	(52)	(44)	(8)	(18.2)
Total operating loss	(360)	290	(650)	(100+)
Loan impairment charges	-	-	-	-
	(360)	290	(650)	(100+)
Operating expenses	1,565	51	1,514	100+
Loss before tax	<u>\$(1,925)</u>	<u>\$239</u>	<u>\$(2,164)</u>	<u>(100+)%</u>

Profit (loss) before tax decreased \$1.4 billion and \$2.2 billion in the three and nine months ended September 30, 2012, respectively, driven largely by credit and interest rate related changes in the fair value of certain of our own debt for which fair value option was elected as well as, in the three and nine months ended September 30, 2012, an expense accrual related to certain regulatory matters totaling \$800 million and \$1.5 billion, respectively. Net interest income was higher in the nine month period due to a reduction in interest expense associated with changes in estimated tax exposures.

Reconciliation of Segment Results As previously discussed, segment results are reported on an IFRS Basis. See Note 18, "Business Segments," in the accompanying consolidated financial statements for a discussion of the differences between IFRSs and U.S. GAAP. For segment reporting purposes, intersegment transactions have not been eliminated. We generally account for transactions between segments as if they were with third parties. Also see Note 18, "Business Segments," in the accompanying consolidated financial statements for a reconciliation of our IFRS Basis segment results to U.S. GAAP consolidated totals.

Credit Quality

In the normal course of business, we enter into a variety of transactions that involve both on and off-balance sheet credit risk. Principal among these activities is lending to various commercial, institutional, governmental and individual customers. We participate in lending activity throughout the U.S. and, on a limited basis, internationally.

Allowance for Credit Losses For a substantial majority of commercial loans, we conduct a periodic assessment on a loan-by-loan basis of losses we believe to be inherent in the loan portfolio. When it is deemed probable based upon known facts and circumstances that full contractual interest and principal on an individual loan will not be collected in accordance with its contractual terms, the loan is considered impaired. An impairment reserve is established based on the present value of expected future cash flows, discounted at the loan's original effective interest rate, or as a practical expedient, the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Updated appraisals for collateral dependent loans are generally obtained only when such loans are considered troubled and the frequency of such updates are generally based on management judgment under the specific circumstances on a case-by-case basis. Problem commercial loans are assigned various obligor grades under the allowance for credit losses methodology. Each credit grade has a probability of default estimate.

Our credit grades align with U.S. regulatory risk ratings and are mapped to our probability of default master scale. These probability of default estimates are validated on an annual basis using back-testing of actual default rates and benchmarking of the internal ratings with external rating agency data like Standard and Poor's ratings and default rates. Substantially all appraisals in connection with commercial real estate loans are ordered by the independent real estate appraisal unit at HSBC. The appraisal must be reviewed and accepted by this unit. For loans greater than \$250,000, an appraisal is generally ordered when the loan is classified as Substandard as defined by the Office of the Comptroller of the Currency (the "OCC"). On average, it is approximately four weeks from the time the appraisal is ordered until it is completed and the values accepted by HSBC's independent appraisal review unit. Subsequent provisions or charge-offs are completed shortly thereafter, generally within the quarter in which the appraisal is received.

In situations where an external appraisal is not used to determine the fair value the underlying collateral of impaired loans, current information such as rent rolls and operating statements of the subject property are reviewed and presented in a standardized format. Operating results such as net operating income and cash flows before and after debt service are established and reported with relevant ratios. Third-party market data is gathered and reviewed for relevance to the subject collateral. Data is also collected from similar properties within the portfolio. Actual sales levels of condominiums, operating income and expense figures and rental data on a square foot basis are derived from existing loans and, when appropriate, used as comparables for the subject property. Property specific data, augmented by market data research, is used to project a stabilized year of income and expense to create a 10-year cash flow model to be discounted at appropriate rates into present value. These valuations are then used to determine if any impairment on the underlying loans exists and an appropriate allowance is recorded when warranted.

Probable losses for pools of homogeneous consumer loans which do not qualify as troubled debt restructures are generally estimated using a roll rate migration analysis that estimates the likelihood that a loan will progress through the various stages of delinquency, or buckets, and ultimately charge off. This analysis considers delinquency status, loss experience and severity and takes into account whether loans have filed for bankruptcy, have been re-aged or are subject to forbearance, an external debt management plan, hardship, modification, extension or deferment. The allowance for credit losses on consumer receivables also takes into consideration the loss severity expected based on the underlying collateral, if any, for the loan in the event of default based on historical and recent trends.

The roll rate methodology is a migration analysis based on contractual delinquency and rolling average historical loss experience which captures the increased likelihood of an account migrating to charge-off as the past due status of such account increases. The roll rate models used were developed by tracking the movement of delinquencies by age of delinquency by month (bucket) over a specified time period. Each “bucket” represents a period of delinquency in 30-day increments. The roll from the last delinquency bucket results in charge-off. Contractual delinquency is a method for determining aging of past due accounts based on the status of payments under the loan. The roll percentages are converted to reserve requirements for each delinquency period (i.e., 30 days, 60 days, etc.). Average roll rates are developed to avoid temporary aberrations caused by seasonal trends in delinquency experienced by some product types. We have determined that a 12-month average roll rate balances the desire to avoid temporary aberrations, while at the same time analyzing recent historical data. The calculations are performed monthly and are done consistently from period to period. In addition, loss reserves on consumer receivables are maintained to reflect our judgment of portfolio risk factors which may not be fully reflected in the statistical roll rate calculation. For consumer loans which have been identified as troubled debt restructures, credit loss reserves are maintained based on the present value of expected future cash flows discounted at the loan’s original effective interest rates.

As discussed above, we estimate probable losses for consumer loans and certain small balance commercial loans which do not qualify as troubled debt restructures using a roll rate migration analysis that estimates the likelihood that a loan will progress through the various stages of delinquency and ultimately charge-off. This has historically resulted in the identification of a loss emergence period for these loans collectively evaluated for impairment using a roll rate migration analysis which approximates less than 12 months of loss coverage in the allowance for credit losses for certain loan products. A loss coverage of 12 months in our allowance for credit losses would be more aligned with U.S. bank industry practice. Our regulators have indicated they would like us to more closely align our loss coverage period with industry practice. During the fourth quarter of 2012, we will review our estimate of loss emergence to determine what changes should be made to our credit loss estimate which could result in an increase to our allowance for credit losses in the fourth quarter of 2012 in an amount that is not expected to exceed 15 percent of our total allowance for credit losses at September 30, 2012.

Our allowance for credit losses methodology and our accounting policies related to the allowance for credit losses are presented in further detail under the caption “Critical Accounting Policies and Estimates” and in Note 2, “Summary of Significant Accounting Policies and New Accounting Pronouncements,” in our 2011 Form 10-K. Our approach toward credit risk management is summarized under the caption “Risk Management” in our 2011 Form 10-K. There have been no material revisions to our policies or methodologies during the first half of 2012, although we continue to monitor current market conditions and will adjust credit policies as deemed necessary.

The following table sets forth the allowance for credit losses for the periods indicated:

	September 30, 2012	June 30, 2012	December 31, 2011
	(dollars are in millions)		
Allowance for credit losses	<u>\$ 637</u>	<u>\$ 619</u>	<u>\$ 743</u>
Ratio of Allowance for credit losses to:			
Loans: ⁽¹⁾			
Commercial .....	.82%	.91%	1.31%
Consumer:			
Residential mortgages, excluding home equity mortgages	1.33	1.27	1.36
Home equity mortgages	1.76	1.91	2.03
Credit card receivables	4.27	3.96	4.71
Other consumer loans	<u>2.28</u>	<u>2.00</u>	<u>2.52</u>
Total consumer loans	<u>1.54</u>	<u>1.50</u>	<u>1.65</u>
Total	<u>1.04%</u>	<u>1.10%</u>	<u>1.43%</u>
Net charge-offs ⁽¹⁾⁽²⁾ :			
Commercial	722.92%	1,062.50%	850.00%
Consumer	<u>135.51</u>	<u>106.90</u>	<u>120.40</u>
Total	<u>243.13%</u>	<u>211.26%</u>	<u>246.03%</u>
Nonperforming loans ⁽¹⁾ :			
Commercial	52.02%	51.75%	52.68%
Consumer	<u>25.82</u>	<u>28.79</u>	<u>31.39</u>
Total	<u>35.59%</u>	<u>38.07%</u>	<u>41.32%</u>

⁽¹⁾ Ratios exclude loans held for sale as these loans are carried at the lower of cost or fair value.

⁽²⁾ Quarter-to-date net charge-offs, annualized.

Changes in the allowance for credit losses by general loan categories for the three and nine months ended September 30, 2012 and 2011 are summarized in the following table:

	Commercial				Consumer				Total
	Construction and Other Real Estate	Business Banking and Middle Market Enterprises	Global banking	Other Comm'l	Residential Mortgage, Excl Home Equity Mortgages	Home Equity Mortgages	Credit Card	Other Consumer	
(in millions)									
Three Months Ended September 30, 2012:									
Allowance for credit losses – beginning of period	\$198	\$ 80	\$ 44	\$ 18	\$188	\$ 47	\$ 31	\$ 13	\$ 619
Provision charged to income	(11)	18	12	-	33	13	15	4	84
Charge offs	(9)	(8)	-	-	(24)	(18)	(14)	(3)	(76)
Recoveries	3	2	-	-	3	-	2	-	10
Net charge offs	(6)	(6)	-	-	(21)	(18)	(12)	(3)	(66)
Allowance for credit losses – end of period	<u>\$181</u>	<u>\$ 92</u>	<u>\$ 56</u>	<u>\$ 18</u>	<u>\$200</u>	<u>\$ 42</u>	<u>\$ 34</u>	<u>\$ 14</u>	<u>\$ 637</u>
Three Months Ended September 30, 2011:									
Allowance for credit losses – beginning of period	\$229	\$ 96	\$110	\$ 21	162	\$ 62	\$ 44	\$ 23	\$ 747
Provision charged to income	(10)	5	28	(23)	53	8	12	5	78
Charge offs	(3)	(11)	-	-	(24)	(15)	(16)	(6)	(75)
Recoveries	1	3	-	20	1	-	3	1	29
Net charge offs	(2)	(8)	-	20	(23)	(15)	(13)	(5)	(46)
Allowance on loans transferred to held for sale	-	(10)	-	-	(4)	(6)	(6)	(4)	(30)
Allowance for credit losses – end of period	<u>\$217</u>	<u>\$ 83</u>	<u>\$138</u>	<u>\$ 18</u>	<u>\$188</u>	<u>\$ 49</u>	<u>\$ 37</u>	<u>\$ 19</u>	<u>\$ 749</u>
Nine Months Ended September 30, 2012:									
Allowance for credit losses – beginning of period	\$212	\$ 78	\$131	\$ 21	\$192	\$ 52	\$ 39	\$ 18	\$ 743
Provision charged to income	(36)	39	9	(9)	72	55	35	8	173
Charge offs	(12)	(31)	(84)	-	(73)	(65)	(47)	(17)	(329)
Recoveries	17	6	-	6	9	-	7	5	50
Net charge offs	5	(25)	(84)	6	(64)	(65)	(40)	(12)	(279)
Allowance for credit losses – end of period	<u>\$181</u>	<u>\$ 92</u>	<u>\$ 56</u>	<u>\$ 18</u>	<u>\$200</u>	<u>\$ 42</u>	<u>\$ 34</u>	<u>\$ 14</u>	<u>\$ 637</u>
Nine Months Ended September 30, 2011:									
Allowance for credit losses – beginning of period	\$243	\$132	\$116	\$ 32	\$167	\$ 77	\$ 58	\$ 27	\$ 852
Provision charged to income	11	(4)	22	(33)	98	31	32	14	171
Charge offs	(46)	(44)	-	(2)	(78)	(53)	(56)	(21)	(300)
Recoveries	9	9	-	21	4	-	9	4	56
Net charge offs	(37)	(35)	-	19	(74)	(53)	(47)	(17)	(244)
Allowance on loans transferred to held for sale	-	(10)	-	-	(3)	(6)	(6)	(5)	(30)
Allowance for credit losses – end of period	<u>\$217</u>	<u>\$ 83</u>	<u>\$138</u>	<u>\$ 18</u>	<u>\$188</u>	<u>\$ 49</u>	<u>\$ 37</u>	<u>\$ 19</u>	<u>\$ 749</u>

The allowance for credit losses at September 30, 2012 increased \$18 million, or 2.9 percent as compared to June 30, 2012 and decreased \$106 million, or 14.3 percent as compared to December 31, 2011. The increase since June 30, 2012 was driven by increased levels of reserves on commercial loans for risk factors associated

with expansion activities in the U.S. as well as higher loss estimates on residential mortgage loan troubled debt restructures. The decrease from December 31, 2011 was driven largely by lower loss estimates in our commercial loan portfolio. Reserve requirements in our commercial loan portfolio have declined since December 31, 2011 due to reductions in certain global banking exposures and improvements in the financial circumstances of several customer relationships which led to credit upgrades on certain problem credits and lower levels of nonperforming loans and criticized assets. Our allowance for credit losses in our consumer loan portfolio also declined due to continued improvements in credit quality including lower delinquency levels as well as lower levels of credit card and other consumer loans outstanding, partially offset by increased reserve requirements associated with higher levels of residential mortgage loan receivables. Reserve levels for all consumer loan categories however continue to be impacted by the slow pace of economic recovery in the U.S. economy, including elevated unemployment rates and as it relates to residential mortgage loans, a housing market which is slow to recover.

The allowance for credit losses as a percentage of total loans at September 30, 2012 decreased as compared to December 31, 2011 for the reasons discussed above.

The allowance for credit losses as a percentage of net charge-offs increased as compared to June 30, 2012, driven largely by higher levels of allowance relating to consumer loans, while consumer loan net charge-offs declined. This was partially offset by the impact of slightly higher commercial loan charge-offs in the third quarter of 2012 while the commercial allowance for credit losses remained relatively flat. The allowance for credit losses as a percentage of net charge-offs remained relatively flat as compared to December 31, 2011.

The allowance for credit losses by major loan categories, excluding loans held for sale, is presented in the following table:

	September 30, 2012		June 30, 2012		December 31, 2011	
	Amount	% of Loans to Total Loans ⁽¹⁾	Amount	% of Loans to Total Loans ⁽¹⁾	Amount	% of Loans to Total Loans ⁽¹⁾
(dollars are in millions)						
Commercial ⁽²⁾	\$347	69.27%	\$340	66.74%	\$442	64.88%
Consumer:						
Residential mortgages, excluding home equity mortgages	200	24.55	188	26.32	192	27.21
Home equity mortgages	42	3.88	47	4.38	52	4.94
Credit card receivables	34	1.30	31	1.40	39	1.60
Other consumer	14	1.00	13	1.16	18	1.37
Total consumer	290	30.73	279	33.26	301	35.12
Total	\$637	100.00%	\$619	100.00%	\$743	100.00%

⁽¹⁾ Excludes loans held for sale.

⁽²⁾ Components of the commercial allowance for credit losses, including exposure relating to off-balance sheet credit risk, and the increases (decreases) since December 31, 2011, are summarized in the following table:

	September 30, 2012	June 30, 2012	December 31, 2011
(in millions)			
On-balance sheet allowance:			
Specific	\$127	\$131	\$213
Collective	167	168	207
Unallocated	53	41	22
Total on-balance sheet allowance	347	340	442
Off-balance sheet allowance	145	151	155
Total commercial allowances	\$492	\$491	\$597

While our allowance for credit loss is available to absorb losses in the entire portfolio, we specifically consider the credit quality and other risk factors for each of our products in establishing the allowance for credit losses.

Reserves for Off-Balance Sheet Credit Risk We also maintain a separate reserve for credit risk associated with certain off-balance sheet exposures, including letters of credit, unused commitments to extend credit and financial guarantees. This reserve, included in other liabilities, was \$145 million, \$151 million and \$155 million at September 30, 2012, June 30, 2012 and December 31, 2011, respectively. The related provision is recorded as a component of other expense within operating expenses. Off-balance sheet exposures are summarized under the caption “Off-Balance Sheet Arrangements” in this MD&A.

Delinquency The following table summarizes dollars of two-months-and-over contractual delinquency and two-months-and-over contractual delinquency as a percent of total loans and loans held for sale (“delinquency ratio”):

	September 30, 2012	June 30, 2012	December 31, 2011
(dollars are in millions)			
Dollars of Delinquency:			
Commercial	\$ 217	\$ 226	\$ 460
Consumer:			
Residential mortgage, excluding home equity mortgages ⁽¹⁾	1,100	1,107	1,101
Home equity mortgages	<u>67</u>	<u>62</u>	<u>99</u>
Total residential mortgages ⁽²⁾	1,167	1,169	1,200
Credit card receivables	22	23	28
Other consumer	<u>29</u>	<u>28</u>	<u>30</u>
Total consumer	1,218	1,220	1,258
Total	<u>\$1,435</u>	<u>\$1,446</u>	<u>\$1,718</u>
Delinquency Ratio:			
Commercial .....	.50%	.59%	1.33%
Consumer:			
Residential mortgage, excluding home equity mortgages	7.04	7.16	7.19
Home equity mortgages	<u>2.81</u>	<u>2.33</u>	<u>2.89</u>
Total residential mortgages ⁽²⁾	6.48	6.45	6.41
Credit card receivables	2.76	2.62	2.25
Other consumer	<u>4.26</u>	<u>3.68</u>	<u>3.17</u>
Total consumer	6.25	6.18	6.01
Total	<u>2.30%</u>	<u>2.49%</u>	<u>3.09%</u>

⁽¹⁾ At September 30, 2012, June, 2012 and December 31, 2011, residential mortgage loan delinquency includes \$970 million, \$938 million and \$803 million, respectively, of loans that are carried at the lower of cost or net realizable value.

⁽²⁾ The following reflects dollars of contractual delinquency and delinquency ratios for interest-only loans and ARM loans:

	September 30, 2012	June 30, 2012	December 31, 2011
(dollars are in millions)			
Dollars of Delinquency:			
Interest-only loans	\$ 121	\$ 120	\$ 133
ARM loans	403	423	452
Delinquency Ratio:			
Interest-only loans	3.03%	3.03%	3.37%
ARM loans	3.94	4.16	4.53

Our total two-months-and-over contractual delinquency ratio decreased 19 basis points compared to the prior quarter. Our two-months-and-over contractual delinquency ratio for consumer loans increased 7 basis points to 6.25 percent at September 20, 2012 as compared to 6.18 percent at June 30, 2012, due to lower receivable levels

driven by a \$355 million decline in residential mortgage loans held for sale during the quarter, a substantial majority of which were less than 60 days delinquent, while residential mortgage dollars of delinquency remained flat, reflecting the continued impact of our decision in late 2010 to suspend new foreclosure proceedings which has resulted in loans which would otherwise have been foreclosed and transferred to REO remaining in loan account. Overall delinquency levels also continue to be impacted by elevated unemployment levels and, as it relates to residential mortgages, a housing market which is slow to recover.

Our commercial two-months-and-over contractual delinquency ratio decreased 9 basis points since June 30, 2012 driven by lower dollars of commercial loan delinquency due to improved credit quality and higher overall outstanding loan balances.

Compared to December 31, 2011, our two-months-and-over contractual delinquency ratio decreased 79 basis points largely due to lower dollars of contractual delinquency and improved credit conditions and higher overall outstanding loan balances.

Net Charge-offs of Loans The following table summarizes net charge-off (recovery) dollars as well as the net charge-off (recovery) of loans for the quarter, annualized, as a percent of average loans, excluding loans held for sale, ("net charge-off ratio"):

	September 30, 2012	June 30, 2012	September 30, 2011
(dollars are in millions)			
Net Charge-off Dollars:			
Commercial:			
Construction and other real estate	\$ 6	\$ 2	\$ 2
Business banking and middle market enterprises	6	11	8
Other commercial	-	(5)	(20)
Total commercial	<u>12</u>	<u>8</u>	<u>(10)</u>
Consumer:			
Residential mortgage, excluding home equity mortgages	21	18	23
Home equity mortgages	18	30	15
Total residential mortgages	<u>39</u>	<u>48</u>	<u>38</u>
Credit card receivables	12	13	13
Other consumer	3	4	5
Total consumer	<u>54</u>	<u>65</u>	<u>56</u>
Total	<u>\$ 66</u>	<u>\$ 73</u>	<u>\$ 46</u>
Net Charge-off Ratio:			
Commercial:			
Construction and other real estate . . . . .	.30%	.10%	.10%
Business banking and middle market enterprises . . . . .	.20	.39	.35
Other commercial	-	(.65)	(2.76)
Total commercial	<u>.12</u>	<u>.09</u>	<u>(.13)</u>
Consumer:			
Residential mortgage, excluding home equity mortgages . . . . .	.56	.50	.65
Home equity mortgages	2.93	4.87	1.88
Total residential mortgages	<u>.89</u>	<u>1.14</u>	<u>.88</u>
Credit card receivables	5.98	6.55	7.59
Other consumer	1.91	2.41	2.36
Total consumer	<u>1.14</u>	<u>1.41</u>	<u>1.18</u>
Total	<u>.45%</u>	<u>.54%</u>	<u>.37%</u>

Our net charge-off ratio as a percentage of average loans decreased 9 basis points for the quarter ended September 30, 2012 compared to the quarter ended June 30, 2012 primarily due to lower consumer loan charge-offs driven by lower home equity mortgage charge-offs as the prior quarter reflects the impact of an increased volume of loans where we decided not to pursue foreclosure, while our commercial loan charge-off dollars and ratio remained relatively flat.

Compared to the year-ago quarter, our charge-off ratio increased 8 basis points, driven by higher commercial loan charge-offs as the prior year quarter includes a partial recovery relating to a previously charged off loan relating to a single client relationship. Also compared to the year-ago quarter, our consumer net charge-off ratio declined 4 basis points driven by lower credit card and other consumer loan charge-offs reflecting continued improvements in economic and credit conditions, while residential mortgage loan charge-offs remained relatively flat and average balances increased.

Nonperforming Assets Nonperforming assets are summarized in the following table.

	September 30, 2012	June 30, 2012	December 31, 2011
	(dollars are in millions)		
Nonaccrual loans:			
Commercial:			
Real Estate:			
Construction and land loans	\$ 98	\$ 101	\$ 103
Other real estate	353	374	512
Business banking and middle market enterprises	46	46	58
Global banking	142	114	137
Other commercial	19	19	15
Total commercial	<u>658</u>	<u>654</u>	<u>825</u>
Consumer:			
Residential mortgages, excluding home equity mortgages	979	844	815
Home equity mortgages	97	77	89
Total residential mortgages ⁽²⁾⁽³⁾⁽⁴⁾	1,076	921	904
Others	5	5	8
Total consumer loans	<u>1,081</u>	<u>926</u>	<u>912</u>
Nonaccrual loans held for sale	51	65	91
Total nonaccruing loans	<u>\$1,790</u>	<u>\$1,645</u>	<u>\$1,828</u>
Accruing loans contractually past due 90 days or more:			
Commercial:			
Real Estate:			
Construction and land loans	\$ -	\$ -	\$ -
Other real estate	1	-	1
Business banking and middle market enterprises	7	2	11
Other commercial	1	1	2
Total commercial	<u>9</u>	<u>3</u>	<u>14</u>
Consumer:			
Credit card receivables	15	17	20
Other consumer	27	26	27
Total consumer loans	<u>42</u>	<u>43</u>	<u>47</u>
Total accruing loans contractually past due 90 days or more	<u>51</u>	<u>46</u>	<u>61</u>
Total nonperforming loans	<u>1,841</u>	<u>1,691</u>	<u>1,889</u>
Other real estate owned	95	99	81
Total nonperforming assets	<u>\$1,936</u>	<u>\$1,790</u>	<u>\$1,970</u>
Allowance for credit losses as a percent of nonperforming loans ⁽¹⁾ :			
Commercial	52.02%	51.75%	55.68%
Consumer	25.82	28.79	31.39

- (1) Represents our commercial or consumer allowance for credit losses, as appropriate divided by the corresponding outstanding balance of total nonperforming loans held for investment. Nonperforming loans include accruing loans contractually past due 90 days or more. Ratio excludes nonperforming loans associated with loan portfolios which are considered held for sale as these loans are carried at the lower of amortized cost or market.
- (2) At September 30, 2012, June, 2012 and December 31, 2011, residential mortgage loan nonaccrual balances include \$1,032 million, \$901 million and \$774 million, respectively, of loans that are carried at the lower of cost or fair value of collateral less cost to sell.
- (3) Nonaccrual residential mortgages includes all receivables which are 90 or more days contractually delinquent as well as second lien loans where the first lien loan that we own or service is 90 or more days contractually delinquent.
- (4) In the third quarter of 2012, we reclassified \$83 million of residential mortgage loans discharged under Chapter 7 bankruptcy and not re-affirmed to nonaccrual, consistent with recently issued regulatory guidance. Interest income reversed on these loans was not material.

Nonaccrual loans at September 30, 2012 increased as compared to June 30, 2012, largely due to the reclassification of \$83 million of residential mortgage loans discharged under Chapter 7 bankruptcy as discussed above. Compared to December 31, 2011, nonaccrual loans declined driven largely by lower levels of commercial non-accrual loans, partially offset by increases in residential mortgage non-accrual loans. The increase in nonaccrual residential mortgage loans reflects the reclassification of certain loans discharged under Chapter 7 bankruptcy as discussed above as well as our earlier decision to temporarily suspend foreclosure activity, which results in loans which would otherwise have been transferred into REO remaining in loan account. Commercial non-accrual loans decreased due to credit risk rating upgrades outpacing credit risk rating downgrades, managed reductions in certain exposures, as well as payments and charge-offs within our global banking portfolio as previously discussed. Accruing loans past due 90 days or more since June 30, 2012 and December 31, 2011 have remained relatively stable with modest changes driven mainly by commercial loan receivable activity.

Our policies and practices for problem loan management and placing loans on nonaccrual status are summarized in Note 2, "Summary of Significant Accounting Policies and New Accounting Pronouncements," in our 2011 Form 10-K.

Accrued but unpaid interest on loans placed on nonaccrual status generally is reversed and reduces current income at the time loans are so categorized. Interest income on these loans may be recognized to the extent of cash payments received. In those instances where there is doubt as to collectability of principal, any cash interest payments received are applied as reductions of principal. Loans are not reclassified as accruing until interest and principal payments are brought current and future payments are reasonably assured.

Impaired Commercial Loans A commercial loan is considered to be impaired when it is deemed probable that all principal and interest amounts due, according to the contractual terms of the loan agreement, will not be collected. Probable losses from impaired loans are quantified and recorded as a component of the overall allowance for credit losses. Generally, impaired commercial loans include loans in nonaccrual status, loans that have been assigned a specific allowance for credit losses, loans that have been partially charged off and loans designated as troubled debt restructurings. Impaired commercial loan statistics are summarized in the following table:

	September 30, 2012	June 30, 2012	December 31, 2011
	(in millions)		
Impaired commercial loans:			
Balance at end of period	\$870	\$907	\$1,087
Amount with impairment reserve	421	421	597
Impairment reserve	128	132	216

Criticized Loan Criticized loan classifications are based on the risk rating standards of our primary regulator. Problem loans are assigned various criticized facility grades under our allowance for credit losses methodology. The following facility grades are deemed to be criticized.

- *Special Mention* – generally includes loans that are protected by collateral and/or the credit worthiness of the customer, but are potentially weak based upon economic or market circumstances which, if not checked or corrected, could weaken our credit position at some future date.
- *Substandard* – includes loans that are inadequately protected by the underlying collateral and/or general credit worthiness of the customer. These loans present a distinct possibility that we will sustain some loss if the deficiencies are not corrected. This category also includes certain non-investment grade securities, as required by our principal regulator.
- *Doubtful* – includes loans that have all the weaknesses exhibited by substandard loans, with the added characteristic that the weaknesses make collection or liquidation in full of the recorded loan highly improbable. However, although the possibility of loss is extremely high, certain factors exist which may strengthen the credit at some future date, and therefore the decision to charge off the loan is deferred. Loans graded as doubtful are required to be placed in nonaccruing status.

Criticized loans are summarized in the following table.

	September 30, 2012	Increase (Decrease) from June 30, 2012		Increase (Decrease) from December 31, 2011	
		Amount	%	Amount	%
(dollars are in millions)					
Special mention:					
Commercial loans	\$1,200	\$(162)	(11.9)%	\$ (398)	(24.9)%
Substandard:					
Commercial loans	1,095	(201)	(15.5)	(665)	(37.8)
Consumer loans	1,022	48	4.9	(334)	(24.6)
Total substandard	2,117	(153)	(6.7)	(999)	(32.1)
Doubtful:					
Commercial loans	257	20	8.4	(50)	(16.3)
Total	\$3,574	\$(295)	(7.6)	\$(1,447)	(28.8)

The overall decreases in criticized commercial loans in the first half of 2012 resulted primarily from changes in the financial condition of certain customers, some of which were upgraded during the period as well as paydowns, note sales and charge-offs related to certain exposures as well as general improvement in market conditions.

Geographic Concentrations Regional exposure at September 30, 2012 for certain loan portfolios is summarized in the following table.

	Commercial Construction and Other Real Estate Loans	Residential Mortgage Loans	Credit Card Receivables
New York State	44.6%	34.8%	57.9%
North Central United States	5.3	6.8	3.7
North Eastern United States	10.1	9.3	12.1
Southern United States	20.0	16.4	13.6
Western United States	20.0	32.7	10.6
Other	-	-	2.1
Total	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>

Exposures to Certain Countries in the Eurozone There has been no significant changes to our exposures to the countries of Greece, Ireland, Italy, Portugal and Spain from the amounts disclosed in our 2011 Form 10-K under caption “Credit Quality”.

Liquidity and Capital Resources

Effective liquidity management is defined as making sure we can meet customer loan requests, customer deposit maturities/withdrawals and other cash commitments efficiently under both normal operating conditions and under unpredictable circumstances of industry or market stress. To achieve this objective, we have guidelines that require sufficient liquidity to cover potential funding requirements and to avoid over-dependence on volatile, less reliable funding markets. Guidelines are set for the consolidated balance sheet of HSBC USA to ensure that it is a source of strength for our regulated, deposit-taking banking subsidiary, as well as to address the more limited sources of liquidity available to it as a holding company. Similar guidelines are set for the balance sheet of HSBC Bank USA to ensure that it can meet its liquidity needs in various stress scenarios. Cash flow analysis, including stress testing scenarios, forms the basis for liquidity management and contingency funding plans.

During the first nine months of 2012, marketplace liquidity continued to remain available for most sources of funding except mortgage securitization although credit spreads continue to be impacted by the European sovereign debt crisis and concerns regarding government spending and the budget deficit continue to impact interest rates. The prolonged period of low Federal funds rates continues to put pressure on spreads earned on our deposit base.

Interest Bearing Deposits with Banks totaled \$15.3 billion and \$25.5 billion at September 30, 2012 and December 31, 2011, respectively. Balances will fluctuate from period to period depending upon our liquidity position at the time and our strategy for deploying such liquidity. The balances decreased during the first nine months of 2012 as we redeployed surplus liquidity primarily into securities purchased under agreements to resell and made payments to First Niagara relating to the sale of 195 retail branches in the second and third quarters of 2012.

Securities Purchased under Agreements to Resell totaled \$11.7 billion and \$3.1 billion at September 30, 2012 and December 31, 2011, respectively. Balances will fluctuate from period to period depending upon our liquidity position at the time and our strategy for deploying such liquidity.

Short-Term Borrowings totaled \$14.1 billion and \$16.0 billion at September 30, 2012 and December 31, 2011, respectively. See “Balance Sheet Review” in this MD&A for further analysis and discussion on short-term borrowing trends.

At December 31, 2011, we had a \$2.5 billion unused line of credit with HSBC France to support issuances of commercial paper. In April 2012, we established a third party back-up line of credit totaling \$1.9 billion to replace the unused line of credit with HSBC France and support issuances of commercial paper. The line of credit with HSBC France was terminated effective July 30, 2012.

Deposits totaled \$121.3 billion and \$139.7 billion at September 30, 2012 and December 31, 2011, respectively. See “Balance Sheet Review” in this MD&A for further analysis and discussion on deposit trends.

Long-Term Debt increased to \$21 billion at September 30, 2012 from \$16.7 billion at December 31, 2011. The following table summarizes issuances and retirements of long-term debt during the nine months ended September 30, 2012 and 2011:

Nine Months Ended September 30,	2012	2011
	(in millions)	
Long-term debt issued	\$ 5,354	\$ 5,152
Long-term debt retired	(1,936)	(3,120)
Net long-term debt issued	<u>\$ 3,418</u>	<u>\$ 2,032</u>

Issuances of long-term debt during the first nine month of 2012 included \$3.1 billion of medium term notes, of which \$237 million was issued by HSBC Bank USA.

Under our shelf registration statement on file with the Securities and Exchange Commission, we may issue debt securities or preferred stock. The shelf has no dollar limit, but the ability to issue debt is limited by the issuance authority granted by the Board of Directors. At September 30, 2012, we were authorized to issue up to \$21 billion, of which \$12.4 billion was available. HSBC Bank USA also has a \$40 billion Global Bank Note Program of which \$17.0 billion was available at September 30, 2012.

As a member of the New York Federal Home Loan Bank (“FHLB”), we have a secured borrowing facility which is collateralized by real estate loans and investment securities. At September 30, 2012 and December 31, 2011, long-term debt included \$1.0 billion, under this facility. The facility also allows access to further borrowings of up to \$4.1 billion based upon the amount pledged as collateral with the FHLB.

Preferred Equity See Note 20, “Preferred Stock,” in our 2011 Form 10-K for information regarding all outstanding preferred share issues.

Common Equity During the first nine month of 2012, we did not receive any cash capital contributions from HNAI. During the first nine month of 2012, we contributed \$2 million of capital to our subsidiary, HSBC Bank USA.

Selected Capital Ratios Capital amounts and ratios are calculated in accordance with current banking regulations. In managing capital, we develop targets for Tier 1 capital to risk weighted assets, Tier 1 common equity to risk weighted assets, Total capital to risk weighted assets and Tier 1 leverage ratio (Tier 1 capital to average assets). Our targets may change from time to time to accommodate changes in the operating environment or other considerations such as those listed above. Selected capital ratios are summarized in the following table:

	September 30, 2012	December 31, 2011
Tier 1 capital to risk weighted assets	13.25%	12.74%
Tier 1 common equity to risk weighted assets	10.97	10.72
Total capital to risk weighted assets	19.20	18.39
Tier 1 capital to average assets	7.35	7.43
Total equity to total assets	8.65	8.80

HSBC USA manages capital in accordance with the HSBC Group policy. HSBC North America and HSBC USA have each approved an Internal Capital Adequacy Assessment Process (“ICAAP”) that works in conjunction with the HSBC Group’s ICAAP. The ICAAP evaluates regulatory capital adequacy, economic capital adequacy, rating agency requirements and capital adequacy under various stress scenarios. Our initial approach is to meet our capital needs for these stress scenarios locally through activities which reduce risk. To the extent that local alternatives are insufficient or unavailable, we will rely on capital support from our parent in accordance with HSBC’s capital management policy. HSBC has indicated that they are fully committed and have the capacity to provide capital as needed to run operations, maintain sufficient regulatory capital ratios and fund certain tax planning strategies.

HSBC North America is required to implement Basel II provisions in accordance with current regulatory timelines. While HSBC USA will not report separately under the new rules, HSBC Bank USA will report under the new rules on a stand-alone basis. Adoption of Basel II requires the approval of U.S. regulators and encompasses enhancements to a number of risk policies, processes and systems to align HSBC Bank USA with the Basel II final rule requirements. We are uncertain as to when we will receive approval to adopt Basel II from the Federal Reserve Board, our primary regulator. We have integrated Basel II metrics into our management reporting and decision making process. As a result of Dodd-Frank, a banking organization that has formally implemented Basel II must calculate its capital requirements under Basel I and Basel II, compare the two results, and then use the lower of such ratios for purposes of determining compliance with its minimum Tier 1 capital and total risk-based capital requirements. On June 7, 2012, the U.S. regulators issued three joint Notices of Proposed Rulemaking which include the proposed changes to the regulatory capital adequacy framework required to implement Basel III in the U.S. If implemented as proposed, the rules would be effective as of January 1, 2013 with phase-in periods for certain provisions.

In June 2012, U.S. regulators published a Final Rule in the Federal Register (known in the industry as Basel 2.5), that would change the US regulatory market risk capital rules to better capture positions for which the market risk capital rules are appropriate, reduce procyclicality, enhance the sensitivity to risks that are not adequately captured under current methodologies and increase transparency through enhanced disclosures. This final rule is effective January 1, 2013. We estimate that this rule will add up to 10% to our December 31, 2011 Basel I risk-weighted asset levels.

U.S. regulators have issued regulations on capital planning for bank holding companies. Under the regulations, from January 1, 2012, U.S. bank holding companies with \$50 billion or more in total consolidated assets would need to obtain approval of their annual capital plans prior to making capital distributions. Additionally, there are certain circumstances in which a bank holding company would be required to provide prior notice for approval of capital distributions, even if included in an approved plan. U.S. regulators have also issued proposed regulations on stress testing which would apply in conjunction with the capital planning regulations.

HSBC Bank USA is subject to restrictions that limit the transfer of funds to its affiliates, including HSBC USA, and its nonbank subsidiaries in so-called “covered transactions.” In general, covered transactions include loans and other extensions of credit, investments and asset purchases, as well as certain other transactions involving the transfer of value from a subsidiary bank to an affiliate or for the benefit of an affiliate. Unless an exemption applies, covered transactions by a subsidiary bank with a single affiliate are limited to 10 percent of the subsidiary bank’s capital and surplus and, with respect to all covered transactions with affiliates in the aggregate, to 20 percent of the subsidiary bank’s capital and surplus. Also, loans and extensions of credit and certain other exposures to affiliates generally are required to be secured in specified amounts. Where cash collateral is provided for an extension of credit to an affiliate, that loan is excluded from the 10 and 20 percent limitations. A bank’s transactions with its nonbank affiliates are also required to be on arm’s length terms.

We and HSBC Bank USA are required to meet minimum capital requirements by our principal regulators. Risk-based capital amounts and ratios are presented in Note 17, “Regulatory Capital,” in the accompanying consolidated financial statements.

2012 Funding Strategy Our current range of estimates for funding needs and sources for 2012 are summarized in the following table.

	Actual January 1 through September 30, 2012	Estimated October 1 through December 31, 2012	Estimated Full Year 2012
	(in billions)		
Funding needs:			
Deposits assumed in branch sale, net	\$15	\$ -	\$15
Net change in loans	7	2	9
Reduction in deposits	3	1	4
Long-term debt maturities	2	1	3
Funding advances to HSBC Finance	<u>1</u>	<u>-</u>	<u>1</u>
Total funding needs	<u>\$28</u>	<u>\$4</u>	<u>\$32</u>
Funding sources:			
Asset sales	\$22	\$ -	\$22
Net change in short term investments	1	2	3
Long-term debt issuances	<u>5</u>	<u>2</u>	<u>7</u>
Total funding sources	<u>\$28</u>	<u>\$4</u>	<u>\$32</u>

The above table reflects a long-term funding strategy. Daily balances fluctuate as we accommodate customer needs, while ensuring that we have liquidity in place to support the balance sheet maturity funding profile. Should market conditions deteriorate, we have contingency plans to generate additional liquidity through the sales of assets or financing transactions. Our prospects for growth are dependent upon our ability to attract and retain deposits and, to a lesser extent, access to the global capital markets. We remain confident in our ability to access the market for long-term debt funding needs in the current market environment. We continue to seek well-priced and stable customer deposits as customers move funds to larger, well-capitalized institutions.

We will continue to sell a substantial portion of new mortgage loan originations to government sponsored enterprises and private investors.

HSBC Finance ceased issuing under its commercial paper program in the second quarter of 2012 and instead will rely on its affiliates, including HSBC USA Inc. to satisfy its short-term funding needs.

For further discussion relating to our sources of liquidity and contingency funding plan, see the caption "Risk Management" in this MD&A.

Off-Balance Sheet Arrangements

As part of our normal operations, we enter into credit derivatives and various off-balance sheet arrangements with affiliates and third parties. These arrangements arise principally in connection with our lending and client intermediation activities and involve primarily extensions of credit and, in certain cases, guarantees.

As a financial services provider, we routinely extend credit through loan commitments and lines and letters of credit and provide financial guarantees, including derivative transactions having characteristics of a guarantee. The contractual amounts of these financial instruments represent our maximum possible credit exposure in the event that a counterparty draws down the full commitment amount or we are required to fulfill our maximum obligation under a guarantee.

The following table provides maturity information related to our credit derivatives and off-balance sheet arrangements. Many of these commitments and guarantees expire unused or without default. As a result, we believe that the contractual amount is not representative of the actual future credit exposure or funding requirements. Descriptions of these arrangements are found in our 2011 Form 10-K under the caption “Off-Balance Sheet Arrangements and Contractual Obligations”.

	Balance at September 30, 2012				Balance at December 31, 2011
	One Year or Less	Over One through Five Years	Over Five Years	Total	
	(in billions)				
Standby letters of credit, net of participations ⁽¹⁾	\$ 5.2	\$ 2.9	\$ -	\$ 8.1	\$ 7.8
Commercial letters of credit	.9	-	-	.9	1.3
Credit derivatives ⁽²⁾	79.0	173.7	10.3	263.0	330.4
Other commitments to extend credit:					
Commercial	13.0	41.9	3.5	58.4	54.7
Consumer	7.1	-	-	7.1	9.3
Total	\$105.2	\$218.5	\$13.8	\$337.5	\$403.5

⁽¹⁾ Includes \$757 million and \$707 million issued for the benefit of HSBC affiliates at September 30, 2012 and December 31, 2011, respectively.

⁽²⁾ Includes \$45.9 billion and \$45.1 billion issued for the benefit of HSBC affiliates at September 30, 2012 and December 31, 2011, respectively.

We provide liquidity support to a number of multi-seller and single seller asset-backed commercial paper conduits (“ABCP conduits”). The tables below present information on our liquidity facilities with ABCP conduits at September 30, 2012. The maximum exposure to loss presented in the first table represents the maximum contractual amount of loans and asset purchases we could be required to make under the liquidity agreements. This amount does not reflect the funding limits discussed above and also assumes that we suffer a total loss on all amounts advanced and all assets purchased from the ABCP conduits. As such, we believe that this measure significantly overstates our expected loss exposure. See our 2011 Form 10-K under the caption “Off-Balance Sheet Arrangements and Contractual Obligations” in MD&A for additional information on these ABCP conduits.

Conduit Type	Maximum Exposure to Loss	Conduit Assets ⁽¹⁾		Conduit Funding ⁽¹⁾	
		Total Assets	Weighted Average Life (Months)	Commercial Paper	Weighted Average Life (Days)
		(dollars are in millions)			
HSBC affiliate sponsored (multi-seller)	\$1,097	\$ 816	9	\$ 817	19
Third-party sponsored:					
Single-seller	454	6,052	44	5,832	60
Total	\$1,551	\$6,868		\$6,649	

⁽¹⁾ For multi-seller conduits, the amounts presented represent only the specific assets and related funding supported by our liquidity facilities. For single-seller conduits, the amounts presented above represent the total assets and funding of the conduit.

Asset Class	Average Asset Mix	Average Credit Quality ⁽¹⁾				
		AAA	AA+/AA	A	A-	BB/BB-
Multi-seller conduits						
Debt securities backed by:						
Auto loans and leases	47%	50%	-%	-%	-%	-%
Credit card receivables	7%	-%	-%	100%	-%	-%
Equipment loans	46%	50%	-%	-%	-%	-%
	100%	100%	-%	100%	-%	-%
Single-seller conduits						
Debt securities backed by:						
Auto loans and leases	-%	-%	-%	-%	-%	-%

⁽¹⁾ Credit quality is based on Standard and Poor's ratings at September 30, 2012 except for loans and trade receivables held by single-seller conduits, which are based on our internal ratings. For the single-seller conduits, external ratings are not available; however, our internal credit ratings were developed using similar methodologies and rating scales equivalent to the external credit ratings.

We receive fees for providing these liquidity facilities. Credit risk on these obligations is managed by subjecting them to our normal underwriting and risk management processes.

During the first nine months of 2012, U.S. asset-backed commercial paper volumes continued to be stable as most major bank conduit sponsors continue to extend new financing to clients but at a slow pace. Credit spreads in the multi-seller conduit market generally trended lower in the first nine months of 2012 following a pattern that was prevalent across the U.S. credit markets. The low supply of ABCP has led to continued investor demand for the ABCP issued by large bank-sponsored ABCP programs. The improved demand for higher quality ABCP programs has led to less volatility in issuance spreads.

The preceding tables do not include information on liquidity facilities that we previously provided to certain Canadian multi-seller ABCP conduits that have been subject to restructuring agreements. As a result of specific difficulties in the Canadian asset backed commercial paper markets, we entered into various agreements during 2007 modifying obligations with respect to these facilities. Under one of these agreements, known as the Montreal Accord, a restructuring proposal to convert outstanding commercial paper into longer term securities was approved by ABCP noteholders and endorsed by the Canadian justice system in 2008. The restructuring plan was formally executed during the first quarter of 2009. As part of the enhanced collateral pool established for the restructuring, we have provided a \$407 million Margin Funding Facility to new Master Conduit Vehicles, which is currently undrawn. HSBC Bank USA derivatives transactions with the previous conduit vehicles have been restructured and assigned to the new Master Conduit Vehicles. Under the restructuring, additional collateral was provided to us to mitigate our derivatives exposures. All of our derivative positions with the Master Conduit Vehicles have subsequently been terminated.

Also in Canada but separately from the Montreal Accord, as part of an ABCP conduit restructuring executed in 2008, we agreed to hold long-term securities of CAD \$300 million and provide a CAD \$100 million credit facility. As of September 30, 2012 this credit facility was undrawn and approximately \$305 million of long-term securities were held. As of December 31, 2011 this credit facility was undrawn and approximately \$294 million of long-term securities were held.

As of September 30, 2012 and December 31, 2011, other than the facilities referred to above, we no longer have outstanding liquidity facilities to Canadian ABCP conduits subject to the Montreal Accord or other agreements.

We have established and manage a number of constant net asset value ("CNAV") money market funds that invest in shorter-dated highly-rated money market securities to provide investors with a highly liquid and secure investment. These funds price the assets in their portfolio on an amortized cost basis, which enables them to

create and liquidate shares at a constant price. The funds, however, are not permitted to price their portfolios at amortized cost if that amount varies by more than 50 basis points from the portfolio's market value. In that case, the fund would be required to price its portfolio at market value and consequently would no longer be able to create or liquidate shares at a constant price. We do not consolidate the CNAV funds as they are not VIEs and we do not hold a majority voting interest.

Fair Value

Fair value measurement accounting principles require a reporting entity to take into consideration its own credit risk in determining the fair value of financial liabilities. The incorporation of our own credit risk accounted for an increase of \$218 million and \$331 million in the fair value of financial liabilities during the three and nine months ended September 30, 2012 compared to a decrease of \$416 million and \$461 million during the prior year periods.

Net income volatility arising from changes in either interest rate or credit components of the mark-to-market on debt designated at fair value and related derivatives affects the comparability of reported results between periods. Accordingly, the gain loss on debt designated at fair value and related derivatives during the nine months ended September 30, 2012 should not be considered indicative of the results for any future period.

Valuation Control Framework We have established a control framework which is designed to ensure that fair values are either determined or validated by a function independent of the risk-taker. See Note 22, "Fair Value Measurements" for further details on our valuation control framework.

Fair Value Hierarchy Fair value measurement accounting principles establish a fair value hierarchy structure that prioritizes the inputs to determine the fair value of an asset or liability (the "Fair Value Framework"). The Fair Value Framework distinguishes between inputs that are based on observed market data and unobservable inputs that reflect market participants' assumptions. It emphasizes the use of valuation methodologies that maximize observable market inputs. For financial instruments carried at fair value, the best evidence of fair value is a quoted price in an actively traded market (Level 1). Where the market for a financial instrument is not active, valuation techniques are used. The majority of our valuation techniques use market inputs that are either observable or indirectly derived from and corroborated by observable market data for substantially the full term of the financial instrument (Level 2). Because Level 1 and Level 2 instruments are determined by observable inputs, less judgment is applied in determining their fair values. In the absence of observable market inputs, the financial instrument is valued based on valuation techniques that feature one or more significant unobservable inputs (Level 3). The determination of the level of fair value hierarchy within which the fair value measurement of an asset or a liability is classified often requires judgment and may change over time as market conditions evolve. We consider the following factors in developing the fair value hierarchy:

- whether the asset or liability is transacted in an active market with a quoted market price;
- the level of bid-ask spreads;
- a lack of pricing transparency due to, among other things, complexity of the product and market liquidity;
- whether only a few transactions are observed over a significant period of time;
- whether the pricing quotations vary substantially among independent pricing services;
- whether inputs to the valuation techniques can be derived from or corroborated with market data; and
- whether significant adjustments are made to the observed pricing information or model output to determine the fair value.

Level 1 inputs are unadjusted quoted prices in active markets that the reporting entity has the ability to access for identical assets or liabilities. A financial instrument is classified as a Level 1 measurement if it is listed on an exchange or is an instrument actively traded in the over-the-counter (“OTC”) market where transactions occur with sufficient frequency and volume. We regard financial instruments such as equity securities and derivative contracts listed on the primary exchanges of a country to be actively traded. Non-exchange-traded instruments classified as Level 1 assets include securities issued by the U.S. Treasury or by other foreign governments, to-be-announced (“TBA”) securities and non-callable securities issued by U.S. government sponsored entities.

Level 2 inputs are inputs that are observable either directly or indirectly but do not qualify as Level 1 inputs. We classify mortgage pass-through securities, agency and certain non-agency mortgage collateralized obligations, certain derivative contracts, asset-backed securities, corporate debt, preferred securities and leveraged loans as Level 2 measurements. Where possible, at least two quotations from independent sources are obtained based on transactions involving comparable assets and liabilities to validate the fair value of these instruments. Where significant differences arise among the independent pricing quotes and the internally determined fair value, we investigate and reconcile the differences. If the investigation results in a significant adjustment to the fair value, the instrument will be classified as Level 3 within the fair value hierarchy. In general, we have observed that there is a correlation between the credit standing and the market liquidity of a non-derivative instrument.

Level 2 derivative instruments are generally valued based on discounted future cash flows or an option pricing model adjusted for counterparty credit risk and market liquidity. The fair value of certain structured derivative products is determined using valuation techniques based on inputs derived from observable benchmark index tranches traded in the OTC market. Appropriate control processes and procedures have been applied to ensure that the derived inputs are applied to value only those instruments that share similar risks to the relevant benchmark indices and therefore demonstrate a similar response to market factors. In addition, a validation process has been established, which includes participation in peer group consensus pricing surveys, to ensure that valuation inputs incorporate market participants’ risk expectations and risk premium.

Level 3 inputs are unobservable estimates that management expects market participants would use to determine the fair value of the asset or liability. That is, Level 3 inputs incorporate market participants’ assumptions about risk and the risk premium required by market participants in order to bear that risk. We develop Level 3 inputs based on the best information available in the circumstances. As of September 30, 2012 and December 31, 2011, our Level 3 instruments included the following: collateralized debt obligations (“CDOs”) and collateralized loan obligations (“CLOs”) for which there is a lack of pricing transparency due to market illiquidity, certain structured deposits as well as certain structured credit and structured equity derivatives where significant inputs (e.g., volatility or default correlations) are not observable, credit default swaps with certain monoline insurers where the deterioration in the creditworthiness of the counterparty has resulted in significant adjustments to fair value, U.S. subprime mortgage loans and subprime related asset-backed securities, mortgage servicing rights, and derivatives referenced to illiquid assets of less desirable credit quality.

Transfers between leveling categories are recognized at the end of each reporting period.

Transfers Between Level 1 and Level 2 Measurements During the three and nine months ended September 30, 2012 and 2011, there were no transfers between Level 1 and Level 2 measurements.

Level 3 Measurements The following table provides information about Level 3 assets/liabilities in relation to total assets/liabilities measured at fair value as of September 30, 2012 and December 31, 2011.

	September 30, 2012	December 31, 2011
	(dollars are in millions)	
Level 3 assets ⁽¹⁾⁽²⁾	\$ 5,453	\$ 6,071
Total assets measured at fair value ⁽³⁾	192,748	179,497
Level 3 liabilities	4,616	4,197
Total liabilities measured at fair value ⁽¹⁾	124,940	117,170
Level 3 assets as a percent of total assets measured at fair value	2.8%	3.4%
Level 3 liabilities as a percent of total liabilities measured at fair value	3.7%	3.6%

⁽¹⁾ Presented without netting which allow the offsetting of amounts relating to certain contracts if certain conditions are met.

⁽²⁾ Includes \$5.0 billion of recurring Level 3 assets and \$482 million of non-recurring Level 3 assets at September 30, 2012 and \$5.4 billion of recurring Level 3 assets and \$670 million of non-recurring Level 3 assets at December 31, 2011.

⁽³⁾ Includes \$192.2 billion of assets measured on a recurring basis and \$519 million of assets measured on a non-recurring basis at September 30, 2012. Includes \$178.7 billion of assets measured on a recurring basis and \$768 million of assets measured on a non-recurring basis at December 31, 2011.

Material Changes in Fair Value for Level 3 Assets and Liabilities

Derivative Assets and Counterparty Credit Risk We made \$6 million and \$16 million positive credit risk adjustments to the fair value of our credit default swap contracts during the nine months ended September 30, 2012 and 2011, respectively, which is reflected in trading revenue. We have recorded a cumulative credit adjustment reserve of \$157 million and \$163 million against our monoline exposure at September 30, 2012 and December 31, 2011, respectively. The fair value of our monoline exposure net of cumulative credit adjustment reserves equaled \$552 million and \$708 million at September 30, 2012 and December 31, 2011, respectively. The decrease in the first nine months of 2012 reflects both reductions in our outstanding positions and improvements in exposure estimates.

Loans As of September 30, 2012 and December 31, 2011, we have classified \$94 million and \$181 million, respectively, of mortgage whole loans held for sale as a non-recurring Level 3 financial asset. These mortgage loans are accounted for on a lower of cost or fair value basis. Based on our assessment, we recorded a loss of \$9 million and \$12 million for such mortgage loans during the three and nine months ended September 30, 2012 compared to a loss of \$8 million and \$22 million during the prior year periods. The changes in fair value are recorded as other revenues in the consolidated statement of income (loss).

Material Additions to and Transfers Into (Out of) Level 3 Measurements During both the three and nine months ended September 30, 2012, we transferred \$370 million of credit derivatives from Level 3 to Level 2 as a result of a qualitative analysis of the foreign exchange and credit correlation attributes of our model used for certain credit default swaps. In addition, during the three and nine months ended September 30, 2012, we transferred \$132 million and \$607 million, respectively, of deposits in domestic offices, which we have elected to carry at fair value, from Level 3 to Level 2 as a result of a result of the embedded derivative no longer being unobservable as the derivative option is closer to maturity and there is more observability in short term volatility.

During the nine months ended September 30, 2011, we transferred \$62 million of credit derivatives from Level 3 to Level 2 as a result of a qualitative analysis of the foreign exchange and credit correlation attributes of our model used for certain credit default swaps. There were no significant transfers of derivatives during the three months ended September 30, 2011. In addition, during the three and nine months ended September 30, 2011, we transferred \$435 million and \$521 million, respectively, of long-term debt from Level 3 to Level 2. The long-term debt relates to medium term debt issuances where the embedded derivative is no longer unobservable as the derivative option is closer in maturity and there is more observability in short-term volatility.

See Note 22, "Fair Value Measurements," in the accompanying consolidated financial statements for information on additions to and transfers into (out of) Level 3 measurements during the three and nine months ended September 30, 2012 and 2011 as well as for further details including the classification hierarchy associated with assets and liabilities measured at fair value.

Credit Quality of Assets Underlying Asset-backed Securities The following tables summarize the types and credit quality of the assets underlying our asset-backed securities as well as certain collateralized debt obligations and collateralized loan obligations held as of September 30, 2012:

Asset-backed securities backed by consumer finance collateral:

Credit Quality of Collateral:

Year of Issuance:		Commercial Mortgages		Prime		Alt-A		Subprime		
		Total	Prior to 2006	2006 to Present	Prior to 2006	2006 to Present	Prior to 2006	2006 to Present	Prior to 2006	2006 to Present
(in millions)										
Rating of securities:	Collateral type:									
AAA	Home equity loans	\$ -	\$ -	\$ -	\$-	\$-	\$ -	\$ -	\$ -	
	Student loans	-	-	-	-	-	-	-	-	
	Residential mortgages	536	53	211	-	-	158	-	114	
	Commercial mortgages	-	-	-	-	-	-	-	-	
	Other	-	-	-	-	-	-	-	-	
	Total AAA	536	53	211	-	-	158	-	114	
AA	Home equity loans	104	-	-	-	-	-	104	-	
	Residential mortgages	-	-	-	-	-	-	-	-	
	Student loans	-	-	-	-	-	-	-	-	
	Other	38	-	-	-	-	38	-	-	
	Total AA	142	-	-	-	-	38	104	-	
A	Home equity loans	-	-	-	-	-	-	-	-	
	Residential mortgages	64	-	-	-	-	-	-	64	
	Commercial mortgages	-	-	-	-	-	-	-	-	
	Student loans	-	-	-	-	-	-	-	-	
	Other	47	-	-	-	-	47	-	-	
	Total A	111	-	-	-	-	47	-	64	
BBB	Home equity loans	77	-	-	-	-	-	77	-	
	Residential mortgages	41	-	-	-	-	41	-	-	
	Other	-	-	-	-	-	-	-	-	
	Total BBB	118	-	-	-	-	41	77	-	
BB	Home equity loans	-	-	-	-	-	-	-	-	
	Residential mortgages	-	-	-	-	-	-	-	-	
	Total BB	-	-	-	-	-	-	-	-	
B	Home equity loans	-	-	-	-	-	-	-	-	
	Auto loans	-	-	-	-	-	-	-	-	
	Residential mortgages	4	-	-	-	-	4	-	-	
	Total B	4	-	-	-	-	4	-	-	
CCC	Home equity loans	62	-	-	-	-	-	62	-	
	Residential mortgages	5	-	-	-	-	1	-	4	
	Total CCC	67	-	-	-	-	1	62	4	
CC	Residential mortgages	-	-	-	-	-	-	-	-	
D	Home equity loans	-	-	-	-	-	-	-	-	
	Residential mortgages	-	-	-	-	-	-	-	-	
	Total D	-	-	-	-	-	-	-	-	
Unrated	Home equity loans	-	-	-	-	-	-	-	-	
	Residential mortgages	1	-	-	-	-	-	1	-	
	Other	-	-	-	-	-	-	-	-	
	Total Unrated	1	-	-	-	-	-	1	-	
		<u>\$979</u>	<u>\$53</u>	<u>\$211</u>	<u>\$-</u>	<u>\$-</u>	<u>\$289</u>	<u>\$244</u>	<u>\$178</u>	<u>\$4</u>

Collateralized debt obligations (CDO) and collateralized loan obligations (CLO):

Credit quality of collateral:		Total	A or Higher	BBB	BB/B	CCC	Unrated
		(in millions)					
Rating of securities:	Collateral type:						
	Corporate loans	\$ 330	\$-	\$ -	\$330	\$ -	\$ -
	Residential mortgages	-	-	-	-	-	-
	Commercial mortgages	187	-	-	122	65	-
	Trust preferred	162	-	162	-	-	-
	Aircraft leasing	-	-	-	-	-	-
	Others	58	-	-	-	-	58
		<u>737</u>	<u>\$-</u>	<u>\$162</u>	<u>\$452</u>	<u>\$65</u>	<u>\$58</u>
	Total asset-backed securities	<u>\$1,716</u>					

Effect of Changes in Significant Unobservable Inputs The fair value of certain financial instruments is measured using valuation techniques that incorporate pricing assumptions not supported by, derived from or corroborated by observable market data. The resultant fair value measurements are dependent on unobservable input parameters which can be selected from a range of estimates and may be interdependent. Changes in one or more of the significant unobservable input parameters may change the fair value measurements of these financial instruments. For the purpose of preparing the financial statements, the final valuation inputs selected are based on management's best judgment that reflect the assumptions market participants would use in pricing similar assets or liabilities.

The unobservable input parameters selected are subject to the internal valuation control processes and procedures. When we perform a test of all the significant input parameters to the extreme values within the range at the same time, it could result in an increase of the overall fair value measurement of approximately \$109 million or a decrease of the overall fair value measurement of approximately \$96 million as of September 30, 2012. The effect of changes in significant unobservable input parameters are primarily driven by mortgage whole loans held for sale or securitization, certain asset-backed securities including CDOs, and the uncertainty in determining the fair value of credit derivatives executed against monoline insurers.

Risk Management

Overview Some degree of risk is inherent in virtually all of our activities. Accordingly, we have comprehensive risk management policies and practices in place to address potential risks, which include the following:

- *Credit risk* is the potential that a borrower or counterparty will default on a credit obligation, as well as the impact on the value of credit instruments due to changes in the probability of borrower default. Credit risk includes risk associated with cross-border exposures;
- *Liquidity risk* is the potential that an institution will be unable to meet its obligations as they become due or fund its customers because of inadequate cash flow or the inability to liquidate assets or obtain funding itself;
- *Interest rate risk* is the potential impairment of net interest income due to mismatched pricing between assets and liabilities as well as losses in value due to rate movements;
- *Market risk* is the potential for losses in daily mark-to-market positions (mostly trading) due to adverse movements in money, foreign exchange, equity or other markets and includes both interest rate risk and trading risk;

- *Operational risk* is the risk of loss resulting from inadequate or failed internal processes, people, or systems, or from external events (including legal risk but excluding strategic and reputational risk);
- *Compliance risk* is the risk arising from failure to comply with relevant laws, regulations and regulatory requirements governing the conduct of specific businesses;
- *Fiduciary risk* is the risk of breaching fiduciary duties where we act in a fiduciary capacity as Trustee, Investment Manager or as mandated by law or regulation, including Regulation 12 CFR 9, Fiduciary Activity of National Banks;
- *Reputational risk* is the risk arising from a failure to safeguard our reputation by maintaining the highest standards of conduct at all times and by being aware of issues, activities and associations that might pose a threat to the reputation of HSBC, locally, regionally or internationally; and
- *Strategic risk* is the risk that the business will fail to identify, execute, and react appropriately to opportunities and/or threats arising from changes in the market, some of which may emerge over a number of years such as changing economic and political circumstances, customer requirements, demographic trends, regulatory developments or competitor action.

See “Risk Management” in MD&A in our 2011 Form 10-K for a more complete discussion of the objectives of our risk management system as well as our risk management policies and practices. Our risk management process involves the use of various simulation models. We believe that the assumptions used in these models are reasonable, but actual events may unfold differently than what is assumed in the models. Consequently, model results may be considered reasonable estimates, with the understanding that actual results may vary significantly from model projections.

Credit Risk Management Credit risk is the potential that a borrower or counterparty will default on a credit obligation, as well as the impact on the value of credit instruments due to changes in the probability of borrower default. Credit risk includes risk associated with cross-border exposures. There have been no material changes to our approach towards credit risk management since December 31, 2011. See “Risk Management” in MD&A in our 2011 Form 10-K for a more complete discussion of our approach to credit risk.

Credit risk is inherent in various on- and off-balance sheet instruments and arrangements, such as:

- loan portfolios;
- investment portfolios;
- unfunded commitments such as letters of credit and lines of credit that customers can draw upon; and
- treasury instruments, such as interest rate swaps which, if more valuable today than when originally contracted, may represent an exposure to the counterparty to the contract.

While credit risk exists widely in our operations, diversification among various commercial and consumer portfolios helps to lessen risk exposure. Day-to-day management of credit and market risk is performed by the Chief Credit Officer / Head of Wholesale Credit and Market Risk North America and the HSBC North America Chief Retail Credit Officer, who report directly to the HSBC North America Chief Risk Officer and maintain independent risk functions. The credit risk associated with commercial portfolios is managed by the Chief Credit Officer, while credit risk associated with retail consumer loan portfolios, such as credit cards, installment loans and residential mortgages, is managed by the HSBC North America Chief Retail Credit Officer. Further discussion of credit risk can be found under the “Credit Quality” caption in this MD&A.

Credit risk associated with derivatives is measured as the net replacement cost in the event the counterparties with contracts in a gain position to us fail to perform under the terms of those contracts. In managing derivative

credit risk, both the current exposure, which is the replacement cost of contracts on the measurement date, as well as an estimate of the potential change in value of contracts over their remaining lives are considered. Counterparties to our derivative activities include financial institutions, foreign and domestic government agencies, corporations, funds (mutual funds, hedge funds, etc.), insurance companies and private clients as well as other HSBC entities. These counterparties are subject to regular credit review by the credit risk management department. To minimize credit risk, we enter into legally enforceable master netting agreements which reduce risk by permitting the closeout and netting of transactions with the same counterparty upon occurrence of certain events. In addition, we reduce credit risk by obtaining collateral from counterparties. The determination of the need for and the levels of collateral will vary based on an assessment of the credit risk of the counterparty.

The total risk in a derivative contract is a function of a number of variables, such as:

- volatility of interest rates, currencies, equity or corporate reference entity used as the basis for determining contract payments;
- current market events or trends;
- country risk;
- maturity and liquidity of contracts;
- credit worthiness of the counterparties in the transaction;
- the existence of a master netting agreement among the counterparties; and
- existence and value of collateral received from counterparties to secure exposures.

The table below presents total credit risk exposure measured using rules contained in the risk-based capital guidelines published by U.S. banking regulatory agencies. Risk-based capital guidelines recognize that bilateral netting agreements reduce credit risk and, therefore, allow for reductions of risk-weighted assets when netting requirements have been met. As a result, risk-weighted amounts for regulatory capital purposes are a portion of the original gross exposures.

The risk exposure calculated in accordance with the risk-based capital guidelines potentially overstates actual credit exposure because: the risk-based capital guidelines ignore collateral that may have been received from counterparties to secure exposures; and the risk-based capital guidelines compute exposures over the life of derivative contracts. However, many contracts contain provisions that allow us to close out the transaction if the counterparty fails to post required collateral. In addition, many contracts give us the right to break the transactions earlier than the final maturity date. As a result, these contracts have potential future exposures that are often much smaller than the future exposures derived from the risk-based capital guidelines.

	September 30, 2012	December 31, 2011
	(in millions)	
Risk associated with derivative contracts:		
Total credit risk exposure	\$41,951	\$43,923
Less: collateral held against exposure	<u>7,659</u>	<u>6,459</u>
Net credit risk exposure	<u>\$34,292</u>	<u>\$37,464</u>

Liquidity Risk Management There have been no material changes to our approach towards liquidity risk management since December 31, 2011. See “Risk Management” in MD&A in our 2011 Form 10-K for a more complete discussion of our approach to liquidity risk. Although our overall approach to liquidity management has not changed, we continue to enhance our implementation of that approach to reflect best practices. The past few

years have suggested that in a market crisis, traditional sources of crisis liquidity such as secured lending and deposits with other banks may not be available. Similarly, the current regulatory initiatives are suggesting banks need to retain a portfolio of extremely high quality liquid assets. Consistent with these items, we are expanding our portfolio of high quality sovereign and sovereign guaranteed securities.

We continuously monitor the impact of market events on our liquidity positions. In general terms, the strains due to the recent credit crisis have been concentrated in the wholesale market as opposed to the retail market (the latter being the market from which we source core demand and time deposit accounts). Financial institutions with less reliance on the wholesale markets were in many respects less affected by those conditions. Our limited dependence upon the wholesale markets for funding has been a significant competitive advantage through the most recent period of financial market turmoil.

Our liquidity management approach includes increased deposits and potential sales (e.g. residential mortgage loans) in liquidity contingency plans. As previously discussed, HSBC Finance is currently winding down its commercial paper program during 2012 and instead will rely on its affiliates, including HSBC USA Inc. to satisfy its short-term funding needs.

Our ability to regularly attract wholesale funds at a competitive cost is enhanced by strong ratings from the major credit ratings agencies. At September 30, 2012, we and HSBC Bank USA maintained the following long and short-term debt ratings:

	Moody's	S&P	Fitch	DBRS ⁽¹⁾
HSBC USA Inc.:				
Short-term borrowings	P-1	A-1	F1+	R-1
Long-term debt	A2	A+	AA	AA
HSBC Bank USA:				
Short-term borrowings	P-1	A-1+	F1+	R-1
Long-term debt	A1	AA-	AA	AA

⁽¹⁾ Dominion Bond Rating Service.

In December 2011, Fitch finalized its revised global criteria for assessing the credit ratings of non-common equity securities which qualify for treatment as bank regulatory capital. In March 2012, Fitch placed the outlook for HSBC and related entities to negative.

In June 2012, Moody's announced rating actions affecting 114 financial institutions in 16 European countries, including the ratings of HSBC. The rating action follows Moody's publications on January 19, 2012 where Moody's announced that they expect to place a number of bank ratings under review for downgrade during the first quarter of 2012 in order to assess the overall negative impact of the adverse trends affecting banks in advanced countries and notably in Europe. On February 22, 2012, Moody's had placed HSBC USA's long-term and short-term ratings and HSBC Bank USA's long-term rating on negative credit watch. In the September action, they downgraded the long term ratings of HSBC USA and HSBC Bank USA but reaffirmed the short term ratings at P-1. Any further downgrade of the HSBC USA's and HSBC Bank USA's long-term rating would likely result in a 1 notch downgrade of the respective short-term rating.

On July 20, 2012, DBRS changed its outlook for HSBC USA Inc. and HSBC Bank USA from "stable" to "rating under review." The outlook change reflects the concerns of DBRS regarding the recent hearing by the U.S. Senate Permanent Subcommittee on investigations, the challenges associated with changing the compliance culture and risk that regulators will impose additional restrictions on financial institutions in reaction to banking industry issues in general.

As of September 30, 2012, there were no other pending actions in terms of changes to ratings on the debt of HSBC USA Inc. or HSBC Bank USA from any of the rating agencies.

Interest Rate Risk Management Various techniques are utilized to quantify and monitor risks associated with the repricing characteristics of our assets, liabilities and derivative contracts. Our approach to managing interest rate risk is summarized in MD&A in our 2011 Form 10-K under the caption “Risk Management”. There have been no material changes to our approach towards interest rate risk management since December 31, 2011.

Present Value of a Basis Point (“PVBP”) is the change in value of the balance sheet for a one basis point upward movement in all interest rates. The following table reflects the PVBP position at September 30, 2012 and December 31, 2011.

	September 30, 2012	December 31, 2011
	(in millions)	
Institutional PVBP movement limit	\$8.0	\$8.0
PVBP position at period end	3.1	4.8

Economic value of equity is the change in value of the assets and liabilities (excluding capital and goodwill) for either a 200 basis point immediate rate increase or decrease. The following table reflects the economic value of equity position at September 30, 2012 and December 31, 2011.

	September 30, 2012	December 31, 2011
	(values as a percentage)	
Institutional economic value of equity limit	+/-15	+/-15
Projected change in value (reflects projected rate movements on January 1):		
Change resulting from an immediate 200 basis point increase in interest rates	3	3
Change resulting from an immediate 200 basis point decrease in interest rates	(9)	(11)

The gain or loss in value for a 200 basis point increase or decrease in rates is a result of the negative convexity of the residential whole loan and mortgage backed securities portfolios. If rates decrease, the projected prepayments related to these portfolios will accelerate, causing less appreciation than a comparable term, non-convex instrument. If rates increase, projected prepayments will slow, which will cause the average lives of these positions to extend and result in a greater loss in market value.

Dynamic simulation modeling techniques are utilized to monitor a number of interest rate scenarios for their impact on net interest income. These techniques include both rate shock scenarios, which assume immediate market rate movements by as much as 200 basis points, as well as scenarios in which rates rise or fall by as much as 200 basis points over a twelve month period. The following table reflects the impact on net interest income of the scenarios utilized by these modeling techniques.

	September 30, 2012		December 31, 2011	
	Amount	%	Amount	%
(dollars are in millions)				
Projected change in net interest income (reflects projected rate movements on January 1):				
Institutional base earnings movement limit		(10)		(10)
Change resulting from a gradual 100 basis point increase in the yield curve	\$ 61	3	\$ 46	2
Change resulting from a gradual 100 basis point decrease in the yield curve	(56)	(3)	(103)	(3)
Change resulting from a gradual 200 basis point increase in the yield curve	101	5	28	1
Change resulting from a gradual 200 basis point decrease in the yield curve	(89)	(5)	(175)	(6)
Other significant scenarios monitored (reflects projected rate movements on January 1):				
Change resulting from an immediate 100 basis point increase in the yield curve	123	6	31	1
Change resulting from an immediate 100 basis point decrease in the yield curve	(77)	(4)	(409)	(14)
Change resulting from an immediate 200 basis point increase in the yield curve	157	8	10	-
Change resulting from an immediate 200 basis point decrease in the yield curve	(102)	(5)	(565)	(19)

The projections do not take into consideration possible complicating factors such as the effect of changes in interest rates on the credit quality, size and composition of the balance sheet. Therefore, although this provides a reasonable estimate of interest rate sensitivity, actual results will vary from these estimates, possibly by significant amounts.

Capital Risk/Sensitivity of Other Comprehensive Income Large movements of interest rates could directly affect some reported capital balances and ratios. The mark-to-market valuation of available-for-sale securities is credited on a tax effective basis to accumulated other comprehensive income. Although this valuation mark is excluded from Tier 1 and Tier 2 capital ratios, it is included in two important accounting based capital ratios: the tangible common equity to tangible assets and the tangible common equity to risk weighted assets. As of September 30, 2012, we had an available-for-sale securities portfolio of approximately \$62.5 billion with a positive mark-to-market of \$1.9 billion included in tangible common equity of \$13.1 billion. An increase of 25 basis points in interest rates of all maturities would lower the mark-to-market by approximately \$208 million to a net gain of \$1.7 billion with the following results on our tangible capital ratios. As of December 31, 2011, we had an available-for-sale securities portfolio of approximately \$53.2 billion with a positive mark-to-market of \$1.5 billion included in tangible common equity of \$14.0 billion. An increase of 25 basis points in interest rates of all maturities would lower the mark-to-market by approximately \$173 million to a net gain of \$1.3 billion with the following results on our tangible capital ratios.

	September 30, 2012		December 31, 2011	
	Actual	Proforma ⁽¹⁾	Actual	Proforma ⁽¹⁾
Tangible common equity to tangible assets	6.39%	6.33%	6.75%	6.70%
Tangible common equity to risk weighted assets	12.15	12.04	11.79	11.69

⁽¹⁾ Proforma percentages reflect a 25 basis point increase in interest rates.

The following table summarizes the frequency distribution of daily market risk-related revenues for trading activities during the nine months ended September 30, 2012. Market risk-related trading revenues include realized and unrealized gains (losses) related to trading activities, but exclude the related net interest income. Analysis of the gain (loss) data for the nine months ended September 30, 2012 shows that the largest daily gain was \$10 million and the largest daily loss was \$22 million.

Ranges of daily treasury trading revenue earned from market risk-related activities	Below	\$(5)	\$0	\$5	Over
	\$(5)	to \$0	to \$5	to \$10	\$10
	(dollars are in millions)				
Number of trading days market risk-related revenue was within the stated range	3	53	114	18	1

VAR – Non-trading Activities Interest rate risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on embedded optionality within certain product areas such as the incidence of mortgage repayments, and from behavioral assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts. The prospective change in future net interest income from non-trading portfolios will be reflected in the current realizable value of these positions if they were to be sold or closed prior to maturity. In order to manage this risk optimally, market risk in non-trading portfolios is transferred to Global Markets or to separate books managed under the supervision of the local ALCO. Once market risk has been consolidated in Global Markets or ALCO-managed books, the net exposure is typically managed through the use of interest rate swaps within agreed upon limits.

The following table summarizes non-trading VAR for the nine months ended September 30, 2012, assuming a 99% confidence level for a two-year observation period and a one-day “holding period”.

	September 30,	Nine Months Ended September 30, 2012			December 31,
	2012	Minimum	Maximum	Average	2011
		(in millions)			
Interest rate	\$84	\$77	\$107	\$90	\$96

Trading Activities – Trading occurs in mortgage banking operations as a result of an economic hedging program intended to offset changes in value of mortgage servicing rights and the salable loan pipeline. Economic hedging may include, for example, forward contracts to sell residential mortgages and derivative instruments used to protect the value of MSRs.

MSRs are assets that represent the present value of net servicing income (servicing fees, ancillary income, escrow and deposit float, net of servicing costs). MSRs are separately recognized upon the sale of the underlying loans or at the time that servicing rights are purchased. MSRs are subject to interest rate risk, in that their value will decline as a result of actual and expected acceleration of prepayment of the underlying loans in a falling interest rate environment.

Interest rate risk is mitigated through an active hedging program that uses trading securities and derivative instruments to offset changes in value of MSRs. Since the hedging program involves trading activity, risk is quantified and managed using a number of risk assessment techniques.

Modeling techniques, primarily rate shock analyses, are used to monitor certain interest rate scenarios for their impact on the economic value of net hedged MSR's, as reflected in the following table.

	September 30, 2012	December 31, 2011
	(in millions)	
Projected change in net market value of hedged MSR's portfolio (reflects projected rate movements on July 1 and January 1, respectively):		
Value of hedged MSR's portfolio	\$173	\$220
Change resulting from an immediate 50 basis point decrease in the yield curve:		
Change limit (no worse than)	(20)	(20)
Calculated change in net market value	3	5
Change resulting from an immediate 50 basis point increase in the yield curve:		
Change limit (no worse than)	(8)	(8)
Calculated change in net market value	5	4
Change resulting from an immediate 100 basis point increase in the yield curve:		
Change limit (no worse than)	(12)	(12)
Calculated change in net market value	18	12

The economic value of the net hedged MSR's portfolio is monitored on a daily basis for interest rate sensitivity. If the economic value declines by more than established limits for one day or one month, various levels of management review, intervention and/or corrective actions are required.

The following table summarized the frequency distribution of the weekly economic value of the MSR asset during the nine months ended September 30, 2012. This includes the change in the market value of the MSR asset net of changes in the market value of the underlying hedging positions used to hedge the asset. The changes in economic value are adjusted for changes in MSR valuation assumptions that were made during the course of the year.

Ranges of mortgage economic value from market risk-related activities	Below \$(2)	\$(2) to \$0	\$0 to \$2	\$2 to \$4	Over \$4
	(dollars are in millions)				
Number of trading weeks market risk-related revenue was within the stated range	-	10	29	-	-

Operational Risk There have been no material changes to our approach toward operational risk since December 31, 2011.

Compliance Risk There have been no material changes to our approach toward compliance risk since December 31, 2011.

Fiduciary Risk There have been no material changes to our approach toward fiduciary risk since December 31, 2011.

Reputational Risk There have been no material changes to our approach toward reputational risk since December 31, 2011.

Strategic Risk There have been no material changes to our approach toward strategic risk since December 31, 2011.

Consolidated Average Balances and Interest Rates

The following table shows the quarter-to-date average balances of the principal components of assets, liabilities and shareholders' equity together with their respective interest amounts and rates earned or paid, presented on a taxable equivalent basis. Net interest margin is calculated by dividing net interest income by the average interest earning assets from which interest income is earned. The calculation of net interest margin includes interest expense of \$54 million for the three months ended September 30, 2011 which has been allocated to our discontinued operations. This allocation of interest expense to our discontinued operations was in accordance with our existing internal transfer pricing policies as external interest expense is unaffected by these transactions.

Three Months Ended September 30,	2012			2011		
	Balance	Interest	Rate ⁽¹⁾	Balance	Interest	Rate ⁽¹⁾
(dollars are in millions)						
Assets						
Interest bearing deposits with banks	\$ 18,768	\$ 13	.29%	\$ 28,626	\$ 21	.29%
Federal funds sold and securities purchased under resale agreements	9,758	10	.40	4,493	14	1.25
Trading securities	11,901	27	.91	14,044	52	1.48
Securities	63,536	257	1.61	49,585	311	2.49
Loans:						
Commercial	40,414	270	2.65	31,609	227	2.83
Consumer:						
Residential mortgages	15,578	151	3.86	15,064	162	4.27
HELOCs and home equity mortgages	2,468	20	3.30	3,341	28	3.31
Credit cards	866	22	9.98	1,142	22	7.86
Other consumer	703	9	5.22	994	17	6.68
Total consumer	19,615	202	4.10	20,541	229	4.43
Total loans	60,029	472	3.13	52,150	456	3.46
Other	3,102	11	1.24	5,783	10	.68
Total earning assets	167,094	\$790	1.88%	154,681	\$864	2.21%
Allowance for credit losses	(625)			(728)		
Cash and due from banks	1,455			1,497		
Other assets	27,975			28,420		
Assets of discontinued operations	339			21,076		
Total assets	\$196,238			\$204,946		
Liabilities and Shareholders' Equity						
Deposits in domestic offices:						
Savings deposits	\$ 47,186	\$ 37	.31%	\$ 57,912	\$ 62	.42%
Other time deposits	15,479	40	1.03	15,632	34	.87
Deposits in foreign offices:						
Foreign banks deposits	7,962	-	.02	5,887	1	.06
Other interest bearing deposits	14,670	3	.08	19,609	3	.06
Deposits held for sale	637	2	.61	9,914	8	.33
Total interest bearing deposits	85,934	82	.38	108,954	108	.43
Short-term borrowings	13,797	9	.27	17,493	11	.24
Long-term debt	20,322	170	3.35	18,844	161	3.39
Total interest bearing deposits and debt	120,053	261	.87	145,291	280	.82
Other	497	14	10.49	387	12	12.41
Total interest bearing liabilities	120,550	275	.91	145,678	292	.85
Net interest income/Interest rate spread		\$515	.97%		\$572	1.36%
Noninterest bearing deposits	33,995			21,173		
Other liabilities	22,488			18,658		
Liabilities of discontinued operations	974			1,543		
Total shareholders' equity	18,231			17,894		
Total liabilities and shareholders' equity	\$196,238			\$204,946		
Net interest margin on average earning assets			1.22%			1.47%
Net interest margin on average total assets			1.04			1.23%

⁽¹⁾ Rates are calculated on amounts that have not been rounded to the nearest million.

Total weighted average rate earned on earning assets includes interest income as reported in the consolidated statement of income(loss) on a taxable equivalent basis, divided by daily average amounts of total interest earning assets, including the daily average amount on nonperforming loans. Loan interest for the three months ended September 30, 2012 and 2011 included fees of \$21 million and \$19 million, respectively.

The following table shows the year-to-date average balances of the principal components of assets, liabilities and shareholders' equity together with their respective interest amounts and rates earned or paid, presented on a taxable equivalent basis. Net interest margin is calculated by dividing net interest income by the average interest earning assets from which interest income is earned. The calculation of net interest margin includes interest expense of \$50 million and \$170 million for the nine months ended September 30, 2012 and 2011, respectively, which has been allocated to our discontinued operations. This allocation of interest expense to our discontinued operations was in accordance with our existing internal transfer pricing policies as external interest expense is unaffected by these transactions.

Nine Months Ended September 30,	2012			2011		
	Balance	Interest	Rate ⁽¹⁾	Balance	Interest	Rate ⁽¹⁾
(dollars are in millions)						
Assets						
Interest bearing deposits with banks	\$ 22,244	\$ 47	.28%	\$ 26,497	\$ 59	.30%
Federal funds sold and securities purchased under resale agreements	7,794	35	.60	5,368	45	1.12
Trading securities	12,025	86	.96	13,138	156	1.59
Securities	59,406	851	1.92	47,772	945	2.64
Loans:						
Commercial	37,834	767	2.71	31,390	663	2.82
Consumer:						
Residential mortgages	15,454	449	3.88	14,775	482	4.36
HELOCs and home equity mortgages	2,953	75	3.39	3,573	88	3.28
Credit cards	1,037	64	8.08	1,175	62	7.03
Other consumer	821	36	5.90	1,041	51	6.61
Total consumer	20,265	624	4.11	20,564	683	4.44
Total loans	58,099	1,391	3.20	51,954	1,346	3.46
Other	3,553	32	1.22	5,970	32	.74
Total earning assets	163,121	\$2,442	2.00%	150,699	\$2,583	2.29%
Allowance for credit losses	(652)			(774)		
Cash and due from banks	1,548			1,616		
Other assets	28,816			26,008		
Assets of discontinued operations	9,101			21,280		
Total assets	\$201,934			\$198,829		
Liabilities and Shareholders' Equity						
Deposits in domestic offices:						
Savings deposits	\$ 53,413	\$ 140	.35%	\$ 57,966	\$ 192	.44%
Other time deposits	15,157	118	1.03	16,463	99	.80
Deposits in foreign offices:						
Foreign banks deposits	8,519	1	.02	6,377	3	.07
Other interest bearing deposits	14,763	8	.08	19,123	11	.08
Deposits held for sale	8,463	17	.27	3,341	29	1.14
Total interest bearing deposits	100,315	284	.38	103,270	334	.45
Short-term borrowings	14,784	24	.22	18,425	32	.23
Long-term debt	19,393	511	3.52	18,371	481	3.50
Total interest bearing deposits and debt	134,492	819	.81	140,066	847	.83
Other	459	27	7.77	297	96	43.56
Total interest bearing liabilities	134,951	846	.84	140,363	943	.92
Net interest income/Interest rate spread		\$1,596	1.16%		\$1,640	1.37%
Noninterest bearing deposits	26,624			23,498		
Other liabilities	20,820			16,350		
Liabilities of discontinued operations	971			1,197		
Total shareholders' equity	18,568			17,421		
Total liabilities and shareholders' equity	\$201,934			\$198,829		
Net interest margin on average earning assets			1.31%			1.45%
Net interest margin on average total assets			1.10			1.23%

⁽¹⁾ Rates are calculated on amounts that have not been rounded to the nearest million.

Total weighted average rate earned on earning assets includes interest income as reported in the consolidated statement of income(loss) on a taxable equivalent basis, divided by daily average amounts of total interest earning assets, including the daily average amount on nonperforming loans. Loan interest for the nine months ended September 30, 2012 and 2011 included fees of \$54 million and \$57 million, respectively.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Refer to Item 2, Management’s Discussion and Analysis of Financial Condition and Results of Operations, under the captions “Interest Rate Risk Management” and “Trading Activities” of this Form 10-Q.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures We maintain a system of internal and disclosure controls and procedures designed to ensure that information required to be disclosed by HSBC USA in the reports we file or submit under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), is recorded, processed, summarized and reported on a timely basis. Our Board of Directors, operating through its audit committee, which is composed entirely of independent outside directors, provides oversight to our financial reporting process.

We conducted an evaluation, with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report so as to alert them in a timely fashion to material information required to be disclosed in reports we file under the Exchange Act.

Changes in Internal Control over Financial Reporting There has been no change in our internal control over financial reporting that occurred during the quarter ended September 30, 2012 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

See Note 21, “Litigation and Regulatory Matters,” in the accompanying consolidated financial statements beginning on page 75 for our legal proceedings disclosure, which is incorporated herein by reference.

Item 1A. Risk Factors

For a discussion of risk factors affecting us, see Part I, Item 1A. Risk Factors, on pages 17-27 of our 2011 Annual Report on Form 10-K and Part II, Item 1A. Risk Factors, on pages 173 – 174 of our Quarterly Report on Form 10-Q for the Quarterly Period ended June 30, 2012 filed with the U.S. Securities and Exchange Commission. The discussion of risk factors provides a description of some of the important risk factors that could affect of actual results and could cause our results to vary materially from those expressed in public statements or documents. However, others factors besides those included in the discussion of risk factors or discussed elsewhere in other of our reports filed with or furnished to the SEC could affect our business or results. The readers should not consider any description of such factors to be complete set of all potential risks that we may face.

Item 6. Exhibits

Exhibits included in this Report:

- 12 Computation of Ratio of Earnings to Fixed Charges and Earnings to Combined Fixed Charges and Preferred Stock Dividends.
- 31 Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS XBRL Instance Document^(1,2)
- 101.SCH XBRL Taxonomy Extension Schema Document^(1,2)
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document^(1,2)
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document^(1,2)
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document^(1,2)
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document^(1,2)

⁽¹⁾ Pursuant to Rule 405 of Regulation S-T, includes the following financial information included in HSBC USA Inc.'s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2012, formatted in eXtensible Business Reporting Language ("XBRL") interactive data files: (i) the Consolidated Statement of Income (Loss) for the three and nine months ended September 30, 2012 and 2011, (ii) the Consolidated Statement of Comprehensive Income (Loss) for the three and nine months ended September 30, 2012 and 2011, (iii) the Consolidated Balance Sheet as of September 30, 2012 and December 31, 2011, (iv) the Consolidated Statement of Changes in Shareholders' Equity for the three and nine months ended September 30, 2012 and 2011, (v) the Consolidated Statement of Cash Flows for the three and nine months ended September 30, 2012 and 2011, and (vi) the Notes to Consolidated Financial Statements.

⁽²⁾ As provided in Rule 406T of Regulation S-T, this information shall be not be deemed "filed" for purposes of Section 11 and 12 of the Securities Act of 1933, as amended, and Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under those sections.

Index

- Assets:
 - by business segment 62
 - consolidated average balances 172
 - fair value measurements 83
 - nonperforming 30, 31, 150
 - trading 13, 118
- Asset-backed commercial paper conduits 68
- Asset-backed securities 14, 98, 162
- Balance sheet:
 - consolidated 5
 - consolidated average balances 172
 - review 115
- Basel II 110, 154
- Basis of reporting 112
- Business:
 - consolidated performance review 104
- Capital:
 - 2012 funding strategy 156
 - common equity movements 154
 - consolidated statement of changes 7
 - regulatory capital 60
 - selected capital ratios 60, 109, 154
- Cash flow (consolidated) 8
- Cautionary statement regarding forward-looking statements 103
- Collateral – pledged assets 75
- Collateralized debt obligations 98, 163
- Commercial banking segment results (IFRSs) 62, 136
- Compliance risk 171
- Controls and procedures 174
- Credit card fees 126
- Credit quality 29, 31, 109, 143, 162
- Credit risk:
 - adjustment 84
 - component of fair value option 46
 - concentration 32
 - exposure 165
 - management 164
 - related contingent features 44
 - related arrangements 70
- Current environment 103
- Deferred tax assets 48
- Deposits 119, 123, 153
- Derivatives:
 - cash flow hedges 41
 - fair value hedges 39
 - notional value 45
 - trading and other 42
- Discontinued operations 10
- Equity:
 - consolidated statement of changes 7
 - ratios 60, 109, 154
- Equity securities available-for-sale 14
- Estimates and assumptions 10
- Executive overview 103
- Fair value measurements:
 - assets and liabilities recorded at fair value on a recurring basis 87
 - assets and liabilities recorded at fair value on a non-recurring basis 95
 - control over valuation process 84, 159
 - fair value adjustments 84
 - financial instruments 85
 - hierarchy 84, 159
 - transfers into/out of level one and two 89, 160
 - transfers into/out of level two and three 94, 161
 - valuation control framework 84, 159
 - valuation techniques 96
- Fiduciary risk 164
- Financial assets:
 - designated at fair value 46
- Financial highlights metrics 109
- Financial liabilities:
 - designated at fair value 46
 - fair value of financial liabilities 86
- Forward looking statements 103
- Funding 156
- Gain (loss) on instruments designated at fair value and related derivatives 47
- Gains less losses from securities 20, 128
- Geographic concentration of receivables 152
- Global Banking and Markets:
 - balance sheet data (IFRSs) 62
 - segment results (IFRSs) 62, 137
- Goodwill 38
- Guarantee arrangements 70
- Impairment:
 - available-for-sale securities 17
 - credit losses 33, 124, 143
 - nonperforming loans 150
 - impaired loans 151
- Income tax expense 48
- Intangible assets 37
- Interest rate risk 163
- Internal control 174
- Key performance indicators 109
- Legal proceedings 174
- Leveraged finance transactions 46

- Liabilities:
 - commitments, lines of credit 157
 - deposits 119, 123, 153
 - financial liabilities designated at fair value 86
 - long-term debt 120
 - short-term borrowings 120
 - trading 13, 118
- Liquidity and capital resources 153
- Liquidity risk 163
- Litigation and regulatory matters 75
- Loan impairment charges – *see Provision for credit losses*
- Loans:
 - by category 22, 116
 - by charge-off (net) 34, 146
 - by delinquency 31, 148
 - criticized assets 29, 152
 - geographic concentration 152
 - held for sale 36, 117
 - impaired 25, 151
 - nonperforming 30, 151
 - overall review 116
 - purchases from HSBC Finance 55
 - risk concentration 32
 - troubled debt restructures 25
- Loan-to-deposits ratio 109
- Market risk 163
- Market turmoil:
 - exposures 166
 - impact on liquidity risk 143
- Monoline insurers 19, 105, 139
- Mortgage lending products 22, 116
- Mortgage servicing rights 37
- Net interest income 122
- New accounting pronouncements 101
- Off balance sheet arrangements 156
- Operating expenses 131
- Operational risk 164
- Other revenue 125
- Other segment results (IFRSs) 61, 142
- Pension and other postretirement benefits 53
- Performance, developments and trends 104
- Pledged assets 75
- Private banking segment results (IFRSs) 61, 140
- Profit (loss) before tax:
 - by segment – IFRSs 61
 - consolidated 3
- Provision for credit losses 124
- Ratios:
 - capital 60, 109, 154
 - charge-off (net) 146
 - credit loss reserve related 145
 - delinquency 31, 148
 - earnings to fixed charges – *Exhibit 12*
 - efficiency 109, 133
 - financial 109
 - loans-to-deposits 109
- Real estate owned 121
- Reconciliation of U.S. GAAP results to IFRSs 112
- Refreshed loan-to-value 116
- Related party transactions 54
- Reputational risk 164
- Results of operations 122
- Retail banking and wealth management segment results (IFRSs) 61, 134
- Risk elements in the loan portfolio 32
- Risk management:
 - credit 163
 - compliance 164
 - fiduciary 164
 - interest rate 163
 - liquidity 163
 - market 163
 - operational 164
 - reputational 164
 - strategic 164
- Securities:
 - fair value 14
 - impairment 17
 - maturity analysis 21
- Segment results – IFRSs basis:
 - retail banking and wealth management 61, 134
 - commercial banking 61, 136
 - global banking and markets 61, 137
 - private banking 61, 140
 - other 61, 141
 - overall summary 134
- Selected financial data 109
- Sensitivity:
 - projected net interest income 122
- Statement of cash flows 8
- Statement of changes in comprehensive income 4
- Statement of changes in shareholders' equity 7
- Statement of income 3
- Strategic risk 164
- Table of contents 2
- Tax expense 48
- Trading:
 - assets 13, 118
 - derivatives 13, 118
 - liabilities 13, 118
 - portfolios 13
- Trading revenue (net) 127
- Troubled debt restructures 25
- Value at risk 169
- Variable interest entities 66

Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: November 5, 2012

HSBC USA Inc.
(Registrant)

/s/ JOHN T. MCGINNIS

John T. McGinnis
Senior Executive Vice President and
Chief Financial Officer

Exhibit Index

12	Computation of Ratio of Earnings to Fixed Charges and Earnings to Combined Fixed Charges and Preferred Stock Dividends.
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⁽²⁾ As provided in Rule 406T of Regulation S-T, this information shall be not be deemed "filed" for purposes of Section 11 and 12 of the Securities Act of 1933, as amended, and Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to liability under those sections.

HSBC USA INC.
COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES AND TO
COMBINED FIXED CHARGES AND PREFERRED STOCK DIVIDENDS

	Nine Months Ended September 30,	
	2012	2011
	(dollars are in millions)	
Ratios excluding interest on deposits:		
Income (loss) from continuing operations	\$(1,295)	\$ 433
Income tax expense (benefit)	357	238
Less: Undistributed equity earnings	-	-
Fixed charges:		
Interest on:		
Borrowed funds	24	32
Long-term debt	502	449
Others	27	96
One third of rents, net of income from subleases	22	23
Total fixed charges, excluding interest on deposits	<u>575</u>	<u>600</u>
Income (loss) from continuing operations before taxes and fixed charges, net of undistributed equity earnings	<u>\$ (363)</u>	<u>\$1,271</u>
Ratio of earnings from continuing operations to fixed charges	<u>(.63)</u>	<u>2.12</u>
Total preferred stock dividend factor ⁽¹⁾	<u>\$ 78</u>	<u>\$ 77</u>
Fixed charges, including the preferred stock dividend factor	<u>\$ 653</u>	<u>\$ 677</u>
Ratio of earnings from continuing operations to combined fixed charges and preferred stock dividends	<u>(.56)</u>	<u>1.88</u>
Ratios including interest on deposits:		
Total fixed charges, excluding interest on deposits	\$ 575	\$ 600
Add: Interest on deposits	243	196
Total fixed charges, including interest on deposits	<u>\$ 818</u>	<u>\$ 796</u>
Earnings from continuing operations before taxes and fixed charges, net of undistributed equity earnings	\$ (363)	\$1,271
Add: Interest on deposits	243	196
Total	<u>\$ (120)</u>	<u>\$1,467</u>
Ratio of earnings from continuing operations to fixed charges	<u>(.15)</u>	<u>1.84</u>
Fixed charges, including the preferred stock dividend factor	\$ 653	\$ 677
Add: Interest on deposits	243	196
Fixed charges, including the preferred stock dividend factor and interest on deposits	<u>\$ 896</u>	<u>\$ 873</u>
Ratio of earnings from continuing operations to combined fixed charges and preferred stock dividends	<u>(.13)</u>	<u>1.68</u>

⁽¹⁾ Preferred stock dividends grossed up to their pretax equivalents.

**Certification of Chief Executive Officer and Chief Financial Officer
Pursuant to Section 302 of The Sarbanes-Oxley Act of 2002**

Certification of Chief Executive Officer

I, Irene M. Dorner, President, Chief Executive Officer and Chairman of the Board of HSBC USA Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of HSBC USA Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2012

/s/ IRENE M. DORNER

Irene M. Dorner
President, Chief Executive Officer and
Chairman of the Board

Certification of Chief Financial Officer

I, John T. McGinnis, Senior Executive Vice President and Chief Financial Officer of HSBC USA Inc., certify that:

1. I have reviewed this quarterly report on Form 10-Q of HSBC USA Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2012

/s/ JOHN T. MCGINNIS

John T. McGinnis
Senior Executive Vice President and
Chief Financial Officer

**Certification of Chief Executive Officer and Chief Financial Officer
Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

**Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to
Section 906 of the Sarbanes-Oxley Act of 2002**

The certification set forth below is being submitted in connection with the HSBC USA Inc. (the "Company") quarterly report on Form 10-Q for the period ending September 30, 2012 as filed with the Securities and Exchange Commission on the date hereof (the "Report") for the purpose of complying with Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Section 1350 of Chapter 63 of Title 18 of the United States Code.

I, Irene M. Dorner, President, Chief Executive Officer and Chairman of the Board of the Company, certify that:

1. the Report fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act; and
2. the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of HSBC USA Inc.

Date: November 5, 2012

/s/ IRENE M. DORNER

Irene M. Dorner
President, Chief Executive Officer and
Chairman of the Board

**Certification pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to
Section 906 of the Sarbanes-Oxley Act of 2002**

The certification set forth below is being submitted in connection with the HSBC USA Inc. (the "Company") quarterly report on Form 10-Q for the period ending September 30, 2012 as filed with the Securities and Exchange Commission on the date hereof (the "Report") for the purpose of complying with Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Section 1350 of Chapter 63 of Title 18 of the United States Code.

I, John T. McGinnis, Senior Executive Vice President and Chief Financial Officer of the Company, certify that:

1. the Report fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act; and
2. the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of HSBC USA Inc.

Date: November 5, 2012

/s/ JOHN T. MCGINNIS

John T. McGinnis
Senior Executive Vice President and
Chief Financial Officer

These certifications accompany each Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by HSBC USA Inc. for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

Signed originals of these written statements required by Section 906 of the Sarbanes-Oxley Act of 2002 have been provided to HSBC USA Inc. and will be retained by HSBC USA Inc. and furnished to the Securities and Exchange Commission or its staff upon request.