HSBC HOLDINGS PLC
Form 20-F
March 07, 2012
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As filed with the Securities and Exchange Commission on March 7, 2012.

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 20-F

¨ **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934**

Or

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2011

Or

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

Or

¨ **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Date of event requiring this shell company report __________

For the transition period from N/A to N/A

Commission file number: 1-14930

HSBC Holdings plc

(Exact name of Registrant as specified in its charter)

N/A	**United Kingdom**
(Translation of Registrant s name into English)	(Jurisdiction of incorporation or organisation)

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London E14 5HQ

United Kingdom

(Address of principal executive offices)

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(Name, Telephone, Email and/or Facsimile number and Address of Company Contact Person)

Securities registered or to be registered pursuant to Section 12(b) of the Securities Exchange Act of 1934:

Title of each class	Name of each exchange on which registered
Ordinary Shares, nominal value US$0.50 each.	London Stock Exchange Hong Kong Stock Exchange Euronext Paris Bermuda Stock Exchange New York Stock Exchange*
American Depository Shares, each representing 5 Ordinary Shares of nominal value US$0.50 each.	New York Stock Exchange
6.20% Non-Cumulative Dollar Preference Shares, Series A	New York Stock Exchange*
American Depositary Shares, each representing one-fortieth of a Share of 6.20% Non-Cumulative Dollar Preference Shares, Series A	New York Stock Exchange
5.25% Subordinated Notes 2012	New York Stock Exchange
5.10% Senior Unsecured Notes Due 2021	New York Stock Exchange
4.875% Senior Unsecured Notes Due 2022	New York Stock Exchange
7.625% Subordinated Notes due 2032	New York Stock Exchange
7.35% Subordinated Notes due 2032	New York Stock Exchange

6.5% Subordinated Notes 2036	New York Stock Exchange
6.5% Subordinated Notes 2037	New York Stock Exchange
6.8% Subordinated Notes Due 2038	New York Stock Exchange
6.100% Senior Unsecured Notes due 2042	New York Stock Exchange
8.125% Perpetual Subordinated Capital Securities Exchangeable at the Issuer s Option into Non-Cumulative Dollar Preference Shares	New York Stock Exchange
8.00% Perpetual Subordinated Capital Securities Exchangeable at the Issuer s Option into Non-Cumulative Dollar Preference Shares, Series 2	New York Stock Exchange

Securities registered or to be registered pursuant to Section 12(g) of the Securities Exchange Act of 1934: None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Securities Exchange Act of 1934: None

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report:

Ordinary Shares, nominal value US$0.50 each 17,868,085,646

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

þ Yes ¨ No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

¨ Yes þ No.

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.

þ 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 (§232.405 of this chapter) 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, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP ¨ International Financial Reporting Standards as issued by the International Accounting Standards Board þ Other ¨

If Other has been checked in response to the previous question indicate by check mark which financial statement item the registrant has elected to follow.

¨ Item 17 ¨ Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

¨ Yes þ No

* Not for trading, but only in connection with the registration of American Depositary Shares.

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HSBC HOLDINGS PLC

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Certain defined terms

Unless the context requires otherwise, HSBC Holdings means HSBC Holdings plc and HSBC , the Group , we , us and our refers to HSBC Holdings together with its subsidiaries. Within this document the Hong Kong Special Administrative Region of the People s Republic of China is referred to as Hong Kong . When used in the terms shareholders equity and total shareholders equity , shareholders means holders of HSBC Holdings ordinary shares and those preference shares classified as equity. The abbreviations US$m and US$bn represent millions and billions (thousands of millions) of US dollars, respectively.

Financial statements

The consolidated financial statements of HSBC and the separate financial statements of HSBC Holdings have been prepared in accordance with International Financial Reporting Standards (IFRSs) as issued by the International Accounting Standards Board (IASB) and as endorsed by the European Union (EU). EU-endorsed IFRSs may differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2011, there were no unendorsed standards effective for the year ended 31 December 2011 affecting these consolidated and separate financial statements, and there was no difference between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to HSBC. Accordingly, HSBC s financial statements for the year ended 31 December 2011 are prepared in accordance with IFRSs as issued by the IASB.

We use the US dollar as our presentation currency because the US dollar and currencies linked to it form the major currency bloc in which we transact and fund our business. Unless otherwise stated, the information presented in this document has been prepared in accordance with IFRSs.

When reference to underlying or underlying basis is made in tables or commentaries, comparative information has been expressed at constant currency (see page 16), eliminating the impact of fair value movements in respect of credit spread changes on HSBC s own debt and adjusting for the effects of acquisitions and disposals of subsidiaries and businesses. A reconciliation of reported and underlying profit before tax is presented on page 17.

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Who we are and what we do

HSBC is one of the world s largest banking and financial services organisations. With around 7,200 offices in both established and faster-growing markets, we aim to be where the growth is, connecting customers to opportunities, enabling businesses to thrive and economies to prosper, and ultimately helping people to fulfil their hopes and realise their ambitions.

We serve around 89 million customers through our four global businesses: Retail Banking and Wealth Management, Commercial Banking, Global Banking and Markets, and Global Private Banking. Our network covers 85 countries and territories in six geographical regions: Europe, Hong Kong, Rest of Asia-Pacific, Middle East and North Africa, North America and Latin America. Our aim is to be acknowledged as the world s leading international bank.

Listed on the London, Hong Kong, New York, Paris and Bermuda stock exchanges, shares in HSBC Holdings plc are held by over 220,000 shareholders in 132 countries and territories.

Highlights

- Profit before tax up 15% to US$21.9bn on a reported basis.
- Underlying pre-tax profit down 6% to US$17.7bn.
- Launched strategy to reshape the Group, improve returns and position for growth.
- Strong performance in faster-growing regions, with revenue up 12% in Hong Kong, Rest of Asia-Pacific, Latin America and the Middle East and North Africa.
- Record year in Commercial Banking with profit before tax of US$7.9bn, up 31%.
- Achieved sustainable cost savings of US$0.9bn with a strong pipeline of further savings.

Dividends declared in respect of 2011 US$7.3bn or US$0.41 per ordinary share, up 14% on 2010.

Core tier 1 capital ratio 10.1%, down from 10.5% in 2010, largely reflecting the introduction of Basel 2.5.

Cover image

A Chinese ship in Brazil s largest port, Santos, illustrates the growing trade links between the two countries. China is today Brazil s largest trading partner, with HSBC financing an increasing share of that trade.

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Report of the Directors: Overview

Financial highlights

Earnings per share

US$0.92 *up 26%*

2010: US$0.73
2009: US$0.34

Dividends per ordinary share[1]

US$0.39

2010: US$0.34
2009: US$0.34

Net assets per share

US$8.48 *up 7%*

2010: US$7.94
2009: US$7.17

For the year

Profit before taxation

US$21,872m *up 15%*

2010: US$19,037m
2009: US$7,079m

Underlying profit before taxation

US$17,696m *down 6%*

2010: US$18,925m

Total operating income

US$83,461m *up 4%*

2010: US$80,014m
2009: US$78,631m

Net operating income before loan impairment charges and other credit risk provisions

US$72,280m *up 6%*

2010: US$68,247m
2009: US$66,181m

Profit attributable to the ordinary shareholders of the parent company

US$16,224m *up 27%*

2010: US$12,746m
2009: US$5,565m

At the year-end

Loans and advances to customers

US$940bn *down 2%*

2010: US$958bn
2009: US$896bn

Customer accounts

US$1,254bn *up 2%*

2010: US$1,228bn
2009: US$1,159bn

Ratio of customer advances to customer accounts

75.0%

2010: 78.1%
2009: 77.3%

Total equity

Average total shareholders equity to average total assets

Risk-weighted assets

US$166bn *up 7%*	5.6%	US$1,210bn *up 10%*
2010: US$155bn 2009: US$136bn	2010: 5.5% 2009: 4.7%	2010: US$1,103bn 2009: US$1,133bn

Capital ratios

Core tier 1 ratio	**Tier 1 ratio**	**Total capital ratio**
10.1%	11.5%	14.1%
2010: 10.5% 2009: 9.4%	2010: 12.1% 2009: 10.8%	2010: 15.2% 2009: 13.7%

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Performance ratios

Credit coverage ratios

Loan impairment charges to total operating income	Loan impairment charges to average gross customer advances	Total impairment allowances to impaired loans at year-end
13.8%	1.2%	42.3%
2010: 16.9%	2010: 1.5%	2010: 43.0% *(restated for change in disclosure policy see page 105)*
2009: 31.7%	2009: 2.8%	

Return ratios

Return on average invested capital[2]	Return on average ordinary shareholders equity[3]	Post-tax return on average total assets	Pre-tax return on average risk-weighted assets
10.2%	10.9%	0.6%	1.9%
2010: 8.7%	2010: 9.5%	2010: 0.6%	2010: 1.7%
2009: 4.1%	2009: 5.1%	2009: 0.3%	2009: 0.6%

Efficiency and revenue mix ratios

Cost efficiency ratio[4]	Net interest income to total operating income	Net fee income to total operating income	Net trading income to total operating income
57.5%	48.7%	20.6%	7.8%
2010: 55.2%	2010: 49.3%	2010: 21.7%	2010: 9.0%
2009: 52.0%	2009: 51.8%	2009: 22.5%	2009: 12.5%

Share information at the year-end

		Closing market price		
US$0.50 ordinary	**Market**	London	Hong Kong	American

shares in issue	**capitalisation**			Depositary Share[5]
17,868m	US$136bn	£4.91	HK$59.00	US$38.10
2010: 17,686m	2010: US$180bn	2010: £6.51	2010: HK$79.70	2010: US$51.04
2009: 17,408m	2009: US$199bn	2009: £7.09	2009: HK$89.40	2009: US$57.09

	Total shareholder return[6]		
	Over 1 year	Over 3 years	Over 5 years
To 31 December 2011	79.1	96.8	78.2
Benchmarks:			
FTSE 100[7]	97.8	140.3	107.9
MSCI World[7]	95.7	129.4	114.9
MSCI Banks[7]	82.7	107.5	60.5

For footnotes, see page 95.

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Cautionary statement regarding forward-looking statements

The *Annual Report and Accounts 2011* contains certain forward-looking statements with respect to HSBC s financial condition, results of operations and business.

Statements that are not historical facts, including statements about HSBC s beliefs and expectations, are forward-looking statements. Words such as expects , anticipates , intends , plans , believes , seeks , estimates , potential and reasonably possible , variations of these words and expressions are intended to identify forward-looking statements. These statements are based on current plans, estimates and projections, and therefore undue reliance should not be placed on them. Forward-looking statements speak only as of the date they are made. HSBC makes no commitment to revise or update any forward-looking statements to reflect events or circumstances occurring or existing after the date of any forward-looking statements.

Written and/or oral forward-looking statements may also be made in the periodic reports to the US Securities and Exchange Commission, summary financial statements to shareholders, proxy statements, offering circulars and prospectuses, press releases and other written materials, and in oral statements made by HSBC s Directors, officers or employees to third parties, including financial analysts.

Forward-looking statements involve inherent risks and uncertainties. Readers are cautioned that a number of factors could cause actual results to differ, in some instances materially, from those anticipated or implied in any forward-looking statement. These include, but are not limited to:

changes in general economic conditions in the markets in which we operate, such as continuing or deepening recessions and fluctuations in employment beyond those factored into consensus forecasts; changes in foreign exchange rates and interest rates; volatility in equity markets; lack of liquidity in wholesale funding markets; illiquidity and downward price pressure in national real estate markets; adverse changes in central banks policies with respect to the provision of liquidity support to financial markets; heightened market concerns over sovereign creditworthiness in over-indebted countries; adverse changes in the funding status of public or private defined benefit pensions; and consumer perception as to the continuing availability of credit and price competition in the market segments we serve;

changes in government policy and regulation, including the monetary, interest rate and other policies of central banks and other regulatory authorities; initiatives to change the size, scope of activities and interconnectedness of financial institutions in connection with the implementation of stricter regulation of financial institutions in key markets worldwide; revised capital and liquidity benchmarks which could serve to deleverage bank balance sheets and lower returns available from the current business model and portfolio mix; imposition of levies or taxes designed to change business mix and risk appetite; the practices, pricing or responsibilities of financial institutions serving their consumer markets; expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership; changes in bankruptcy legislation in the principal markets in which we operate and the consequences thereof; general changes in government policy that may significantly influence investor decisions; extraordinary government actions as a result of current market turmoil; other unfavourable political or diplomatic developments producing social instability or legal uncertainty which in turn may affect demand for our products and services; the costs, effects and outcomes of product regulatory reviews, actions or litigation, including any additional compliance requirements; and the effects of competition in the markets where we operate including increased competition from non-bank financial services companies, including securities firms; and

factors specific to HSBC, including our success in adequately identifying the risks we face, such as the incidence of loan losses or delinquency, and managing those risks (through account management, hedging and other techniques). Effective risk management depends on, among other things, our ability through stress testing and other techniques to prepare for events that cannot be captured by the statistical models it uses; and our success in addressing operational, legal and regulatory, and litigation challenges.

Report of the Directors: Overview (continued)

Group Chairman s Statement

Throughout its history HSBC has sought to facilitate economic growth, as it is through such growth that businesses flourish and individuals fulfil the aspirations they have for themselves and those close to them. The cover of this year s Annual Report and Accounts illustrates a core element of HSBC s strategic direction that is connecting markets by providing the financing and risk management products that facilitate trade and investment flows. In so doing, we help our customers to achieve their growth ambitions and generate economic returns for savers and investors.

The picture also illustrates the shift in emphasis towards the faster-growing markets that underpins HSBC s investment priorities. The port is Santos in Brazil, which is the largest container port in South America; the ship is from China, delivering heavy machinery. The Brazil-China trade corridor has been one of the fastest growing over the last decade with a compound annual rate of growth of around 30%. China is now Brazil s largest trade partner representing 18% of its total trade flows, versus 4% in 2000.

HSBC entered Brazil in 1997 and since then has built its operations to generate pre-tax profits of US$1.2 billion in 2011, an increase of 19% over the prior year. We estimate that we finance over 6% of Brazil s total trade and some 9% of its trade with China. In 2011 we were recognised as Financial institution of the year by the Brazil-China Chamber of Commerce for having contributed most to the growth and development of the Brazil-China trade corridor.

The purpose of the above introduction is to highlight the fact that, notwithstanding the major

uncertainties and risks concentrating minds in the advanced economies of Europe and the US, there are still attractive growth opportunities to pursue where our international network and strong balance sheet provide distinctive advantages.

Performance in 2011

In 2011 in our heartland of Asia, throughout the Middle East and in Latin America we made good progress in developing customer business in line with the risk appetite endorsed by the Board. Largely driven by growth in lending in these faster-growing regions, our Commercial Banking business delivered a record performance. In Europe and the US we concentrated on supporting our core customer base, targeting trade services while constraining risk appetite within the financial sector. We also made significant further progress in working down our exit businesses in the US. The Group Chief Executive s Review expands upon the execution of our strategy during 2011.

The strong progress made on strategy execution was all the more marked when contrasted with the fragile confidence that pervaded the advanced economies of the world. Continuing uncertainties arising from the eurozone debt crisis contributed to credit demand remaining muted in Europe, while US recovery lagged expectations held earlier in the year. As investors crowded into the safest asset classes, market activity levels dropped markedly and prices of securities outside the favoured asset classes weakened. These factors markedly reduced trading revenues in the second half of the year.

Against the backdrop of the economic and financial market conditions described above, the Board considered the Group s performance in 2011 to be satisfactory in aggregate and strong in the faster growing markets. Earnings per share rose by 26% to US$0.92 and the Board approved a fourth interim dividend of US$0.14 per ordinary share taking total dividends in respect of 2011 to US$0.41 per share, an increase of US$0.05 per share or 14%. The Board confirmed its intention to continue to pay quarterly dividends during 2012 at the rate of US$0.09 per ordinary share

in respect of each of the first three quarters, in line with 2011.

Notably, the capital strengthening required by regulatory reform is being successfully delivered while maintaining the strongest dividend paying record of any bank outside mainland China.

Total dividends declared during 2011 amounted to US$7.3 billion and in the last four years, that is since the financial crisis started, they have amounted

Report of the Directors: Overview (continued)

to US$27.2 billion, making HSBC the second largest dividend payer in the FTSE100 during this period.

Addressing a matter of public interest, the cost to shareholders of performance-related rewards made within our Global Banking and Markets business in 2011 and during the past four years amounted to some US$1 billion and US$4.7 billion, respectively. Pre-tax profit from Global Banking and Markets was, in aggregate, US$30 billion in the same four years, and represented the largest contribution, at 52%, of Group pre-tax profits during that period.

At the end of 2011, total shareholders equity stood at US$159 billion, up 24% from its pre-crisis level of US$128 billion at the end of 2007. Over the same period, our balance sheet grew by only 9%. The core tier 1 ratio at the end of 2011 stood at 10.1%, in line with our target range.

As foreshadowed in last year s Statement, the UK government proceeded with its plan to raise £2.5 billion through a levy on the global balance sheets of UK domiciled banks. The cost to HSBC was US$570 million of which US$340 million related to non-UK banking activity. The levy, which is not tax deductible, is the equivalent of US$0.03 per ordinary share and, as indicated last year, would otherwise be available for distribution to shareholders.

Progress on regulatory reform

A number of important milestones were passed during 2011 on the regulatory reform agenda. In the UK the Independent Commission on Banking (ICB) delivered its report in September and the Government published its response in December. In the US, greater clarity on the Dodd-Frank legislation was delivered through a multitude of notices of proposed new regulation and four US financial regulatory agencies issued proposed uniform regulations that would implement the Volcker Rule, which aims to constrain major financial institutions from engaging in proprietary trading and most hedge fund and proprietary investment activities. The Basel Committee, in conjunction with the Financial Stability Board, set out its proposals to identify and increase capital requirements for Global Systemically Important Banks and most major jurisdictions published their proposals around recovery and resolution planning for major institutions. Europe continued to embed the Basel III proposals within a new draft Capital Requirements Directive (CRD IV), the European Banking Authority formally came into existence as the hub of financial regulatory bodies in Europe and, in the UK,

HM Treasury published its proposals for a new approach to financial regulation and the replacement of the FSA with a new supervisory structure, directed by the Bank of England.

Many topics remain subject to further debate including cross-border resolution protocols, the governance and operation of central counterparties, the prospective role of clearing systems and exchanges, the calibration of the proposed new liquidity framework, the definition and operation of proposed proprietary trading restrictions, the possible harmonisation and peer review of the calculation of the risk weights that drive capital requirements, a re-assessment of the risk free treatment of sovereign debt and some 22 follow-on workstreams are ongoing in the wake of the UK Government s response to the ICB Report.

It is clear from the above that the industry will continue to bear a heavy burden of both time commitment and cost as it works with policymakers to finalise the regulatory reforms, including addressing the many inconsistencies within and extra-territorial dimensions of national rule-making. We are committed to all necessary constructive dialogue and support to speed the finalisation of these remaining issues. Our input will stress that it is critical that the reforms deliver a sustainable business model that can attract external economic capital. This is essential for the financial system to be able to contribute as fully as it should to the economic growth agenda which is being mandated by political leaders globally.

Board changes

We bid farewell at the upcoming AGM to two directors who have given huge service to HSBC over many years and who will not stand for re-election.

Sir Brian Williamson has served on the Board of HSBC Holdings since 2002 and brought great insight and wisdom to the Board from a distinguished career in financial services, most notably in the areas of money and bond markets, clearing, exchanges and electronic trading platforms where he was a pioneer in establishing The London International Financial Futures and Options Exchange.

Gwyn Morgan has served on the Board of HSBC Holdings since 2006 and before that on the Board of HSBC Canada for some nine years. His vast experience of leading large international companies in the engineering and energy sectors brought a balanced industrialist s perspective to Board discussions and debate.

Report of the Directors: Overview (continued)

We shall miss them both and thank them sincerely for their contributions over many years.

We are delighted to welcome two new faces to the Board. Joachim Faber and John Lipsky will join the Board on 1 March.

Joachim Faber stepped down from the Management Board of Allianz at the end of 2011 where he served latterly as CEO of Allianz Global Investors one of the top five investment managers globally. He brings a wealth of experience from the perspective of the investor as well as in depth knowledge of banking, insurance, finance and capital markets from previous roles in a long and distinguished career.

John Lipsky is one of the world s best known and respected economists who most recently served as First Deputy Managing Director at the IMF from which he retired in November 2011. Over the last five years John has been one of the key links between macroeconomic policymakers and the financial community and brings to the Board an exceptional depth of knowledge and understanding of the macroeconomic and geopolitical issues that will shape the future of the global economy.

Fuller details of their background and experience are set out in the Directors Report.

Brand and reputation

At HSBC we continue to think long-term as we build business platforms and relationships that will create options for value creation in generations to come.

Tactically there are necessary difficult decisions to take in today s subdued economic environment but these are always weighed against what is right for the long-term health of the business. Similarly when things go wrong, as they will from time to time, we judge ourselves, inter alia, against how we respond and how quickly we learn from the experience. Nothing is more important than our reputation.

It was a moment of great pride within the organisation when we were judged to be the most valuable banking brand in the world in the recent *Brand Finance® Banking 500 2012* report. This is the fourth time HSBC has headed the list in the last five years. This recognition is a testament to the work of all my colleagues in building value for customers that translates to shareholder value.

At the same time, however, we reflect that in 2011 we continued to deal with legacy regulatory, legal and reputational issues which remind us that our good work can be destroyed by lapses of judgement or control. The settlement of claims around the historical selling of Payment Protection Insurance in the UK, the fine and compensation arising from the now closed NHFA Limited business and ongoing regulatory and legal investigations in the US across a number of areas are all matters from which we need to learn to ensure they do not recur. The programme of values training which the Group Chief Executive is leading for all employees is but one measure to this end. We are truly sorry to all those who were adversely affected by our failings and to our shareholders for the reputational damage incurred.

Looking ahead

It is just over a year now since Stuart Gulliver and I took on our respective roles. During that time, the leadership team around Stuart has grown in stature and cohesion and is, I believe, among the best in our industry. That team is supported strongly by talented colleagues whose engagement and commitment to the strategic priorities laid out before them is evident and enthusiastic. On behalf of the Board I want to take this opportunity to thank them for their support and dedication. The uncertain economic and geopolitical backdrop will continue to raise challenges throughout 2012 and beyond. I am, however, confident that HSBC has the people, the financial strength and the right strategic focus and values to do well for those who place their trust in us, thereby meeting their expectations of us and contributing to the fulfilment of their aspirations and ambitions. That is what we exist to do.

D J Flint, *Group Chairman*

27 February 2012

Report of the Directors: Overview (continued)

Group Chief Executive s

Business Review

2011 was a year of change for HSBC as we articulated a clear strategy to become the world s leading international bank. We made significant progress in executing this strategy to reshape the Group and improve returns. First, we conducted a Group-wide portfolio review to improve our capital deployment and have now announced the disposal or closure of 16 non-strategic businesses during the year, and a further three in 2012. Second, we took action to improve our cost efficiency, achieving sustainable cost saving of US$0.9bn. Third, and most importantly, we continued to position the business for growth, increasing revenues in each of the world s faster-growing regions, particularly in mainland China, India, Malaysia, Brazil and Argentina. Commercial Banking achieved record revenue and profits, helped by loan growth as well as growth in cross-selling from Global Banking and Markets. In Wealth Management we made modest progress towards our target of US$4bn of incremental revenue over the medium term.

Executing our strategy is the primary lever to improve the Group s performance. A substantial amount has been achieved during 2011 but this will be a long journey with significant headwinds, so we are increasing the intensity of execution in 2012.

Group performance headlines

HSBC s financial performance was resilient.

Reported profit before tax was US$21.9bn, up US$2.8bn on 2010, including US$3.9bn of favourable fair value movements on our own debt attributable to credit spreads, compared with a negative movement of US$63m in 2010.
Underlying profit before tax was US$17.7bn, down US$1.2bn on 2010 due to higher costs which were partly offset by a significant improvement in loan impairment charges and other credit risk provisions.

We recorded a strong performance in each of the faster-growing regions. Underlying revenues grew in Rest of Asia-Pacific by 12%, in Hong Kong by 6% and in Latin America by 13%. The strong performance in these regions also led to record revenues in Commercial Banking.

We achieved strong revenue growth in key markets including mainland China, India, Malaysia, Brazil and Argentina, driving increases in profit before tax.

On an underlying basis, total revenues were broadly in line with 2010, despite the turmoil in the eurozone and its adverse effect on Credit and Rates revenue, combined with lower income in Balance Sheet Management and the continued reduction of our consumer finance portfolios

in the US.

As the process of internationalising the renminbi continued, we strengthened our leadership position with a bond clearing licence in mainland China and as the market leader in the offshore Dim Sum bond market. In addition, Commercial Banking and Global Banking and Markets successfully completed our first global US dollar-renminbi cross-currency swap and we extended our renminbi capability to over 50 markets in all regions.

Despite the eurozone sovereign debt concerns which dominated European market sentiment and depressed revenues in Global Banking and Markets, revenues grew strongly in over half of our business lines in Global Banking and Markets, including Equities and Foreign Exchange, and in Global Banking. This in part reflected the collaboration with Commercial Banking which has delivered more than US$500m in incremental revenues.

In Wealth Management we made modest progress towards our medium-term target of US$4bn incremental revenue, with revenue growth of some US$300m. Notably, we generated strong sales of insurance products in Hong Kong, Latin America and Rest of Asia-Pacific, while revenue from distribution of investment products to our clients and Global Asset Management was broadly unchanged, reflecting difficult market conditions, particularly in the second half of the year.

Report of the Directors: Overview (continued)

Costs rose by 10%, reflecting wage inflation in key markets and higher average full-time equivalent employee numbers for the year (although numbers have fallen since the first quarter), as well as an increase in significant items. These included restructuring costs (including the impairment of certain intangible assets) of US$1.1bn, UK customer redress programmes of US$898m and a bank levy introduced by the UK Government of US$570m, partly offset by a UK pension credit of US$587m. The rise in costs was partially offset by US$0.9bn in sustainable cost savings achieved so far in executing our strategy.

As a result of these factors, the cost efficiency ratio worsened from 55.2% to 57.5% on a reported basis, and from 55.6% to 61.0% on an underlying basis.

Our results continue to be adversely affected by the losses in the US consumer finance business, which, on an underlying basis, were US$2.4bn and US$2.2bn in 2011 and 2010, respectively. We have agreed the sale of the profitable US Card and Retail Services portfolio with the remainder of the loss-making US consumer finance business being run down.

Return on average ordinary shareholders equity was 10.9%, up from 9.5% in 2010, reflecting the favourable movement on the fair value of our own debt.

The Group s pre-tax return on risk-weighted assets (RoRWA) for 2011 was 1.9%, or 1.5% on an underlying basis. Adjusting for negative returns on US consumer finance business and legacy credit in Global Banking and Markets, the remainder of the Group achieved a RoRWA of 2.2% in 2011 and 2.3% in 2010.

Dividends declared in respect of 2011 totalled US$7.3bn, or US$0.41 per ordinary share, an increase of 14%, with a fourth interim dividend for 2011 of US$0.14 per ordinary share.

The core tier 1 ratio was 10.1% at 31 December 2011, down from 10.5% at 31 December 2010, reflecting an increase in risk-weighted assets (RWA s) due to the introduction of Basel 2.5 in Global Banking and Markets and growth in lending balances including those classified as held for sale. The growth in RWAs was notably in Commercial Banking, which included an increase in the RWAs of our mainland China associates.
Profit attributable to ordinary shareholders increased by 27% to US$16.2bn, of which US$7.3bn was declared in dividends in respect of the year. This compared with US$3.4bn of variable pay awarded (net of tax) to our employees for 2011.

Progress on strategy

There are two major trends which are key to HSBC s future: the continuing growth of international trade and capital flows; and wealth creation, particularly in faster-growing markets. In May, we defined a new strategy for the Group to capitalise on these trends and connect customers to opportunities by building on our distinctive presence in the network of markets which generate the major trade and capital flows, capturing wealth creation in target markets and focusing on retail banking only where we can achieve profitable scale.

In a difficult operating environment this strategy is key to improving our performance and we remain focused on delivering our targets of a return on average shareholders equity of 12-15% and a cost efficiency ratio of 48-52% by the end of 2013. We are executing the strategy by deploying capital more effectively, implementing measures to improve our cost efficiency and positioning the business for growth. We have made significant progress in all of these three areas.

First, to ensure effective deployment of capital, we undertook a Group-wide review of our business, testing each part of the portfolio against our five filters framework. This looks at the strategic relevance of each country, and each business in each country, assessing their connectivity, economic development, profitability, cost efficiency and liquidity. As a result, we announced 16 disposals or closures in 2011 and a further three in 2012, including two large transactions in the US, the withdrawal from Georgia and the exit of Retail Banking and Wealth Management operations in Russia, Chile, Thailand and Poland. When completed, these disposals and closures should represent a reduction of around US$50bn of risk-weighted assets and the transfer to the acquirers of approximately 12,000 full-time equivalent employees. We are continuing this process in 2012 and have identified a number of further transactions.

Second, to improve cost efficiency we achieved US$0.9bn of sustainable savings. Our programmes to implement consistent business models and restructure global businesses and global functions progressed well. We are creating a leaner Group, removing layers of management to give staff greater

Report of the Directors: Overview (continued)

responsibility, improve decision making and reduce bureaucracy. We have identified a strong pipeline of further sustainable cost savings which we believe will deliver at the upper end of our target of US$2.5-3.5bn of sustainable savings by 2013.

Third, we continued to position the business for growth, as outlined in the performance headlines.

We are increasing the intensity of strategy execution in 2012 and will provide a further update at our forthcoming Investor Strategy Day.

Our purpose and values

HSBC is one of the world s largest banking and financial services organisations. We serve around 89 million customers and our network covers 85 countries and territories. With around 7,200 offices in both established and faster-growing markets, we aim to be where the growth is, connecting customers to opportunities, enabling businesses to thrive and economies to prosper, and ultimately helping people to realise their ambitions.

We are putting a new emphasis on values at HSBC, so that our employees are empowered to do the right thing and to act with courageous integrity. We recognise that we have not always got this right in the past. The inappropriate advice given to customers of NHFA Limited was completely unacceptable. We are profoundly sorry about what happened and are committed to standing fully behind our customers. This case has reinforced our determination to address legacy issues in HSBC.

Over the past year we have made our values more explicit to ensure we meet the expectations of society, customers, regulators and investors. Those values are that we are dependable, open to different ideas and cultures and connected to customers, communities, regulators and each other. We are ensuring that everyone who works for HSBC lives by these values and have made them a key part of every individual s annual performance review. By

setting the highest standards of behaviour our aim is that all of our employees and customers can be proud of our business.

Outlook

In 2012, notwithstanding the macroeconomic, regulatory and political uncertainties which we believe will persist, we expect continued strong growth in the dynamic markets of Asia, Latin America and the Middle East, although at a more moderate pace than in 2011, and that mainland China will achieve a soft landing. We believe that trade and capital flows between emerging areas of the world will also continue to grow, and could increase tenfold in the next 40 years.

As these results demonstrate, HSBC is well-positioned in the faster-growing markets and across international trade flows to benefit from these engines of global growth.

In 2011 we generated a return on average ordinary shareholders equity of 10.9% compared with 9.5% in 2010. The strength of our position gives us confidence that by the end of 2012 we will have developed a clear trajectory towards meeting our target of 12-15% by the end of 2013.

Finally, I am pleased to report we had good results in January.

S T Gulliver, *Group Chief Executive*

27 February 2012

Report of the Directors: Overview (continued)

Principal activities

HSBC is one of the largest banking and financial services organisations in the world, with a market capitalisation of US$136bn at 31 December 2011. We are headquartered in London.

Our products and services are delivered to clients through four global businesses, Retail Banking and Wealth Management (RBWM), Commercial Banking (CMB), Global Banking and Markets (GB&M), and Global Private Banking (GPB).

We operate through long-established businesses and have an international network of some 7,200 offices in 85 countries and territories in six geographical regions; Europe, Hong Kong, Rest of Asia-Pacific, Middle East and North Africa (MENA), North America and Latin America.

Taken together, our five largest customers do not account for more than 1% of our income. We have contractual and other arrangements with numerous third parties in support of our business activities. None of the arrangements is individually considered to be essential to the business of the Group.

Following a Group-wide review of our businesses, 16 disposals or closures were announced in 2011, and a further three in 2012. The most significant of these were the sales of 195 retail branches, primarily in upstate New York, our US Card and Retail Services portfolio and our businesses in Costa Rica, El Salvador and Honduras. For further information on these disposals, see page 379.

There were no significant acquisitions during the year.

Business and operating models

Business model

We accept deposits and channel these deposits into lending activities, either directly or through the capital markets. We also offer a range of products and financial services including broking, underwriting and credit facilities, trade finance, credit cards, sales of insurance and investment products and funds under management. These banking and financial services are provided to a wide range of clients including governments, large and mid-market corporates, small and medium-sized enterprises (SMEs), high net worth individuals, and mass affluent and retail customers.

Our operating income is primarily derived from:

- net interest income interest income on customer loans and advances, less interest expense on interest bearing customer accounts and debt securities in issue;

- net fee income fee income earned from the provision of financial services and products to customers of our global businesses; and

net trading income income from trading activities primarily conducted in Global Markets, including Foreign Exchange, Credit, Rates and Equities trading.

Operating model

HSBC has a matrix management structure which includes global businesses, geographical regions and global functions.

Holding company

HSBC Holdings plc, the holding company of the Group, has listings in London, Hong Kong, New York, Paris and Bermuda. HSBC Holdings is the primary provider of equity capital to its subsidiaries and provides non-equity capital to them where necessary.

Under authority delegated by the Board of HSBC Holdings, the Group Management Board (GMB) is responsible for management and day-to-day running of the Group. The Board, together with GMB, ensures that there are sufficient cash resources to pay dividends to shareholders, interest to bondholders, expenses and taxes.

HSBC Holdings does not provide core funding to any subsidiary, is not a lender of last resort and does not carry out any banking business in its own right. HSBC has a legal entity-based Group structure, sometimes referred to as subsidiarisation, which underpins our strong balance sheet and helps generate a resilient stream of earnings.

Global businesses

Our four global businesses are responsible for developing, implementing and managing their business propositions consistently across the Group, focusing on profitability and efficiency. They set their strategies within the confines of the Group strategy in liaison with the geographical regions, are responsible for issuing planning guidance regarding their businesses, are accountable for their profit and loss performance and manage their headcount.

Report of the Directors: Overview (continued)

Geographical regions

The geographical regions share responsibility for executing the strategies set by the global businesses. They represent the Group to clients, regulators, employee groups and other stakeholders, allocate capital, manage risk appetite, liquidity and funding by legal entity and are accountable for profit and loss performance in line with the global business plans.

Within the geographical regions, the Group is structured as a network of regional banks and locally incorporated regulated banking entities. Each bank is separately capitalised in accordance with applicable prudential reporting requirements and maintains a capital buffer consistent with the Group s appetite for risk in its country or region. Each bank manages its own funding and liquidity within parameters set centrally, and is required to consider its risk appetite, consistent with the Group s risk appetite for the relevant country or region.

Global functions

Our global functions are Communications, Company Secretaries, Corporate Sustainability, Finance, Human Resources, Internal Audit, Legal, Marketing, Risk (including Compliance) and Strategy and Planning. They establish and manage all policies, processes and delivery platforms relevant to their activities, are fully accountable for their costs globally and are responsible for managing their headcount.

Strategic direction

Our strategy is aligned to two long-term trends:

Financial flows the world economy is becoming ever-more connected. Growth in world trade and cross-border capital flows continues to outstrip growth of gross domestic product. Financial flows between countries and regions are highly concentrated. Over the next decade we expect 35 markets to represent 90% of world trade growth and a similar degree of concentration in cross-border capital flows.

Economic development by 2050, we expect economies currently deemed emerging to have increased five-fold in size, benefiting from demographics and urbanisation, and they will be larger than the developed world. By then, we expect 19 of the 30 largest economies will be markets that are currently described as emerging.

HSBC is one of the few truly international banks and our advantages lie in our network of markets relevant for international financial flows, our access and exposure to high growth markets and businesses, and our strong balance sheet generating a resilient stream of earnings.

Based on these long-term trends and our competitive position, our strategy has two parts:

Network of businesses connecting the world HSBC is ideally positioned to capture the growing international financial flows. Our franchise puts us in a privileged position to serve corporate clients as they grow from small enterprises into large and international corporates, and personal clients as they become more affluent. Access to local retail funding and our international product capabilities allows us to offer distinctive solutions to these clients in a profitable manner.

Wealth management and retail with local scale we will leverage our position in faster-growing markets to capture social mobility and wealth creation through our Wealth Management and Private Banking businesses. We will only invest in retail businesses in markets where we can achieve profitable scale.

Implementing this strategy relies on actions across three areas:

Capital deployment (five filters) we are improving the way we deploy capital as part of our efforts to achieve our targeted return on equity of between 12% and 15% over the business cycle. We have introduced a strategic and financial framework assessing each of our businesses on a set of five strategic evaluation criteria, namely international connectivity, economic development, profitability, cost efficiency and liquidity. The results of this review determine whether we invest in, turn around, continue with or exit businesses.

Cost efficiency (four programmes) we have launched four programmes which we believe will achieve sustainable savings of between US$2.5bn and US$3.5bn by the end of 2013, resulting in a leaner and more values-driven organisation. These are: (i) implement consistent business models, (ii) re-engineer operational processes, (iii) streamline IT, and (iv) re-engineer global functions. Sustainable cost savings are intended to facilitate self-funded growth in key markets and investment in new products, processes and technology, and provide a buffer against regulatory and inflationary headwinds.

Growth we continue to position ourselves for growth. We are increasing our relevance in fast-growing markets and in wealth management,

Report of the Directors: Overview (continued)

and are improving the collaboration between our international network of businesses, particularly between CMB and GB&M.

If we are successful in executing this strategy, we will be regarded as The world s leading international bank . We have defined financial targets to achieve a return on equity of between 12% and 15% with a core tier 1 ratio of between 9.5% and 10.5%, and achieve a cost efficiency ratio of between 48% and 52%. We have also defined Key Performance Indicators to monitor the outcomes of actions across the three areas of capital deployment, cost efficiency and growth.

Risk

As a provider of banking and financial services, risk is at the core of our day-to-day activities.

We have identified a comprehensive suite of risk factors which informs our assessment of our top and emerging risks. This assessment may result in our risk appetite being revised.

Risk factors

Our businesses are exposed to a variety of risk factors that could potentially affect our results of operations or financial condition. These are:

Macroeconomic and geopolitical risk

- Current economic and market conditions may adversely affect our results.
- We have exposure to the ongoing economic crisis in the eurozone.
- We are subject to political and economic risks in the countries in which we operate.
- Changes in foreign currency exchange rates may affect our results.

Macroprudential, regulatory and legal risks to our business model

- Our businesses are subject to wide-ranging legislation and regulation and to regulatory and governmental oversight. Unfavourable legislative or regulatory developments, or changes in the policy of regulators or governments, could have a significant adverse effect on our operations, financial condition and

prospects.

The Independent Commission on Banking has published its final report on competition and possible structural reforms in the UK banking industry. The implementation of the recommendations included in the final report could have a material adverse effect on us.

We are subject to a number of legal and regulatory actions and investigations, the outcomes of which are inherently difficult to predict, but unfavourable outcomes could have a material adverse effect on our operating results and brand.

We are subject to tax-related risks in the countries in which we operate which could have a material adverse effect on our operating results.

Risks related to our business operations, governance and internal control systems

Our risk management measures may not be successful.

Operational risks are inherent in our business.

Our operations are highly dependent on our information technology systems.

Our operations have inherent reputational risk.

We may suffer losses due to employee misconduct.

We rely on recruiting, retaining and developing appropriate senior management and skilled personnel.

Our financial statements are based in part on assumptions and estimates which, if inaccurate, could cause material misstatement of the results and financial position of the Group.

Third parties may use us as a conduit for illegal activities without our knowledge, which could have a material adverse effect on us.

We may not achieve all the expected benefits of our strategic initiatives.

Risks related to our business

We have significant exposure to counterparty risk within the financial sector and to other risk concentrations.

Market fluctuations may reduce our income or the value of our portfolios.

Liquidity, or ready access to funds, is essential to our businesses.

Any reduction in the credit rating assigned to HSBC Holdings, any subsidiaries of HSBC Holdings or any of their respective debt securities could increase our cost or availability of funding and adversely affect our liquidity position and interest margins.

Risks concerning borrower credit quality are inherent in our businesses.

Our insurance businesses are subject to risks relating to insurance claim rates and changes in insurance customer behaviour.

HSBC Holdings is a holding company and, as a result, is dependent on dividends from its subsidiaries to meet its obligations including its obligations with respect to its debt securities, and to provide profits for payment of future dividends to shareholders.

We may be required to make substantial contributions to our pension plans.

Report of the Directors: Overview (continued)

Macroeconomic and geopolitical risk

Current economic and market conditions may adversely affect our results

Our earnings are affected by global and local economic and market conditions. Following the global financial crisis in 2007, a difficult economic climate remains with continued pressures on household and corporate finances. The peripheral eurozone economies, such as Greece, Ireland, Italy, Portugal and Spain, came under increasing pressure in 2011, the dominant concern being over the high levels of their sovereign debt. The large budget deficit and growing government indebtedness of the US and the recent downgrade of its sovereign debt by a major ratings agency are generating concerns regarding the financial position and economic prospects of the US, the global economy and the financial services sector. In addition, mainland China experienced a slowdown in economic growth in 2011 and faces uncertainty over future growth.

With unemployment remaining high and consumer confidence weak in developed markets, and amid signs of inflationary pressures in emerging markets, economic conditions are fragile and volatile and markets are weak. These adverse economic conditions continue to create a challenging operating environment for financial services companies such as HSBC. In particular, we may face the following challenges to our operations and operating model in connection with these factors:

- the demand for borrowing from creditworthy customers may diminish if economic activity slows or remains subdued;
- the heightened risk of overheating economies in emerging markets in recent years is giving rise to concerns that asset and credit bubbles may be created, leading to volatility and losses;
- European banks may come under stress as a result of the sovereign debt crisis in the eurozone;
- trade and capital flows may contract as a result of protectionist measures being introduced in certain markets or on the emergence of geopolitical risks;
- a prolonged period of modest interest rates will constrain, for example, through margin compression and low returns on assets, the interest income we earn from investing our excess deposits;
- our ability to borrow from other financial institutions or to engage in funding transactions may be adversely affected by market disruption, for example, in the event of contagion from stress in the eurozone sovereign and financial sectors; and
- market developments may depress consumer and business confidence. If growth in the UK or the US remains subdued, for example, asset prices and payment patterns may be adversely affected, leading to increases in delinquencies, default rates, write-offs and loan impairment charges beyond our expectations.

We have exposure to the ongoing economic crisis in the eurozone

The sovereign debt crisis that erupted in 2010 extended through 2011. Concern regarding the financial position of several economies which spread from those of peripheral eurozone countries such as Greece, Ireland, Italy, Portugal and Spain to include certain core eurozone countries, became increasingly widespread and severe. These negative trends caused considerable turbulence on the global financial markets.

The risk of contagion throughout and beyond the eurozone remains noteworthy. A significant number of financial institutions throughout Europe, including in core eurozone countries, have substantial exposure to sovereign debt issued by states which have come under considerable financial pressure, such as Greece. Should any of those nations default on their debt or experience a significant widening of credit spreads, major financial institutions and banking systems throughout Europe could be destabilised, intensifying the economic crisis. Although our direct exposure to peripheral eurozone economies is limited, we have substantial exposure to financial institutions and central banks in core European countries which may be affected by the ongoing crisis. For a further description of our exposures to selected eurozone countries, eurozone banks and other financial institutions and corporates see Areas of special interest on page 112.

While the authorities throughout Europe continue to work on agreeing a political solution which will encompass economic plans designed to address the fiscal instability of the eurozone, the ongoing economic crisis has increased the risk of its break-up. This would have a dramatic impact on the whole financial sector, creating new challenges in sovereign and corporate lending and resulting in significant disruption to financial activities at both the wholesale and retail levels.

Report of the Directors: Overview (continued)

We are subject to political and economic risks in the countries in which we operate

We operate through an international network of subsidiaries and affiliates in 85 countries and territories around the world. Our results are, therefore, subject to the risk of loss from unfavourable political developments, currency fluctuations, social instability and changes in government policies on such matters as expropriation, authorisations, international ownership, interest-rate caps, limits on dividend flows and tax in the jurisdictions in which we operate. For example, in the Middle East, the Arab Spring has led to political instability across the region. In Asia, tensions persist in certain areas following leadership/regime changes which pose the threat of instability and potential conflict. A break-up of the eurozone or continued social unrest triggered by the ongoing economic crisis and related austerity programmes may result in political and social disruption throughout Europe. The occurrence of any of these events or circumstances could have a material adverse effect on our business, financial condition and/or results of operations.

Changes in foreign currency exchange rates may affect our results

We prepare our accounts in US dollars, but because a substantial portion of our assets, liabilities, assets under management, revenues and expenses are denominated in other currencies, changes in foreign exchange rates have an effect on our reported income, cash flows and shareholders equity and may have a material adverse effect on our business, financial condition and/or results of operations.

Macroprudential, regulatory and legal risks to our business model

Our businesses are subject to wide-ranging legislation and regulation and to regulatory and governmental oversight. Unfavourable legislative or regulatory developments, or changes in the policy of regulators or governments, could have a significant adverse effect on our operations, financial condition and prospects

Our businesses are subject to ongoing regulation and associated regulatory risks, including the effects of changes in the laws, regulations, policies, voluntary codes of practice and interpretations in the UK, the US, Hong Kong, the European Union (EU) and the other markets where we operate. This is particularly the case in the current market environment, where

we are witnessing increased levels of government and regulatory intervention in the banking sector, which we expect to continue for the foreseeable future. Since 2008, regulators and governments have focused on the reform of the financial services industry, including enhanced capital, liquidity and leverage requirements, changes in compensation practices, tax levies and measures to address systemic risk. The US government, the UK government, the Financial Services Authority (FSA) and other regulators in the UK, Hong Kong, the EU or elsewhere may intervene further in relation to areas of industry risk already identified, or in new areas, which could adversely affect us. Future changes are difficult to predict but could materially and unfavourably affect our business.

Areas where changes could have an adverse impact include, but are not limited to:

- general changes in government, central bank or regulatory policy, or changes in regulatory regimes that may influence investor decisions in particular markets in which we operate, which may change the structure of those markets and the products offered or may increase the costs of doing business in those markets;

- external bodies applying or interpreting standards or laws differently to us;

- changes in competitive and pricing environments;

- further requirements relating to financial reporting, corporate governance, conduct of business and employee compensation; and

- expropriation, nationalisation, confiscation of assets and changes in legislation relating to foreign ownership.

Beginning in April 2011, the FSA commenced an internal reorganisation as a first step in a process towards the formal transition of regulatory and supervisory powers from it to the new Financial Conduct Authority (FCA) for the conduct of business supervision and to the Prudential Regulatory Authority (PRA) for capital and liquidity supervision in 2012. Until this time, the responsibility for regulating and supervising the activities of HSBC will remain with the FSA. In addition, new European supervisory authorities, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority are likely to exert greater influence on regulatory issues across the EU. These could change the way in which we are regulated and supervised.

Report of the Directors: Overview (continued)

The Basel Committee has approved significant changes to the regulation of banking institutions capital and liquidity, involving a substantial strengthening of the minimum requirements. Implementation at the national level remains ongoing.

HSBC has been classified by the Financial Stability Board (FSB) as a Global Systemically Important Financial Institution (G-SIFI) under proposals that would place an additional capital buffer on the Group and may place us under additional regulatory scrutiny. As proposed, the capital surcharge will apply at a Group level and have implications for capital management for all our locally incorporated banks and branch operations which hold capital. The Basel committee issued in November 2011 its rules for Global Systemically Important Banks (G-SIBs). These provide a framework for more intensive supervision of G-SIBs and assessment methodology to determine additional requirements for loss absorbing capacity. See Capital on pages 211 to 217.

The implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and related final regulations could result in additional costs or limit or restrict the way we conduct our business. Uncertainty remains about many of the details, impact and timing of these reforms and the effect they will ultimately have on HSBC. While we do not have segregated proprietary trading desks, the Volcker Rule could affect our businesses in North America and elsewhere in the world. In addition, the Federal Reserve Board stated in December 2011 that it expects to issue shortly a proposal to apply enhanced supervisory standards to large foreign banking organisations such as HSBC.

There are also a number of ongoing regulatory initiatives at the EU and at national level in various stages of development which could result in additional costs or limit or restrict the way we conduct business. These include the EU s proposed Crisis Management Directive and its ongoing review of the existing Markets in Financial Instruments Directive. At a national level they include the FSA s Retail Distribution and Mortgage Market Reviews. Uncertainty remains about the details, impact and timing of some of these reforms and the effect they will ultimately have on HSBC.

Notwithstanding our efforts to comply with applicable regulations, we may fail, particularly in areas where applicable regulations may be unclear or where regulators revise existing guidance or courts overturn previous rulings. Authorities in many jurisdictions have the power to bring administrative

or judicial proceedings against us which could result in, among other things, suspension or revocation of our licenses, cease and desist orders, fines, civil penalties, criminal penalties or other disciplinary action which could materially adversely affect our results of operations and seriously harm our reputation.

Changes in laws, rules or regulations, or in their interpretation or enforcement, or the implementation of new laws, rules or regulations, may adversely affect our business, financial condition and/or results of operations. Further, uncertainty and lack of international regulatory coordination as enhanced supervisory standards are developed and implemented may adversely affect our ability to engage in effective business, capital and risk management planning.

The Independent Commission on Banking has published its final report on competition and possible structural reforms in the UK banking industry. The implementation of the recommendations included in the final report could have a material adverse effect on us

The UK Independent Commission on Banking (ICB) published its Final Report on 12 September 2011. The Commission s reform proposals, if adopted as legislation in substantially the form prescribed, would have wide-ranging implications for the structure and costs of large UK-headquartered banks and the UK banking industry.

In respect of large banks, including HSBC, the ICB proposes that there should be primary loss-absorbing capacity equal to at least 17% of risk-weighted assets (RWA s) calculated under Basel III. This capacity should be satisfied by complying with the Basel III capital requirements and issuing additional equity and/or long-term, unsecured bonds that are loss-absorbing at the point of non-viability. The UK supervisor would retain the power to increase this minimum loss-absorbing capacity to 20% of RWAs if it had concerns about the ability of the bank to restructure or liquidate at the point of failure.

In addition, in respect of UK universal banks, including HSBC s major UK banking subsidiary, HSBC Bank plc, the ICB has proposed a separation of the UK retail and wholesale banking operations through the creation of a ring-fenced retail bank. The ICB recommends that a large ring-fenced bank should be required to maintain an equity ring-fence buffer of at least 3% of RWAs above the Basel III base requirement of 7% of RWAs.

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Report of the Directors: Overview (continued)

The Chancellor of the Exchequer expressed broad approval of the ICB s Final Report and indicated that the UK Government endorses in principle the proposals to establish a ring-fenced bank and greater primary loss absorbing capacity. The Government is not, however, bound to adopt the Commission s recommendations and are proposing to undertake extensive consultation in two stages during 2012.

If the proposals described above are adopted, major changes to our corporate structure and business activities conducted in the UK through HSBC Bank plc might be required. The changes may include separating the ring-fenced bank from the existing UK incorporated universal bank. The proposals, if adopted, would take an extended period of time to implement and would significantly increase our costs, both to implement and to run the ongoing operations as restructured.

We are subject to a number of legal and regulatory actions and investigations, the outcomes of which are inherently difficult to predict, but unfavourable outcomes could have a material adverse effect on our operating results and brand

We face significant legal risks in our business and the volume and amount of damages claimed in litigation, regulatory proceedings and other adversarial proceedings against financial institutions are increasing.

We are subject to a number of material legal proceedings, regulatory actions and investigations as described in Note 44 on the Financial Statements on pages 405 to 409. It is inherently difficult to predict the outcome of many of the legal, regulatory and other adversarial proceedings involving our businesses, particularly those cases in which the matters are brought on behalf of various classes of claimants, seek damages of unspecified or indeterminate amounts or involve novel legal claims. An unfavourable result in one or more of these proceedings could have a material adverse effect on our results of operations.

We are subject to tax-related risks in the countries in which we operate which could have a material adverse effect on our operating results

HSBC is subject to the substance and interpretation of tax laws in all countries in which we operate and is subject to routine review and audit by tax authorities in relation thereto. We provide for

potential tax liabilities that may arise on the basis of the amounts expected to be paid to the tax authorities. The amounts ultimately paid may differ materially from the amounts provided depending on the ultimate resolution of such matters. Changes to tax law, tax rates and penalties for failure to comply could have a material adverse effect on our business, financial condition and/or results of operations.

For example, HM Treasury introduced a new bank levy in the Finance Act 2011. The bank levy is imposed on (among other entities) UK banking groups and subsidiaries, and therefore applies to HSBC. A charge of US$570m has been recognised in 2011 in respect of this levy, based on the consolidated balance sheet at the year end. A reduced rate is applied to longer-term liabilities. Other countries, including France, Germany and South Korea, have also introduced bank levies. These do not have the same global basis as the UK bank levy and do not have a material effect on the Group at present. It is possible that we will become subject to higher levies in the future, to similar taxes in other jurisdictions and/or to financial activity or transaction taxes which are currently under consideration.

Risks related to our business operations, governance and internal control systems

Our risk management measures may not be successful

The management of risk is an integral part of all our activities. Risk constitutes our exposure to uncertainty and the consequent variability of return. Specifically, risk equates to the adverse effect on profitability or financial condition arising from different sources of uncertainty including retail and wholesale credit risk, market risk, operational risk, non-traded market risk, insurance risk, concentration risk, liquidity and funding risk, reputational risk, strategic risk, pension obligation risk and regulatory risk. We seek to monitor and manage our risk exposure through a variety of separate but complementary control and reporting systems such as financial, credit, market, operational, compliance and

legal. While we employ a broad and diversified set of risk monitoring and risk mitigation techniques, such techniques, and the judgements that accompany their application, cannot anticipate every unfavourable event or the specifics and timing of every outcome. Failure to manage risks appropriately could have a significant effect on our business, financial condition and/or results of operations.

Report of the Directors: Overview (continued)

Operational risks are inherent in our business

We are exposed to many types of operational risk, including fraudulent and other criminal activities (both internal and external), breakdowns in processes or procedures and systems failure or non-availability. For example, failure to protect our operations from internet crime or cyber attacks could result in the loss of customer data or other sensitive information which could impact our reputation and our ability to attract and keep customers. The threat of external fraud may increase during adverse economic conditions especially in retail and commercial banking. We are also subject to the risk of disruption of our business arising from events that are wholly or partially beyond our control (for example, natural disasters, acts of terrorism, epidemics and transport or utility failures) which may give rise to losses in service to customers and/or economic loss to us. All of these risks are also applicable when we rely on outside suppliers or vendors to provide services to us and our customers.

Our operations are highly dependent on our information technology systems

The reliability and security of our information and technology infrastructure and our customer databases are crucial to maintaining the service availability of banking applications and processes and to protecting the HSBC brand. The proper functioning of our payment systems, financial control, risk management, credit analysis and reporting, accounting, customer service and other information technology systems, as well as the communication networks between our branches and main data processing centres, are critical to our operations. Critical system failure, any prolonged loss of service availability or any material breach of data security, particularly involving confidential customer data, could cause serious damage to our ability to service our clients, could breach regulations under which we operate and could cause long-term damage to our business and brand. For example, in 2010 HSBC Private Bank (Suisse) SA was the victim of a significant data theft resulting in reputational harm, intervention by regulators and remediation costs.

Our operations have inherent reputational risk

Reputational risk, meaning the risk to earnings and capital from negative public opinion, is inherent in our business. Negative public opinion can result from the actual or perceived manner in which we conduct our business activities, from our financial

performance, or from actual or perceived practices in the banking and financial industry. Modern technologies, in particular online social networks and other broadcast tools which facilitate communication with large audiences in short time frames and with minimal costs, may significantly enhance and accelerate the impact of damaging information and allegations. Negative public opinion may adversely affect our ability to keep and attract customers and, in particular, corporate and retail depositors.

We may suffer losses due to employee misconduct

Our businesses are exposed to risk from potential non-compliance with policies, employee misconduct or negligence and fraud, which could result in regulatory sanctions and serious reputational or financial harm. In recent years, a number of multinational financial institutions have suffered material losses due to the actions of rogue traders or other employees. It is not always possible to deter employee misconduct and the precautions we take to prevent and detect this activity may not always be effective.

We rely on recruiting, retaining and developing appropriate senior management and skilled personnel

Our continued success depends in part on the continued service of key members of our management team. The ability to continue to attract, train, motivate and retain highly qualified professionals is a key element of our strategy. The successful implementation of our growth strategy depends on the availability of skilled management, both at our head office and at each of our business units. If one of our business units or other functions fails to staff its operations appropriately or loses one or more of its key senior executives, and fails to replace them in a satisfactory and timely manner, our business, financial condition and/or results of operations, including control and operational risks, may be adversely affected. Likewise, if we fail to attract and appropriately train, motivate and retain qualified professionals, our business may be adversely affected.

Our financial statements are based in part on assumptions and estimates which, if inaccurate, could cause material misstatement of the results and financial position of the Group

The preparation of financial statements requires management to make judgements, estimates and

Report of the Directors: Overview (continued)

assumptions that affect the reported amounts of assets, liabilities, income and expenses. Due to the inherent uncertainty in making estimates, actual results reported in future periods may be based upon amounts which differ from those estimates. Estimates, judgements and assumptions are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected. The accounting policies deemed critical to our results and financial position, based upon materiality and significant judgements and estimates, include impairment of loans and advances, goodwill impairment, valuation of financial instruments, impairment of available-for-sale financial assets, deferred tax assets and provision for liabilities, which are discussed in detail in Critical accounting policies on page 38.

The valuation of financial instruments measured at fair value can be subjective, in particular where models are used which include unobservable inputs. Given the uncertainty and subjectivity associated with valuing such instruments it is possible that the results of operations and financial position of the Group could be materially misstated if the estimates and assumptions used prove to be inaccurate. For further details, see Critical accounting policies on page 38.

If the judgement, estimates and assumptions we use in preparing our consolidated financial statements are subsequently found to be incorrect, there could be a material effect on our results of operations and a corresponding effect on our funding requirements and capital ratios.

Third parties may use us as a conduit for illegal activities without our knowledge, which could have a material adverse effect on us

We are required to comply with applicable anti-money laundering laws and regulations and have adopted various policies and procedures, including internal control and know-your-customer procedures, aimed at preventing use of HSBC for money laundering. A major focus of US governmental policy relating to financial institutions in recent years has been combating money laundering and enforcing compliance with US economic sanctions. For example, subsidiaries of HSBC Holdings have entered into a consent cease and desist order with the OCC and a similar consent order with the Federal Reserve Board which requires

the implementation of improvements to compliance procedures regarding obligations under the US Bank Secrecy Act (the BSA) and anti-money laundering (AML) rules. These consent orders do not preclude additional enforcement actions by bank regulatory, governmental or law enforcement agencies. Investigations by various authorities pertaining to, among other things, alleged violations of AML laws, the BSA and regulations issued by the Office of Foreign Asset Control are ongoing. See Note 44 on the Financial Statements on page 405.

In relevant situations and where permitted by regulation, we may rely upon certain counterparties to maintain and properly apply their own appropriate anti-money laundering procedures. While permitted by regulation, such reliance may not be completely effective in preventing third parties from using us (and our relevant counterparties) as a conduit for money laundering including illegal cash operations without our (and our relevant counterparties) knowledge. If we are associated with, or even accused of being associated with, or become a party to, money laundering, our reputation could suffer and we could become subject to fines, sanctions and/or legal enforcement (including being added to any blacklists that would prohibit certain parties from engaging in transactions with us), any one of which could have a material adverse effect on our business, financial condition and/or results of operations.

We may not achieve all the expected benefits of our strategic initiatives

In 2011 we developed and presented a new strategy for the Group. See further discussion in Strategic direction on page 11. Our strategy is built around two trends, continued growth of international trade and capital flows, and wealth creation, particularly in faster growing markets. Based on our analysis of those trends, we have developed criteria to help us better deploy capital. We have also launched an initiative to reduce costs, part of which includes the disposal of non-core businesses. The development and implementation of our strategy requires difficult, subjective and complex judgements, including forecasts of economic conditions in various parts of the world. We may fail to correctly identify the trends we seek to exploit and the relevant factors in making decisions as to capital deployment and cost reduction. Our ability to execute our strategy may also be limited by our operational capacity and the increasing complexity of the regulatory environment in which we operate. For example,

the complexities of separating disposed assets from continuing operations, including transitional

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Report of the Directors: Overview (continued)

arrangements, could increase operational and reputational risks and threaten successful execution of an announced disposal. In addition, factors beyond our control, including but not limited to the market and economic conditions and other challenges discussed in detail above, could limit our ability to achieve all of the expected benefits of these initiatives.

Risks related to our business

We have significant exposure to counterparty risk within the financial sector and to other risk concentrations

We have exposure to virtually all major industries and counterparties, and we routinely execute transactions with counterparties in financial services, including brokers and dealers, commercial banks, investment banks, mutual and hedge funds, and other institutional clients. Many of these transactions expose us to credit risk in the event of default by our counterparty or client. Our ability to engage in routine transactions to fund our operations and manage our risks could be adversely affected by the actions and commercial soundness of other financial services institutions. Financial institutions are necessarily interdependent because of trading, clearing, counterparty or other relationships. As a consequence, a default by, or decline in market confidence in, individual institutions, or anxiety about the financial services industry generally, can lead to further individual and/or systemic difficulties, defaults and losses. Where counterparty risk has been mitigated by taking collateral, our credit risk may remain high if the collateral we hold cannot be realised or has to be liquidated at prices which are insufficient to recover the full amount of our loan or derivative exposure.

Market fluctuations may reduce our income or the value of our portfolios

Our businesses are inherently subject to risks in financial markets and in the wider economy, including changes in, and increased volatility of, interest rates, inflation rates, credit spreads, foreign exchange rates, commodity, equity, bond and property prices and the risk that our customers act in a manner inconsistent with our business, pricing and hedging assumptions.

Market movements will continue to have a significant impact on us in a number of key areas. For example, our pension scheme assets include equity and debt securities, the cash flows of which change as equity prices and interest rates vary. Banking and trading activities are subject to interest

rate risk, foreign exchange risk, inflation risk and credit spread risk. Changes in interest rate levels, interbank spreads over official rates, yield curves and spreads affect the interest rate spread realised between lending and borrowing costs. The potential for future volatility and margin changes remains. Competitive pressures on fixed rates or product terms in existing loans and deposits sometimes restrict our ability to change interest rates applying to customers in response to changes in official and wholesale market rates.

Our insurance businesses are exposed to the risk that market fluctuations will cause mismatches to occur between product liabilities and the investment assets which back them. Market risks can affect our insurance products in a number of ways depending upon the product and associated contract. For example, mismatches between assets and liability yields and maturities give rise to interest rate risk. Some of these risks are borne directly by the customer and some are borne by the insurance businesses. Some insurance contracts involve guarantees and options that increase in value in adverse investment markets. There is a risk that the insurance businesses will bear some of the cost of such guarantees and options. The insurance businesses also have capital directly invested in the markets that are exposed to market risk. The performance of the investment markets will thus have a direct impact upon the value embedded in the insurance and investment contracts and our operating results, financial condition and prospects.

It is difficult to predict with any accuracy changes in market conditions, and such changes may have a material adverse effect on our operating results, financial condition and prospects.

Liquidity, or ready access to funds, is essential to our businesses

Our ability to borrow on a secured or unsecured basis and the cost of so doing can be affected by increases in interest rates or credit spreads, the availability of credit, regulatory requirements relating to liquidity or the market perceptions of risk relating to us or the banking sector, including our perceived or actual creditworthiness.

Current accounts and savings deposits payable on demand or at short notice form a significant part of our funding, and we place considerable importance on maintaining their stability. For deposits, stability depends upon preserving investor confidence in our capital strength and liquidity, and on comparable and transparent pricing. Although

Report of the Directors: Overview (continued)

deposits have been, over time, a stable source of funding, this may not continue.

We also access professional markets in order to provide funding for non-banking subsidiaries that do not accept deposits, to align asset and liability maturities and currencies and to maintain a presence in local money markets. While we continued to have good access to debt capital markets in 2011, market disruption continued to have adverse effects on the liquidity and funding risk profile of the banking system in the year. An inability to obtain financing in the unsecured long-term or short-term debt capital markets, or to access the secured lending markets, could have a substantial adverse effect on our liquidity. In challenging credit markets, our funding costs may increase or we may be unable to raise funds to support or expand our businesses, adversely affecting our results of operations. Even though we continued to have good access to debt capital markets during 2011 at competitive prices, the costs of liquidity have risen, and we expect to incur additional costs as a result of regulatory requirements for increased liquidity and the challenging economic environment in Europe, the US and elsewhere.

If we are unable to raise funds through deposits and/or in the capital markets, our liquidity position could be adversely affected and we might be unable to meet deposit withdrawals on demand or at their contractual maturity, to repay borrowings as they mature, to meet our obligations under committed financing facilities and insurance contracts, or to fund new loans, investments and businesses. We may need to liquidate unencumbered assets to meet our liabilities. In a time of reduced liquidity, we may be unable to sell some of our assets, or we may need to sell assets at depressed prices, which in either case could adversely affect our results of operations and financial condition.

Any reduction in the credit rating assigned to HSBC Holdings, any subsidiaries of HSBC Holdings or any of their respective debt securities could increase our cost or availability of funding and adversely affect our liquidity position and interest margins

Credit ratings affect the cost and other terms upon which we are able to obtain funding. Rating agencies regularly evaluate HSBC Holdings and certain of its subsidiaries, as well as their respective debt securities. Their ratings are based on a number of factors, including their assessment of the relative

financial strength of HSBC or of the relevant entity, as well as conditions affecting the financial services industry generally. There can be no assurance that the rating agencies will maintain HSBC s or the relevant entity s current ratings or outlook, especially in light of the difficulties in the financial services industry and the financial markets. HSBC Holdings long-term credit rating was recently downgraded by Standard & Poor s, after the rating agency applied its new rating methodology to banks globally. HSBC experienced no change in market demand or the cost of issuing liabilities and negligible changes in its collateral requirements arising from this change in rating. Further reductions in those ratings and outlook could increase the cost of our funding, limit access to capital markets and require additional collateral to be placed and, consequently, adversely affect our interest margins and/or our liquidity position.

Risks concerning borrower credit quality are inherent in our businesses

Risks arising from changes in credit quality and the recoverability of loans and amounts due from borrowers and counterparties (e.g. reinsurers and counterparties in derivative transactions) are inherent in a wide range of our businesses. Adverse changes in the credit quality of our borrowers and counterparties as a consequence of a general deterioration in economic conditions, or arising from systemic risks in the financial systems, could reduce the recoverability and value of our assets and require an increase in our loan impairment charges.

We estimate and recognise impairment allowances for credit losses inherent in our credit exposure. This process, which is critical to our results and financial condition, requires difficult, subjective and complex judgements, including forecasts of how these economic conditions might impair the ability of our borrowers to repay their loans and the ability of other counterparties to meet their obligations. As is the case with any such assessments, we may fail to estimate accurately the effect of factors that we identify or fail to identify relevant factors. Further, the information we use to assess the creditworthiness of our counterparties may be inaccurate or incorrect. Any failure by us to accurately estimate the ability of our counterparties to meet their obligations may have a material adverse impact on our business, financial condition and/or results of operations. For further information on the nature of our credit risk, see Credit risk on page 104.

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HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Our insurance businesses are subject to risks relating to insurance claim rates and changes in insurance customer behaviour

We provide various insurance products for customers with whom we have a banking relationship, including several types of life insurance products. The cost of claims and benefits can be influenced by many factors, including mortality and morbidity rates, lapse and surrender rates and, if the policy has a savings element, the performance of assets to support the liabilities. Adverse developments in any of these factors may adversely affect our financial condition and results of operations.

Our general insurance businesses are exposed to the risk of uncertain insurance claim rates. For example, extreme weather conditions can result in high property damage claims, higher levels of theft can increase claims on home insurance and changes to unemployment levels can increase claims on loan protection insurance. These claims rates may differ from business assumptions and negative developments may adversely affect our financial condition and results of operations.

HSBC Holdings is a holding company and as a result, is dependent on dividends from its subsidiaries to meet its obligations including its obligations with respect to its debt securities, and to provide profits for payment of future dividends to shareholders.

HSBC Holdings is a non-operating holding company and as such the principal sources of its income are from operating subsidiaries which hold the principal assets of HSBC. As a separate legal entity, HSBC Holdings relies on remittance of its subsidiaries profits and other funds in order to be able to pay obligations to shareholders and debt holders as they fall due. The ability of HSBC s subsidiaries and affiliates to pay dividends could be restricted by changes in official banking measures, exchange controls and other requirements.

We may be required to make substantial contributions to our pension plans.

We operate a number of pension plans throughout the world, including defined benefit plans. Pension scheme obligations fluctuate with changes in long-term interest rates, inflation, salary levels and the longevity of scheme members. The level of contributions we make to our pension plans has a direct impact on our cash flow. To the extent plan assets are insufficient to cover existing liabilities higher levels of contributions will be required. As a result, deficits in those pension plans may have a material adverse impact on our business, financial condition and/or results of operations.

Report of the Directors: Overview (continued)

Top and emerging risks

We classify certain risks as top or emerging . We define a top risk as being a current, emerged risk which has arisen across any of our risk categories, regions or global businesses and has the potential to have a material impact on our financial results or our reputation and the sustainability of our long-term business model, and which may form and crystallise within a one year horizon. We consider an emerging risk to be one which has large uncertain outcomes which may form and crystallise beyond a one year horizon and, if it were to crystallise, could have a material effect on our long term strategy.

Our approach to identifying and monitoring top and emerging risks is informed by the risk factors.

All of our activities involve, to varying degrees, the measurement, evaluation, acceptance and management of risk or combinations of risks which we assess on a Group-wide basis. Top and emerging risks fall under the following three broad categories:

- macro-economic and geopolitical risk;
- macro-prudential, regulatory and legal risks to our business model;
- risks related to our business operations, governance and internal control systems.

During 2011 our senior management paid particular attention to a number of top and emerging risks which are summarised below:

Macro-economic and geopolitical risk

- Eurozone risk of sovereign defaults
- Eurozone member departing from the currency union
- Increased geopolitical risk in certain regions

Macro-prudential, regulatory and legal risks to our business model

- Regulatory developments affecting our business model and Group profitability

Regulatory investigations and requirements relating to conduct of business and financial crime negatively affecting our results and brand

Dispute risk

Risks related to our business operations, governance and internal control systems

Challenges to achieving our strategy in a downturn

Internet crime and fraud

Social media risk

Level of change creating operational complexity and heightened operational risk

Information security risk

All of the above risks are regarded as top risks with the exception of social media risk which is an emerging risk.

A detailed account of these risks is provided on page 99. Further comments on expected risks and uncertainties are made throughout the *Annual Report and Accounts 2011*, particularly in the section on Risk, pages 98 to 210.

Risk appetite

Risk appetite is a key component of our management of risk and describes the types and level of risk we are prepared to accept in delivering our strategy. It is discussed further on page 234.

Our risk appetite may be revised in response to the top and emerging risks we have identified.

HSBC Values

The role of HSBC Values in daily operating practice is significant in the context of the financial services sector and the wider economy, particularly in the light of developments and changes in regulatory policy, investor confidence and society s view of the role of banks. We expect our executives and employees to act with courageous integrity in the execution of their duties by being:

dependable and doing the right thing;

open to different ideas and cultures; and

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

We continue to enhance our values-led culture by embedding HSBC Values into how we conduct our business and through the personal sponsorship of the Group Chief Executive and senior executives. These initiatives will continue in 2012 and beyond.

Key performance indicators

The Board of Directors and the GMB monitor HSBC s progress against its strategic objectives. Progress is assessed by comparison with our strategy, our operating plan and our historical performance using both financial and non-financial measures.

Following a review of our high-level key performance indicators (KPI s) and reflecting the increased focus on the quality of the capital base, the GMB decided to adopt a core tier 1 capital ratio instead of a tier 1 capital ratio as the primary indicator of the strength of our capital base and its ability to support the growth of the business and meet regulatory requirements.

The GMB remains focused on improving our capital deployment to support the achievement of our medium term target for return on equity of between 12% and 15%, utilising the five filter analysis across the portfolio of businesses. We will continue to evaluate our businesses in 2012 using this methodology.

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HSBC HOLDINGS PLC

Report of the Directors: Overview (continued)

Strategy	Capital deployment improving the way we deploy capital		
	Return on average ordinary shareholders equity[3]	**Core tier 1 capital[8]**	**Advances to core funding ratio[9]**
	Measure: (percentage) profit attributable to shareholders divided by average ordinary shareholders equity.	**Measure:** (percentage) core tier 1 capital comprising shareholders equity and related non-controlling interests less regulatory deductions and adjustments.	**Measure:** loans and advances to customers as a percentage of the total of core customer deposits and term funding with a remaining term to maturity in excess of one year.
	Target: to maintain a return in the medium term of between 12% and 15%.	**Target:** to maintain a strong capital base to support the development of the business and meet regulatory capital requirements at all times.	**Target:** to maintain an advances to core funding ratio below limits set for each entity.
	Outcome: return on average ordinary shareholders equity was below the target range, but 1.4 percentage points higher than 2010.	**Outcome:** the decrease in core tier 1 capital to 10.1% reflected an increase in RWAs due to a growth in lending balances, including those held for sale and an increase in the RWAs of our mainland China associates, as well as the introduction of Basel 2.5.	**Outcome:** the strong funding position of HBAP has allowed us to take advantage of loan growth opportunities during the year, while reduced lending in the US resulted in further strengthening of our funding position.

Strategy	Cost efficiency a lean and values-driven organisation	
	Cost efficiency (2011: underlying cost efficiency 61%)	**Employee engagement**
	Measure: (percentage) total operating expenses divided by net operating income before loan impairment and other credit risk provisions.	**Measure:** (percentage) measure of employee s emotional and rational attachment to HSBC, a combination of advocacy, satisfaction, commitment and pride.
	Target: to be between 48% and 52%, a range within which business is expected to remain to accommodate both returns to shareholders and the need for continued investment in support of future business growth.	**Target:** to achieve a 72% global rating in 2011, with progressive improvement to best in class.
	Outcome: on a reported and underlying basis the ratio was outside the target range, in part due to notable items including restructuring costs, customer redress programmes and a bank levy introduced by the UK government, but also due to an increase in staff costs reflecting wage inflation in key markets and higher average staff numbers.	**Outcome:** employee engagement behind global best in class. Improvement in 2011 despite a challenging environment.

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Report of the Directors: Overview (continued)

Growth continue to position ourselves for growth **Strategy**

Risk-adjusted revenue growth

(2011: underlying growth 2%)

Measure: (percentage) increase in reported net operating income after loan impairment and other credit risk charges since last year.

Target: to deliver consistent growth in risk adjusted revenues.

Outcome: reported risk-adjusted revenue increased primarily due to favourable movements on the fair value of own debt due to credit spreads and on an underlying basis due to lower loan impairment charges.

Basic earnings per ordinary share

Measure: (US$) level of basic earnings generated per ordinary share.

Target: to deliver consistent growth in basic earnings per share.

Outcome: Earnings per share (EPS) increased in 2011 reflecting significant favourable movements on the fair value of own debt due to credit spreads which resulted in an increase in reported profits.

Dividends per ordinary share growth

Measure: (percentage) increase in dividends per share since last year, based on dividends paid in respect of the year to which the dividend relates.

Target: to deliver sustained dividend per share growth.

Outcome: dividends per share increased by 14%.

Customer recommendation

Measure: we measure our customer satisfaction through an independent market research survey of retail banking and business banking customers in selected countries, using a specific metric of customer recommendation (the CRI) to score performance. We benchmark our performance against key competitors in each market and set targets for performance based on our peer group of banks.

Target: the Group target is for 75% of all the selected markets (based on their weighted revenue) to meet their CRI targets.

Outcome: CMB Business Banking exceeded its target. RBWM experienced a challenging environment in many of its large retail markets, with strong local competition and negative reaction to some strategic portfolio management activity, and only met its target in 35% of the markets by weighted revenue. It got to within 2 percentage points of its target in a further 44% of markets. See page 46 for further details. RBWM had a strong fourth quarter, with 77% of the markets meeting target and it finished the year ranked first in five of the six markets surveyed in Asia.

Brand value

Measure: in 2011, we moved our brand measure to the Brand Finance valuation method as reported in *The Banker* Magazine. Our previous measure only gave us a score derived from a survey of our personal and small business customers. The Brand Finance methodology gives us a more complete measure of the strength of the brand and its impact across all business lines and customer groups. It is a wholly independent measure and is publicly reported.

Target: a top 3 position in the banking peer group.

Outcome: HSBC s brand value in 2009 followed a sharp drop in industry brand values in 2008/9 which coincided with the financial crisis. The subsequent increase reflected a general rise in values, with HSBC s brand remaining one of the strongest in the sector.

For footnotes, see page 95.

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HSBC HOLDINGS PLC

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The management commentary included in the Report of the Directors: Overview and Operating and Financial Review , together with the Employees and Corporate sustainability sections of Corporate Governance and the Directors Remuneration Report is presented in compliance with the IFRS Practice Statement Management Commentary *issued by the IASB.*

Reconciliation of reported and underlying profit before tax

In addition to results reported on an IFRSs basis, we measure our performance internally on a like-for-like basis by eliminating the effects of foreign currency translation differences, acquisitions and disposals of subsidiaries and businesses, and fair value movements on own debt attributable to credit spread where the net result of such movements will be zero upon maturity of the debt; all of which distort year-on-year comparisons. We refer to this as our underlying performance.

Reported results include the effects of the above items. They are excluded when monitoring progress against operating plans and past results because management believes that the underlying basis more accurately reflects operating performance.

Constant currency

Constant currency comparatives for 2010 referred to in the commentaries are computed by retranslating into US dollars for non-US dollar branches, subsidiaries, joint ventures and associates:

the income statements for 2010 at the average rates of exchange for 2011; and

the balance sheet at 31 December 2010 at the prevailing rates of exchange on 31 December 2011.

Constant currency comparatives for 2009 referred to in the 2010 commentaries are computed on the same basis, by applying average rates of exchange for 2010 to the 2009 income and rates of exchange on 31 December 2010 to the balance sheet at 31 December 2009.

No adjustment has been made to the exchange rates used to translate foreign currency denominated assets and liabilities into the functional currencies of any HSBC branches, subsidiaries, joint ventures or associates. When reference is made to constant currency in tables or commentaries, comparative data reported in the functional currencies of HSBC s operations have been translated at the appropriate exchange rates applied in the current period on the basis described above.

Underlying performance

The following tables compare our underlying performance in 2011 and 2010 with reported profits in those years. Equivalent tables are provided for each of HSBC s global businesses and geographical segments in the Form 20-F filed with the SEC, which is available on www.hsbc.com.

The foreign currency translation differences reflect the relative weakening of the US dollar against most major currencies during 2011.

The following acquisitions and disposals affected both comparisons:

the gain of US$62m on reclassification of Bao Viet Holdings (Bao Viet) from an available-for-sale asset to an associate in January 2010;

Report of the Directors: Operating and Financial Review (continued)

the gain of US$66m on sale of our stake in Wells Fargo HSBC Trade Bank in March 2010;

the gain of US$107m on disposal of HSBC Insurance Brokers Limited in April 2010;

the dilution gains which arose on our holding in Ping An Insurance (Group) Company of China, Limited (Ping An) following the issue of share capital to third parties in May 2010 and June 2011 of US$188m and US$181m, respectively;

the loss of US$42m on the sale of our investment in British Arab Commercial Bank plc in October 2010;

the gain of US$74m on the deconsolidation of private equity funds following the management buy-out of Headland Capital Partners Ltd (formerly known as HSBC Private Equity (Asia) Ltd) in November 2010;
the gain of US$255m on the sale of Eversholt Rail Group in December 2010;

the gain of US$83m on the sale of HSBC Afore S.A. de C.V. (HSBC Afore) in August 2011;

a loss of US$48m being our share of the loss recorded by Ping An on remeasurement of its previously held equity interest in Shenzen Development Bank (SDB) when Ping An took control and fully consolidated SDB in July 2011; and

the dilution gain of US$27m in December 2011 as a result of the merger between HSBC Saudi Arabia Limited and SABB Securities Limited.

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Report of the Directors: Operating and Financial Review (continued)

Reconciliation of reported and underlying profit before tax

	2011 compared with 2010								
HSBC	**2010 as reported US$m**	**2010 adjust-ments[10] US$m**	**Currency translation[11] US$m**	**2010 at 2011 exchange rates[12] US$m**	**2011 as reported US$m**	**2011 adjust-ments[10] US$m**	**2011 under-lying US$m**	**Re-ported change[13] %**	**Under-lying change[13] %**
Net interest income	39,441	48	781	40,270	40,662		40,662	3	1
Net fee income	17,355	(55)	349	17,649	17,160		17,160	(1)	(3)
Changes in fair value[14]	(63)	63			3,933	(3,933)			
Other income[15]	11,514	(847)	284	10,951	10,525	(291)	10,234	(9)	(7)
Net operating income[16]	68,247	(791)	1,414	68,870	72,280	(4,224)	68,056	6	(1)
Loan impairment charges and other credit risk provisions	(14,039)		(206)	(14,245)	(12,127)		(12,127)	14	15
Net operating income	54,208	(791)	1,208	54,625	60,153	(4,224)	55,929	11	2
Operating expenses	(37,688)	220	(842)	(38,310)	(41,545)		(41,545)	(10)	(8)
Operating profit	16,520	(571)	366	16,315	18,608	(4,224)	14,384	13	(12)
Income from associates	2,517		93	2,610	3,264	48	3,312	30	27
Profit before tax	19,037	(571)	459	18,925	21,872	(4,176)	17,696	15	(6)
By geographical region									
Europe	4,302	(88)	167	4,381	4,671	(2,947)	1,724	9	(61)
Hong Kong	5,692	(130)	(10)	5,552	5,823		5,823	2	5
Rest of Asia-Pacific	5,902	(187)	227	5,942	7,471	(135)	7,336	27	23
Middle East and North Africa	892	42	(10)	924	1,492	(41)	1,451	67	57
North America	454	(208)	39	285	100	(970)	(870)	(78)	
Latin America	1,795		46	1,841	2,315	(83)	2,232	29	21
Profit before tax	19,037	(571)	459	18,925	21,872	(4,176)	17,696	15	(6)
By global business									
Retail Banking and Wealth Management[17]	3,839	(3)	126	3,962	4,270	(83)	4,187	11	6
Commercial Banking	6,090	(119)	126	6,097	7,947		7,947	30	30
Global Banking and Markets[17]	9,215	(262)	198	9,151	7,049		7,049	(24)	(23)
Global Private Banking	1,054		6	1,060	944		944	(10)	(11)
Other	(1,161)	(187)	3	(1,345)	1,662	(4,093)	(2,431)		(81)
Profit before tax	19,037	(571)	459	18,925	21,872	(4,176)	17,696	15	(6)

For footnotes, see page 95.

Additional information is available on the HSBC website www.hsbc.com.

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Consolidated income statement

Five-year summary consolidated income statement

	2011	2010	2009	2008	2007
	US$m	US$m	US$m	US$m	US$m
Net interest income	**40,662**	39,441	40,730	42,563	37,795
Net fee income	**17,160**	17,355	17,664	20,024	22,002
Net trading income	**6,506**	7,210	9,863	6,560	9,834
Net income/(expense) from financial instruments designated at fair value	**3,439**	1,220	(3,531)	3,852	4,083
Gains less losses from financial investments	**907**	968	520	197	1,956
Dividend income	**149**	112	126	272	324
Net earned insurance premiums	**12,872**	11,146	10,471	10,850	9,076
Gains on disposal of French regional banks				2,445	
Other operating income	**1,766**	2,562	2,788	1,808	2,531
Gains arising from dilution of interests in associates and joint ventures	**208**	188			1,092
Other	**1,558**	2,374	2,788	1,808	1,439
Total operating income	**83,461**	80,014	78,631	88,571	87,601
Net insurance claims incurred and movement in liabilities to policyholders	**(11,181)**	(11,767)	(12,450)	(6,889)	(8,608)
Net operating income before loan impairment charges and other credit risk provisions	**72,280**	68,247	66,181	81,682	78,993
Loan impairment charges and other credit risk provisions	**(12,127)**	(14,039)	(26,488)	(24,937)	(17,242)
Net operating income	**60,153**	54,208	39,693	56,745	61,751
Total operating expenses[19]	**(41,545)**	(37,688)	(34,395)	(49,099)	(39,042)
Operating profit	**18,608**	16,520	5,298	7,646	22,709
Share of profit in associates and joint ventures	**3,264**	2,517	1,781	1,661	1,503
Profit before tax	**21,872**	19,037	7,079	9,307	24,212
Tax expense	**(3,928)**	(4,846)	(385)	(2,809)	(3,757)
Profit for the year	**17,944**	14,191	6,694	6,498	20,455
Profit attributable to shareholders of the parent company	**16,797**	13,159	5,834	5,728	19,133
Profit attributable to non-controlling interests	**1,147**	1,032	860	770	1,322

Five-year financial information

	US$	US$	US$	US$	US$
Basic earnings per share[20]	**0.92**	0.73	0.34	0.41	1.44
Diluted earnings per share[20]	**0.91**	0.72	0.34	0.41	1.42

Dividends per ordinary share[1]	**0.39**	0.34	0.34	0.93	0.87
	%	%	%	%	%
Dividend payout ratio[21]	**42.4**	46.6	100.0	226.8	60.4
Post-tax return on average total assets	**0.65**	0.57	0.27	0.26	0.97
Return on average ordinary shareholders equity	**10.9**	9.5	5.1	4.7	15.9
Average foreign exchange translation rates to US$:					
US$1: £	**0.624**	0.648	0.641	0.545	0.500
US$1:	**0.719**	0.755	0.719	0.684	0.731

For footnotes, see page 95.

Reported profit before tax of US$21.9bn in 2011 was US$2.8bn higher than in 2010, primarily due to US$3.9bn of favourable fair value movements on own debt attributable to credit spreads compared with a negative movement of US$63m in 2010. On an underlying basis, profit before tax was 6% lower than

in 2010 due to increased operating expenses which were partly offset by lower loan impairment charges and other credit risk provisions.

The results of the Group continued to be adversely affected by the losses in the US consumer

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finance business, which were US$2.4bn in 2011 and US$2.2bn in 2010. We have agreed to sell the profitable US Card and Retail Services portfolio, with the remainder of the loss-making US consumer finance business being run down. We expect the sale of this business to have a significant impact on both revenue and profitability in North America for the foreseeable future.

The difference between reported and underlying results is explained on page 16. Except where stated otherwise, the commentaries in the Financial Summary are on an underlying basis and references to HSBC Finance Corporation (HSBC Finance) and HSBC Bank USA N.A. (HSBC Bank USA) are on a management basis, rather than a legal entity basis.

Net operating income before loan impairment charges and other credit risk provisions (revenue) was broadly in line with 2010, due to the adverse effect on GB&M revenue in Europe of the turmoil in the eurozone sovereign debt market and a decline in lending balances in RBWM in North America being offset by revenue growth in faster-growing regions. The eurozone turmoil resulted in lower trading income from our Credit and Rates businesses as problems escalated, particularly in the second half of 2011. Our GB&M performance was also affected by lower revenues in Balance Sheet Management, as higher yielding positions matured and interest rates remained low, and in our legacy credit portfolio (see page 23). In North America, we continued to reposition our business and we remained focused on managing down our run-off portfolios. As a consequence, revenue fell, reflecting declining customer loan balances in the run-off portfolios and in the Card and Retail Services businesses.

These factors were broadly offset by increased net interest income in CMB as a result of strong balance sheet growth in 2010 which continued into 2011, albeit at a slower pace during the latter part of the year. Revenue also benefited from balance sheet growth in RBWM in Rest of Asia-Pacific and Latin America. There were also strong performances in over half of our business lines in GB&M, including Global Banking, Foreign Exchange and Equities, particularly in the faster growing regions of Rest of Asia-Pacific and Latin America.

Loan impairment charges and other credit risk provisions were considerably lower than in 2010, with decreases across all regions except Latin America and Hong Kong. The most significant decline in loan impairment charges was in RBWM in North America, reflecting lower balances in our

consumer finance portfolios and lower lending balances and improved credit quality in Card and Retail Services. There was also a notable decline in loan impairment charges in Europe, due to successful initiatives taken to mitigate risk within RBWM which resulted in a reduction in delinquency rates in personal lending in the UK. Loan impairment charges and other credit risk provisions fell in the Middle East in GB&M due to the non-recurrence of restructuring activity for a small number of large customers. In Latin America, loan impairment charges and other credit risk provisions increased as a result of strong lending growth in RBWM and CMB, along with a rise in delinquency rates in Brazil during the second half of 2011.

Operating expenses were higher than in 2010, reflecting an increase in notable items and higher staff costs in faster-growing regions. Notable items included restructuring costs of US$1.1bn, a bank levy introduced by the UK government of US$570m, higher provisions relating to customer redress programmes of US$898m and US mortgage servicing costs of US$257m. The restructuring costs were incurred as a result of actions taken following the review of our capital deployment and operational effectiveness. This led to a reduction of more than 7,600 FTEs during the second half of 2011 and sustainable savings of US$0.9bn. These notable items were partially offset by a credit of US$587m resulting from a change in the inflation measure used to calculate the defined benefit obligation of the HSBC Bank plc (HSBC Bank) UK defined benefit plan for deferred pensions.

Income from associates increased, mainly driven by strong results in our mainland China associates. The contribution from Bank of Communications Co., Limited (BoCom) rose due to loan growth, wider deposit spreads and higher fee income. Our share of profits from Industrial Bank Co. Limited (Industrial Bank) rose due to strong growth in customer lending and an increase in fee-based revenue.

The reported profit after tax was US$3.8bn or 26% higher, due to the increase in taxable profits, primarily from movements on the fair value of own debt and a lower tax expense. This reflected the inclusion in 2011 of a deferred tax benefit now eligible to be recognised in respect of foreign tax credits. In addition, the tax charge in 2010 included US$1.2bn attributable to a taxable gain from an internal reorganisation in North

America. As a result of these factors, the effective tax rate for 2011 was 18% compared with 25.5% in 2010.

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Group performance by income and expense item

Net interest income

	2011	2010	2009
	US$m	US$m	US$m
Interest income	**63,005**	58,345	62,096
Interest expense	**(22,343)**	(18,904)	(21,366)
Net interest income[22]	**40,662**	39,441	40,730
Average interest-earning assets	**1,622,658**	1,472,294	1,384,705
Gross interest yield[23]	**3.88%**	3.96%	4.48%
Less: cost of funds	**(1.56%)**	(1.41%)	(1.58%)
Net interest spread[24]	**2.32%**	2.55%	2.90%
Net interest margin[25]	**2.51%**	2.68%	2.94%

Summary of interest income by type of asset

	2011			2010			2009		
	Average balance US$m	**Interest income US$m**	**Yield %**	Average balance US$m	Interest income US$m	Yield %	Average balance US$m	Interest income US$m	Yield %
Short-term funds and loans and advances to banks	**261,749**	**5,860**	**2.24**	236,742	4,555	1.92	192,578	4,199	2.18
Loans and advances to customers	**945,288**	**45,250**	**4.79**	858,499	44,186	5.15	870,057	48,301	5.55
Financial investments	**384,059**	**10,229**	**2.66**	378,971	9,375	2.47	322,880	9,425	2.92
Other interest-earning assets[26]	**31,562**	**1,666**	**5.28**	(1,918)	229	(11.94)	(810)	171	(21.11)
Total interest-earning assets	**1,622,658**	**63,005**	**3.88**	1,472,294	58,345	3.96	1,384,705	62,096	4.48
Trading assets and financial assets designated at fair value[27, 28]	**410,038**	**8,671**	**2.11**	385,203	7,060	1.83	419,647	8,646	2.06
Impairment provisions	**(18,738)**			(22,905)			(26,308)		
Non-interest-earning assets	**752,965**			664,308			667,942		
Total assets and interest income	**2,766,923**	**71,676**	**2.59**	2,498,900	65,405	2.62	2,445,986	70,742	2.89

Summary of interest expense by type of liability and equity

	2011			2010			2009		
	Average	**Interest**	**Cost %**	Average	Interest	Cost %	Average	Interest	Cost %

	balance US$m	expense US$m		balance US$m	expense US$m		balance US$m	expense US$m	
Deposits by banks[29]	**106,099**	**1,591**	**1.50**	111,443	1,136	1.02	117,847	1,659	1.41
Financial liabilities designated at fair value own debt issued[30]	**73,635**	**1,313**	**1.78**	66,706	1,271	1.91	60,221	1,558	2.59
Customer accounts[31]	**1,058,326**	**13,456**	**1.27**	962,613	10,778	1.12	940,918	11,346	1.21
Debt securities in issue	**181,482**	**5,260**	**2.90**	189,898	4,931	2.60	225,657	5,901	2.62
Other interest-bearing liabilities	**14,024**	**723**	**5.16**	8,730	788	9.03	8,640	902	10.44
Total interest-bearing liabilities	**1,433,566**	**22,343**	**1.56**	1,339,390	18,904	1.41	1,353,283	21,366	1.58
Trading liabilities and financial liabilities designated at fair value (excluding own debt issued)	**355,345**	**4,564**	**1.28**	275,804	3,780	1.37	221,358	4,280	1.93
Non-interest bearing current accounts	**162,369**			142,579			123,271		
Total equity and other non-interest bearing liabilities	**815,643**			741,127			748,074		
Total equity and liabilities	**2,766,923**	**26,907**	**0.97**	2,498,900	22,684	0.91	2,445,986	25,646	1.05

For footnotes, see page 95.

Net interest income was US$40.7bn, 3% higher than in 2010. On an underlying basis, net interest income was broadly in line with the previous year, as the benefit to income from continued strong growth in

average interest-earning balances was largely offset by a decline in spreads.

Average loans and advances to customers grew strongly in 2011, reflecting targeted lending growth during 2010 and the first half of 2011 in CMB and

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GB&M, as well as strong mortgage lending growth in our RBWM businesses in the UK, Hong Kong and Rest of Asia-Pacific throughout both years. During the year, we announced the sale of 195 non-strategic branches and our Cards and Retail Services business in the US, and reclassified the related loans and advances to customers to other assets held for sale, reported within Other interest-earning assets . This, together with the continued decline in the consumer finance portfolios in run-off, partly offset the rise in average lending balances in other regions.

The benefit to interest income of the strong customer lending volume growth was offset in part by a reduction in gross yields from loans and advances to customers. This reflected the transfer of balances to assets held for sale, including higher yielding unsecured lending, the continued decline within the US consumer finance portfolios and the repositioning of RBWM towards higher quality secured lending, particularly mortgages, together with intense competition in certain markets.

Interest income from short-term funds and loans and advances to banks also increased, attributable to higher average balances with central banks. This reflected higher deposit requirements by central banks in certain markets, together with the placement of excess liquidity in Asia with central banks. Interest income from short-term funds and loans and advances to banks, as well as financial investments, also benefited from higher yields as interest rates rose, particularly in mainland China, India and Brazil.

Interest income from other interest earning assets rose as a result of the reclassification of assets held for sale and the related income.

The rise in interest income was largely offset by higher interest expense. This was driven by a

significant increase in average customer account balances in Hong Kong, Rest of Asia-Pacific and Europe as a result of targeted deposit campaigns. The cost of funds also rose as a result of base rate increases, notably in mainland China, India and Brazil, and competitive pricing to attract and retain deposits in many markets.

The increase in interest expense on deposits by banks was driven by a rise in the cost of funds in Europe, reflecting the maturity of derivatives used to hedge interest rate risk and their replacement at lower prevailing interest rates.

The interest expense on own debt designated at fair value also rose, reflecting the volume of new issuances during the year. Although the average balance of debt securities in issue declined due to maturities not being replaced in North America and Europe, the related interest expense increased as a result of a general widening of credit spreads in the financial sector.

Net interest income includes the expense of internally funding trading assets, while related revenue is reported in Net trading income . The internal cost of funding these assets rose due to the increase in average trading assets during the year. In reporting our global business results, this cost is included within Net trading income .

The decrease in the net interest spread compared with 2010 was attributable to lower yields on loans and advances to customers as we continued to target higher quality assets, coupled with a rising cost of funds on customer accounts. Our net interest margin also fell, but by a lesser amount, due to the benefit from net free funds. This benefit rose as a result of the increase in the Group s cost of funds, coupled with higher third party funding of our trading book, in line with the growth of trading assets.

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Net fee income

	2011 US$m	2010 US$m	2009 US$m
Cards	**3,955**	3,801	4,625
Account services	**3,670**	3,632	3,592
Funds under management	**2,753**	2,511	2,172
Credit facilities	**1,749**	1,635	1,479
Broking income	**1,711**	1,789	1,617
Imports/exports	**1,103**	991	897
Insurance	**1,052**	1,147	1,421
Remittances	**770**	680	613
Global custody	**751**	700	988
Unit trusts	**657**	560	363
Underwriting	**578**	623	746
Corporate finance	**441**	440	396
Trust income	**294**	291	278
Investment contracts	**136**	109	97
Mortgage servicing	**109**	118	124
Taxpayer financial services	**2**	73	87
Maintenance income on operating leases		99	111
Other	**1,766**	1,918	1,797
Fee income	**21,497**	21,117	21,403
Less: fee expense	**(4,337)**	(3,762)	(3,739)
Net fee income	**17,160**	17,355	17,664

Reported net fee income was broadly in line with 2010. Reported results in 2010 included revenue from Eversholt Rail Group and HSBC Insurance Brokers Ltd. These items are excluded from our underlying results which declined by 3%. This was mainly due to increased fee expenses in North America and the impact of discontinuing certain business operations.

Fee expenses increased in North America, reflecting higher revenue-share payments to our credit card partners as improved portfolio performance resulted in increased cash flows. Fee expenses also rose in Latin America, reflecting increased transaction volumes, and in Europe, notably in GB&M, which benefited from higher recoveries from the securities investment conduits in 2010.

Card-related income was higher, led by growth in Hong Kong due to higher transaction volumes, driven by increased retail spending and customer promotions, and in Europe due to increased interchange commissions from higher volumes and rates.

Fee income from unit trusts increased due to higher transaction volumes, notably in Hong Kong, reflecting increased product offerings, competitive pricing and successful sales activity as clients sought to maximise returns in the low interest rate environment. However, broking income was lower, primarily in Hong Kong due to increased competition in the territory during the second half of the year.

Remittances and trade-related fee income increased, notably in the Rest of Asia-Pacific region, due to higher trade and transaction volumes as we targeted asset growth and trade activity in the region, supported by marketing activities, customer acquisition and a rise in transactions from existing customers.

The negligible income from Taxpayer Financial Services in the US during 2011 resulted from the decision to exit the business.

We expect the sale of the Card and Retail Services business to have a significant impact on both fee income related to cards and insurance, and fee expenses.

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Net trading income

	2011	2010	2009
	US$m	US$m	US$m
Trading activities	**4,873**	5,708	5,312
Net interest income on trading activities	**3,223**	2,530	3,627
Other trading income hedge ineffectiveness:			
on cash flow hedges	**26**	(9)	90
on fair value hedges	**(224)**	38	(45)
Non-qualifying hedges	**(1,392)**	(1,057)	951
Losses on Bernard L Madoff Investment Securities LLC fraud			(72)
Net trading income[32,33]	**6,506**	7,210	9,863

For footnotes, see page 95.

Reported net trading income was US$6.5bn, 10% lower than in 2010. On an underlying basis, net trading income declined by 15%, driven by significantly lower net income from trading activities in GB&M as turmoil in eurozone sovereign debt markets escalated, particularly in the second half of 2011. Increased risk aversion and limited client activity led to a significant widening of spreads on certain eurozone sovereign and corporate bonds, resulting in trading losses in our European Credit and Rates businesses.

Net trading income also declined from our legacy credit portfolio, a separately identifiable, discretely managed business comprising Solitaire Funding Limited, the securities investment conduits, the asset-backed securities trading portfolios and credit correlation portfolios, derivative transactions entered into directly with monoline insurers, and certain other structured credit transactions. This reflected the non-recurrence of the price appreciation during the previous year and lower holdings as a result of maturities and disposals aimed at reducing capital consumption, coupled with the non-recurrence of an US$89m gain from a 2010 legal settlement relating to certain loans previously purchased for resale from a third party.

In addition, lower favourable foreign exchange movements were reported on trading assets held as economic hedges of foreign currency debt designated at fair value. These offset lower adverse foreign exchange movements on the foreign currency debt which are reported in Net expense from financial instruments designated at fair value .

Notwithstanding the difficult trading conditions, there were strong performances across other parts of GB&M. Rates trading revenues in Hong Kong, North America and Latin America remained resilient as client flows increased. Fair value gains on structured liabilities also increased, mainly in Rates, as credit spreads widened more significantly than in 2010, resulting in a gain of US$458m compared with US$23m in 2010.

Our Foreign Exchange business benefited from increased activity from both Global Banking and CMB customers, particularly in Hong Kong, Rest of Asia-Pacific, North America and Latin America, coupled with an improved trading environment compared with 2010. The latter reflected market volatility caused by geopolitical tensions, ongoing eurozone sovereign debt concerns and interventions by central banks. Equities revenues also rose as investment in platforms improved our competitive positioning and helped capture increased client flows, notably in the first half of the year in Europe and Hong Kong.

In addition to the decline in net income from trading activities in GB&M, we reported adverse fair value movements on derivatives relating to certain legacy provident funds in Hong Kong as long-term investment returns fell. This was offset in part by a reduction in the loss provisions

for mortgage loan repurchase obligations associated with loans previously sold in RBWM in North America, which decreased by US$341m to US$92m.

There were adverse fair value movements on non-qualifying hedges. These are derivatives entered into as part of a documented interest rate management strategy for which hedge accounting was not, or could not be, applied. They are principally cross-currency and interest rate swaps used to economically hedge fixed rate debt issued by HSBC Holdings and floating rate debt issued by HSBC Finance. The size and direction of the changes in fair value of non-qualifying hedges that are recognised in the income statement can be volatile from year to year, but do not alter the cash flows expected as part of the documented interest rate management strategy for both the instruments and the underlying economically hedged assets and liabilities. The adverse fair value movement on non-qualifying hedges in North America was higher in 2011 as long-term US interest rates declined to a greater extent than in 2010. This was partly offset by lower adverse fair value movements on these

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instruments in Europe.

Ineffectiveness in the hedging of available-for-sale investment portfolios resulted in adverse movements on fair value hedges. This was due to growth in the underlying investment portfolio in Europe as a result of new purchases and a more pronounced decline in yield curves in North America than in 2010.

Net interest income earned on trading activities rose by 23%, driven by an increase in average holdings and higher yields on our trading portfolio. This was partly offset by higher interest expense on trading liabilities reflecting an increase in funding requirements in line with the growth in average trading assets. The cost of internally funding these assets also rose, but this interest expense is reported within Net interest income .

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

	2011	2010	2009
	US$m	US$m	US$m
Net income/(expense) arising from:			
financial assets held to meet liabilities under insurance and investment contracts	**(933)**	2,349	3,793
liabilities to customers under investment contracts	**231**	(946)	(1,329)
HSBC s long-term debt issued and related derivatives	**4,161**	(258)	(6,247)
Change in own credit spread on long-term debt	**3,933**	(63)	(6,533)
Other changes in fair value[34]	**228**	(195)	286
other instruments designated at fair value and related derivatives	**(20)**	75	252
Net income/(expense) from financial instruments designated at fair value	3,439	1,220	(3,531)

Assets and liabilities from which net income/(expense) from financial instruments designated at fair value arose

	2011	2010	2009
	US$m	US$m	US$m
Financial assets designated at fair value at 31 December	**30,856**	37,011	37,181
Financial liabilities designated at fair value at 31 December	**85,724**	88,133	80,092
Including:			
Financial assets held to meet liabilities under:			
insurance contracts and investment contracts with DPF[35]	**7,221**	7,167	6,097
unit-linked insurance and other insurance and investment contracts	**20,033**	19,725	16,982
Long-term debt issues designated at fair value	**73,808**	69,906	62,641

For footnotes, see page 95.

The accounting policies for the designation of financial instruments at fair value and the treatment of the associated income and expenses are described in Notes 2i and 2b on the Financial Statements, respectively.

The majority of the financial liabilities designated at fair value relate to certain fixed-rate long-term debt issues whose rate profile has been changed to floating through interest rate swaps as part of a documented interest rate management strategy. The movement in fair value of these long-term debt issues includes the effect of our credit spread changes and any ineffectiveness in the economic relationship between the related swaps and own debt. As credit spreads widen or narrow, accounting profits or losses, respectively, are booked. The size and direction of the changes in the credit spread on our debt and ineffectiveness, which are recognised in the income statement, can be volatile from year to year, but do not alter the cash flows envisaged as part

of the documented interest rate management strategy. As a consequence, fair value movements arising from changes in our own credit spread on long-term debt and other fair value movements on the debt and related derivatives are not regarded internally as part of managed performance and are therefore not allocated to customer groups, but are reported in Other . Credit spread movements on own debt are excluded from underlying results, and related fair value movements are not included in the calculation of regulatory capital.

We reported net income from financial instruments designated at fair value of US$3.4bn in 2011 compared with US$1.2bn in 2010. This included the credit spread-related movements in the fair value of our own long-term debt, on which we reported favourable fair value movements of US$3.9bn in 2011 and adverse movements of US$63m in 2010. These favourable fair value movements arose in 2011 as credit spreads widened,

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in comparison with smaller favourable fair value movements in North America and adverse fair value movements in Europe, both in 2010.

On an underlying basis, which excludes credit spread-related movements in the fair value of our own long-term debt, the equivalent figures were net expense of US$494m in 2011 and net income of US$1.3bn in 2010. Net expense arising from financial assets held to meet liabilities under insurance and investment contracts reflected net investment losses in 2011 as a result of adverse movements in equity markets, primarily in Europe and Hong Kong, compared with net investment gains experienced during 2010. This predominantly affected the value of assets held to support unit-linked contracts in the UK and Hong Kong, insurance contracts with discretionary participation features (DPF) in Hong Kong, and investment contracts with DPF in France.

The investment gains or losses arising from equity markets resulted in a corresponding

movement in liabilities to customers, reflecting the extent to which unit-linked policyholders, in particular, participate in the investment performance of the associated asset portfolio. Where these relate to assets held to back investment contracts, the corresponding movement in liabilities to customers is also recorded under Net income from financial instruments designated at fair value . This is in contrast to gains or losses related to assets held to back insurance contracts or investment contracts with DPF, where the corresponding movement in liabilities to customers is recorded under Net insurance claims incurred and movement in liabilities to policyholders .

Within net income from financial instruments designated at fair value were lower adverse foreign exchange movements than in 2010 on foreign currency debt designated at fair value issued as part of our overall funding strategy, with an offset from trading assets held as economic hedges reported in Net trading income .

Gains less losses from financial investments

	2011 US$m	2010 US$m	2009 US$m
Net gains/(losses) from disposal of:			
debt securities	**712**	564	463
equity securities	**360**	516	407
other financial investments	**12**	(7)	8
	1,084	1,073	878
Impairment of available-for-sale equity securities	**(177)**	(105)	(358)
Gains less losses from financial investments	**907**	968	520

Reported gains less losses from financial investments decreased by US$61m to US$907m. On an underlying basis, excluding an accounting gain of US$62m arising from the reclassification of Bao Viet as an associate in 2010, they declined by 4%.

The reduction was principally driven by lower net gains from the disposal of available-for-sale equity securities, as deterioration in market confidence resulted in fewer disposal opportunities and lower gains from the sale of private equity investments, notably in Europe. We also recognised a gain on disposal in 2010 of an equity investment in a Singaporean property company which did not recur. This was partly offset by a gain on sale of shares in a Mexican listed company.

Impairments of available-for-sale equity securities rose, due to write downs of our equity investments in real estate companies, reflecting a decline in property values in 2011.

Net gains from the disposal of available-for-sale debt securities increased in Europe and North America following sales of government bonds and mortgage-backed securities by Balance Sheet Management as part of normal portfolio management activities. However, this was offset in part by lower net gains in Hong Kong and Rest of Asia-Pacific on the disposal of government debt securities in 2011.

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Net earned insurance premiums

	2011 US$m	2010 US$m	2009 US$m
Gross insurance premium income	**13,338**	11,609	10,991
Reinsurance premiums	**(466)**	(463)	(520)
Net earned insurance premiums	**12,872**	11,146	10,471

Net earned insurance premiums which relate to insurance and investment contracts with DPF increased by 15% on a reported basis and by 13% on an underlying basis, primarily driven by strong sales in the Hong Kong life insurance business and also in Latin America. This reflected the strategic focus of the Group on wealth management, of which insurance is a key part.

In Hong Kong, sales of deferred annuities, unit-linked products and a universal life product targeted at high net worth individuals all rose, coupled with higher levels of renewals from a larger in-force book of business due to an increased demand for wealth products. Sales of a universal life insurance product targeted at high net worth individuals were also higher in Rest of Asia-Pacific, notably in Singapore, driven by successful sales initiatives.

In Latin America, net earned premiums also grew strongly due to a rise in contributions from unit-linked, life and credit protection products in Brazil, reflecting investment in the distribution network. This was supported by higher premiums from the motor insurance business in Argentina as a result of volume growth and repricing initiatives.

In Europe, net earned premiums decreased resulting from the non-renewal and transfer to third parties of certain contracts in our Irish business as well as the continued run-off and subsequent disposal of the motor business in the UK during 2011.

This was partly offset by premium growth in both France, on investment contracts with DPF as a result of targeted sales campaigns aimed at high net worth clients, and the UK, on unit-linked products due to increased distribution channels.

Other operating income

	2011 US$m	2010 US$m	2009 US$m
Rent received	**217**	535	547
Gains/(losses) recognised on assets held for sale	**55**	(263)	(115)
Valuation gains/(losses) on investment properties	**118**	93	(24)
Gain on disposal of property, plant and equipment, intangible assets and non-financial investments	**57**	701	1,033

Gains arising from dilution of interests in associates and joint ventures	**208**	188	
Change in present value of in-force long-term insurance business	**726**	705	605
Other	**385**	603	742
Other operating income	**1,766**	2,562	2,788

Reported other operating income of US$1.8bn decreased by US$796m in 2011. Reported results in 2011 included a gain of US$181m arising from a dilution of our holding in Ping An following its issue of share capital to a third party and a gain of US$83m from the sale of HSBC Afore, our Mexican pension administration business. We also reported a dilution gain of US$27m as a result of the reduction in our holding in HSBC Saudi Arabia Limited following its merger with SABB Securities Limited. Income in 2010 included a gain of US$188m following the dilution of our holding in Ping An along with gains from the sale of HSBC Insurance Brokers (US$107m), the Wells Fargo HSBC Trade Bank (US$66m), Eversholt Rail Group (US$255m) and HSBC Private Equity (Asia) Ltd (US$74m), partly offset by a loss of US$42m on the disposal

of our shareholding in British Arab Commercial Bank plc.

On an underlying basis, excluding the items referred to above, other operating income decreased by US$71m compared with 2010. Lower losses on assets held for sale driven by the non-recurrence of the US$207m loss on the sale of the US vehicle finance servicing operation in 2010 and associated loan portfolio were more than offset by the non-recurrence of gains of US$250m on the sale and leaseback of our Paris and New York headquarters in 2010, which exceeded gains recorded in 2011 on the sale of buildings including US$61m from the sale and leaseback of branches in Mexico.

Favourable net movements in the present value of in-force (PVIF) long-term insurance business

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compared with 2010 were driven by a one-off gain of US$243m recognised upon the refinement of the calculation of the PVIF asset to bring greater comparability and consistency across our insurance operations, and strong sales of life insurance

products, notably in Hong Kong and Singapore. Largely offsetting this was a net decrease from experience and assumption updates and a higher unwind of cash flows from the growing in-force book.

Net insurance claims incurred and movement in liabilities to policyholders

	2011	2010	2009
	US$m	US$m	US$m
Insurance claims incurred and movement in liabilities to policyholders:			
gross	**11,631**	11,969	12,560
reinsurers share	**(450)**	(202)	(110)
net[36]	**11,181**	11,767	12,450

For footnote, see page 95.

Net insurance claims incurred and movement in liabilities to policyholders decreased by 5% on a reported basis and by 7% on an underlying basis, driven by investment losses on insurance assets, notably in Europe and Hong Kong.

In France, the UK and Hong Kong we experienced a reduction in the movement in liabilities to policyholders resulting from a fall in fair value of the assets held to support policyholder funds, particularly in relation to unit-linked insurance contracts and investment and insurance contracts with DPF, as a result of equity market falls.

The gains or losses experienced on the financial assets designated at fair value held to support insurance contract liabilities and investment contracts

with DPF are reported in Net income from financial instruments designated at fair value .

Further declines in the movement in liabilities to policyholders resulted from the non-renewal and transfer to third parties of certain contracts in our Irish businesses as well as the continued run-off and subsequent sale of the motor business in the UK during 2011.

Reductions in the movement in liabilities to policyholders were partly offset by additional liabilities established for new business premiums written, notably in Hong Kong, Brazil, France, the UK and Singapore, which are consistent with increases in net earned premiums.

Loan impairment charges and other credit risk provisions

	2011	2010	2009
	US$m	US$m	US$m
Loan impairment charges			
New allowances net of allowance releases	**12,931**	14,568	25,832
Recoveries of amounts previously written off	**(1,426)**	(1,020)	(890)
	11,505	13,548	24,942
Individually assessed allowances	**1,915**	2,625	4,458
Collectively assessed allowances	**9,590**	10,923	20,484
Impairment of available-for-sale debt securities	**631**	472	1,474
Other credit risk provisions/(recoveries)	**(9)**	19	72
Loan impairment charges and other credit risk provisions	**12,127**	14,039	26,488
	%	%	%
as a percentage of net operating income excluding the effect of fair value movements in respect of credit spread on own debt and before loan impairment charges and other credit risk provisions	**17.7**	20.6	36.4
Impairment charges on loans and advances to customers as a percentage of gross average loans and advances to customers	**1.2**	1.5	2.8

Loan impairment charges and other credit risk provisions were US$12.1bn, a decline of 14% compared with 2010 on a reported basis and 15% on an underlying basis.

At 31 December 2011, the aggregate balance of customer loan impairment allowances was US$17.5bn, representing 1.9% of gross loans and advances to customers (net of reverse repos and

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settlement accounts) compared with 2.2% at 31 December 2010.

In 2011, loan impairment charges and other credit risk provisions declined in all regions except Latin America and Hong Kong. The reduction was most significant in our consumer finance portfolios in HSBC Finance in North America, which contributed 66% of the reduction, reflecting lower lending balances in the run-off portfolio along with a reduction in lending balances and lower delinquency rates as our Card and Retail Services customers focused on repayments. In Latin America, principally Brazil, and also in Hong Kong, collective loan impairment allowances rose as we grew our lending book on the back of strong economic growth and increased customer demand.

During 2011, we reported US$631m of impairments related to available-for-sale debt securities, compared with US$472m in 2010. In 2011, we recognised a charge of US$212m to write down to market value available-for-sale Greek sovereign debt now judged to be impaired following the deterioration in Greece s fiscal position. This was partly offset as losses arising in underlying collateral pools generated lower charges on asset-backed securities.

In our US run-off portfolios, loan impairment charges of US$5.0bn were 14% lower than in 2010. The decline was mainly in our Consumer and Mortgage Lending (CML) portfolio, driven by the reduction in customer lending balances, in part offset by higher loan impairment allowances reflecting a rise in the estimated cost to obtain collateral as well as delays in the timing of expected cash flows, both the result of the industry-wide delays in foreclosure processing.

In the third quarter of 2011, loan impairment charges in the CML portfolio increased markedly as delinquency worsened compared with the first half of 2011. In addition, we increased our loan impairment allowances to reflect a rise in the expected cost to obtain and realise collateral following delays in foreclosure processing. Despite a decline in loan impairment charges in the fourth quarter, these factors contributed significantly to a rise in the Group s loan impairment charges in the second half of 2011 compared with the first half of the year.

In Card and Retail Services, loan impairment charges fell by 26% to US$1.6bn reflecting lower lending balances and improved delinquency rates as customer repayment rates remained strong during 2011.

In CMB, loan impairment charges and other credit risk provisions in North America declined in both Canada and the US reflecting improved credit quality, and in Canada this was also due to lower lending balances. These declines were partly offset by a loan impairment charge on a commercial real estate lending exposure.

The reduction in loan impairment charges and other credit risk provisions in North America was partly offset by an increase in GB&M, reflecting lower releases of collective loan impairment allowances compared with 2010. In addition, 2011 included a loan impairment charge associated with a corporate lending relationship.

Loan impairment charges and other credit risk provisions in Europe fell by 20% to US$2.5bn, notably in the UK. The reduction was mainly in our RBWM business where loan impairment charges declined by 53% to US$596m despite the difficult economic climate and continued pressures on households finances. Delinquency rates declined across both the secured and unsecured lending portfolios, reflecting improvement in portfolio quality and the continued low interest rate environment as well as successful actions taken to mitigate credit risk and proactive account management. In CMB, loan impairment charges and other credit risk provisions were 7% lower, mainly in the UK. This was partly offset by an increase in individually assessed loan impairment charges in Greece as economic conditions worsened.

In GB&M in Europe, loan impairment charges and other credit risk provisions increased by 8% as we recorded an impairment of US$145m to write down to market value available-for-sale Greek sovereign debt now judged to be impaired following the deterioration in Greece s fiscal position. Further information on our exposures to countries in the eurozone is provided in Areas of special interest wholesale lending on page 112.

In the Middle East and North Africa, loan impairment charges and other credit risk provisions fell by 53% to US$293m, primarily due to a marked decline in loan impairment charges and other credit risk provisions in our GB&M business. This reflected the non-recurrence of individually assessed loan impairment charges recorded in the first half of 2010 related to restructuring activity for a small number of large corporate customers in the United Arab Emirates (UAE). In RBWM, loan impairment charges declined by 45%, due to significantly improved delinquency rates reflecting a repositioning of the loan book towards higher quality lending as

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we continued to manage down unsecured lending, together with impaired collections practices.

In Rest of Asia-Pacific, loan impairment charges and other credit risk provisions declined by 42% to US$267m, driven by reductions in India and Singapore. The marked decline in India reflected an improvement in delinquency, particularly in the unsecured portfolios as lending balances were managed down. In GB&M, loan impairment charges and other credit risk provisions declined by 58%, mainly in Singapore, due to a reduction in individually assessed loan impairment charges.

In Latin America, loan impairment charges increased by 17% to US$1.9bn. In Brazil, loan impairment charges and other credit risk provisions rose by 43% to US$1.4bn due to a rise in collective loan impairment allowances in both RBWM and CMB following the strong growth in our customer lending balances

and a rise in delinquency rates in the second half of 2011. In addition, we recognised a significant individually assessed loan impairment charge related to a commercial customer. The increase in Brazil was partly offset by a 28% decline in loan impairment charges and other credit risk provisions in Mexico. This was mainly in our RBWM business due to lower balances in our credit card portfolio as certain higher risk portfolios were run-down and both credit quality and collections improved.

In Hong Kong, loan impairment charges and other credit risk provisions increased by 36% to US$156m. In CMB, higher loan impairment charges included a specific impairment charge related to a single customer, as well as higher collectively assessed charges reflecting growth in lending balances. In GPB, loan impairment charges and other credit risk provisions also increased, reflecting an impairment of available-for-sale Greek sovereign debt.

Operating expenses

	2011 US$m	2010 US$m	2009 US$m
By expense category			
Employee compensation and benefits	**21,166**	19,836	18,468
Premises and equipment (excluding depreciation and impairment)	**4,503**	4,348	4,099
General and administrative expenses	**12,956**	10,808	9,293
Administrative expenses	**38,625**	34,992	31,860
Depreciation and impairment of property, plant and equipment	**1,570**	1,713	1,725
Amortisation and impairment of intangible assets	**1,350**	983	810
Operating expenses	**41,545**	37,688	34,395
Included in the above are the following notable cost items:			
Restructuring costs (including impairment of assets)	**1,122**	154	301
UK customer redress programmes	**898**	78	
UK bank levy	**570**		
Payroll tax	**(13)**	324	
US mortgage foreclosure and servicing costs	**257**		
UK pension credit	**(587)**		(499)
US accounting gain on change in staff benefits		(148)	
Deferred variable compensation awards accelerated amortisation	**163**		

Staff numbers (full-time equivalents)

	At 31 December		
	2011	2010	2009
Europe	**74,892**	75,698	76,703
Hong Kong	**28,984**	29,171	27,614
Rest of Asia-Pacific	**91,051**	91,607	87,141
Middle East and North Africa	**8,373**	8,676	8,281
North America	**30,981**	33,865	35,458
Latin America	**54,035**	56,044	54,288
Staff numbers	**288,316**	295,061	289,485

Operating expenses increased by 10% to US$41.5bn on a reported basis. On an underlying basis, costs increased by 8% compared with 2010, driven by a

higher amount of notable items in 2011 as listed in the table above and a rise in staff costs, primarily in faster growing regions. Notable items included

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restructuring costs, provisions relating to customer redress programmes in the UK, including a charge in respect of the possible mis-selling of Payment Protection Insurance (PPI) in previous years, the UK bank levy and a new provision for US mortgage foreclosure and servicing costs. These were partially offset by a credit resulting from a change in the inflation measure used to calculate the defined benefit obligation in the UK for deferred pensions and the non-recurrence of the 2010 payroll and bonus taxes in the UK and France.

Salaries and wages rose, primarily driven by wage inflation in Rest of Asia-Pacific and Hong Kong and union-agreed salary increases in Latin America.

The growth in business volumes, primarily in Hong Kong, Rest of Asia-Pacific and Latin America, was supported by a small rise in average staff numbers (expressed as FTEs) which grew marginally in 2011. Staff costs also rose due to higher amortisation charges for previous years restricted and performance share awards and an acceleration in the expense recognition for deferred bonus awards of US$163m, in line with regulatory and best practice guidance (see page 95). Otherwise, performance-related costs were lower than in 2010, primarily in GB&M where net operating income declined.

During the year, we incurred US$1.1bn of restructuring costs including US$542m which were staff related and US$325m of impairment of certain software projects now deferred or cancelled.

During 2011, we began a Group-wide review of our organisational effectiveness. We achieved US$0.9bn of sustainable savings in 2011, approximately one third of our objective of US$2.5bn to US$3.5bn over three years. We started implementing consistent business models in RBWM and CMB and undertook a detailed review of our head offices. In addition, we began the re-engineering of our global functions, we commenced the streamlining of our IT function including the consolidation of some data centres and other services, and we re-engineered a number of customer-facing and back-office processes leading to a more efficient use of our corporate real estate.

This resulted in a net reduction of staff numbers of more than 7,600 during the second half of 2011 despite continuing to recruit selectively in our target growth areas.

The savings achieved by delivering on these programmes enabled the funding of investment in strategic initiatives, including the development of Prime Services and equity market capabilities and the expansion of the Rates and Foreign Exchange e-commerce platforms in Europe, and the recruitment of additional front office staff in selected markets.

Costs increased due to a rise in compliance costs in GB&M and litigation expenses in RBWM, both predominantly in the US. However, marketing costs fell in North America and Latin America as discretionary costs were tightly controlled.

Cost efficiency ratios[4]

	2011	2010	2009
	%	%	%
HSBC	**57.5**	55.2	52.0
Geographical regions			

Europe	**70.4**	67.9	59.4
Hong Kong	**44.5**	43.4	41.7
Rest of Asia-Pacific	**54.2**	55.7	55.6
Middle East and North Africa	**44.5**	44.7	38.6
North America	**55.7**	48.8	51.5
Latin America	**63.3**	65.7	59.6
Global businesses			
Retail Banking and Wealth Management[17]	**63.2**	58.1	52.3
Commercial Banking	**46.3**	49.4	46.4
Global Banking and Markets[17]	**57.0**	48.8	37.5
Global Private Banking	**68.8**	65.8	60.5

For footnote, see page 95.

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Share of profit in associates and joint ventures

	2011 US$m	2010 US$m	2009 US$m
Associates			
Bank of Communications Co., Limited	**1,370**	987	754
Ping An Insurance (Group) Company of China, Limited	**946**	848	551
Industrial Bank Co., Limited	**471**	327	216
The Saudi British Bank	**308**	161	172
Other	**126**	156	42
Share of profit in associates	**3,221**	2,479	1,735
Share of profit in joint ventures	**43**	38	46
Share of profit in associates and joint ventures	**3,264**	2,517	1,781

The reported share of profit in associates and joint ventures was US$3.3bn, an increase of 30% compared with 2010. On an underlying basis, which excludes the re-measurement loss relating to Ping An s acquisition of Shenzhen Development Bank, the share of profits from associates increased by 27%. This was driven mainly by higher contributions from our mainland China associates.

Our share of profits from BoCom rose, driven by strong loan growth, wider spreads following benchmark interest rate rises by the People s Bank of China and effective re-pricing. Fee-based income also increased due to the continued development of investment banking services as well as increased

credit card spending. The contribution from Industrial Bank rose as a result of continued growth in customer lending, higher fee income and a fall in loan impairment charges.

Profits from Saudi British Bank increased, driven by a decline in loan impairment charges as the credit environment improved in Saudi Arabia and due to good cost control.

Higher profits from Ping An resulted from strong growth in sales in the insurance business and higher income from the banking business following the acquisition of Shenzhen Development Bank in July 2011.

Tax expense

	2011 US$m	2010 US$m	2009 US$m
Profit before tax	**21,872**	19,037	7,079

Tax expense	**(3,928)**	(4,846)	(385)
Profit after tax	**17,944**	14,191	6,694
Effective tax rate	**18.0%**	25.5%	5.4%

Our reported tax expense decreased by US$0.9bn compared with 2010. The lower tax charge reflected the benefit of a deferred tax credit of US$0.9bn now eligible to be recognised in respect of foreign tax credits in the US. In addition, the tax charge in

2010 included US$1.2bn attributable to a taxable gain from an internal reorganisation in our North American operations. The resulting reported effective tax rate for 2011 was 18% compared with 25.5% in 2010.

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2010 compared with 2009

Reconciliation of reported and underlying profit before tax

	2010 compared with 2009								
HSBC	2009 as reported US$m	2009 adjust-ments[10] US$m	Currency translation[11] US$m	2009 at 2010 exchange rates[18] US$m	2010 as reported US$m	2010 adjust-ments[10] US$m	2010 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	40,730	(1)	642	41,371	39,441	(31)	39,410	(3)	(5)
Net fee income	17,664	(210)	182	17,636	17,355	(3)	17,352	(2)	(2)
Changes in fair value[14]	(6,533)	6,533			(63)	63		99	
Other income[15]	14,320	(283)	228	14,265	11,514	(719)	10,795	(20)	(24)
Net operating income[16]	66,181	6,039	1,052	73,272	68,247	(690)	67,557	3	(8)
Loan impairment charges and other credit risk provisions	(26,488)		(330)	(26,818)	(14,039)		(14,039)	47	48
Net operating income	39,693	6,039	722	46,454	54,208	(690)	53,518	37	15
Operating expenses	(34,395)	200	(568)	(34,763)	(37,688)	19	(37,669)	(10)	(8)
Operating profit	5,298	6,239	154	11,691	16,520	(671)	15,849	212	36
Income from associates	1,781	(1)	11	1,791	2,517		2,517	41	41
Profit before tax	7,079	6,238	165	13,482	19,037	(671)	18,366	169	36
By geographical region									
Europe	4,009	2,546	(152)	6,403	4,302	(164)	4,138	7	(35)
Hong Kong	5,029	1	(10)	5,020	5,692	(130)	5,562	13	11
Rest of Asia-Pacific	4,200	3	205	4,408	5,902	(211)	5,691	41	29
Middle East and North Africa	455		(2)	453	892	42	934	96	106
North America	(7,738)	3,688	46	(4,004)	454	(208)	246		
Latin America	1,124		78	1,202	1,795		1,795	60	49
Profit before tax	7,079	6,238	165	13,482	19,037	(671)	18,366	169	36
By global business									
Retail Banking and Wealth Management[17]	(1,846)	(2)	(67)	(1,915)	3,839	(10)	3,829		
Commercial Banking	4,275	(306)	64	4,033	6,090	(133)	5,957	42	48
Global Banking and Markets[17]	10,262	13	170	10,445	9,215	(342)	8,873	(10)	(15)
Global Private Banking	1,108		1	1,109	1,054	1	1,055	(5)	(5)
Other	(6,720)	6,533	(3)	(190)	(1,161)	(187)	(1,348)	83	(609)
Profit before tax	7,079	6,238	165	13,482	19,037	(671)	18,366	169	36

For footnotes, see page 95.

Consolidated income statement

Reported profit before tax of US$19.0bn in 2010 was 169% higher than in 2009, and 36% higher on an underlying basis. The difference between reported and underlying results is explained on page 16. Except where stated otherwise, the commentaries in the Financial Summary are on an underlying basis and references to HSBC Finance and HSBC Bank USA are on a management basis, rather than a legal entity basis.

Net operating income before loan impairment charges and other credit risk provisions (revenue)

was lower than in 2009, notably due to a decline in balances in North America, lower trading income from adverse movements on non-qualifying hedges and a fall in revenue from GB&M. In the former, we continued to reposition our core businesses and we remained focused on managing down our run-off portfolios. As a consequence, revenue fell, reflecting declining balances in the run-off portfolios and in the Card and Retail Services business, where revenue was also adversely affected by new regulations. In GB&M, lower revenue was generated in Balance Sheet Management as higher yielding positions matured and funds were invested in lower yielding

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assets. Trading income declined driven by increased competition and reduced margins across core products, and less favourable market conditions caused by the European sovereign debt crisis. These factors were partly offset by increased CMB revenue from balance sheet growth, particularly in Asia, and higher trade-related fees.

Loan impairment charges were significantly lower than in 2009, with decreases across all regions and global businesses as economic conditions improved. The most significant decline in loan impairment charges was in North America, reflecting lower balances due to increased repayments, an improvement in delinquency rates in Card and Retail Services, and the continued run-off of balances in the Consumer Finance business. There were also marked declines in the Middle East and North Africa and in Latin America, primarily in Mexico and Brazil, reflecting a reduction in personal lending balances as selected portfolios were managed down, and an improvement in credit quality as origination criteria were tightened and collection practices improved. In GB&M, loan impairment charges were significantly lower, reflecting the improvement in the credit environment which resulted in fewer significant charges than those taken in 2009 in relation to a small number of clients, notably in Europe and other credit risk provisions fell in the available-for-sale asset-backed securities (ABS) portfolio due to a slowing in the rate of anticipated losses in the underlying collateral pools.

Underlying profit before tax rose by 36% as a significant fall in impairment charges offset a decline in revenue.

Operating expenses were higher than in 2009, in part due to specific one-off items such as a US$0.3bn charge for UK bank payroll tax in 2010 and the non-recurrence of a pension accounting gain of US$0.5bn in 2009 relating to the treatment of staff benefits. Excluding these items, operating expenses rose in support of strategic growth initiatives in our target markets to invest in operational infrastructure and the selective recruitment of customer-facing staff.

Income from associates increased, driven by strong results in Asia which reflected robust economic growth in mainland China.

In 2010, taxable profits were achieved in the US, principally as the result of a gain from an internal reorganisation that was not recognised for accounting purposes which increased the effective tax rate by 6.4 percentage points. If this were excluded, the effective tax rate would be 19.1% which is in line

with our geographical range of business activities. Reported profit after tax was US$7.5bn higher than in 2009.

Group performance by income and expense item

Net interest income

Reported net interest income fell by 3% to US$39bn; the decline was 5% on an underlying basis. This was driven by the exceptionally low interest rate environment and by the effect of repositioning our customer assets towards secured lending as we reduced our higher risk and higher yielding portfolios.

Revenues in Balance Sheet Management decreased, as expected, from the strong levels of 2009 as higher yielding positions taken in prior years matured and opportunities for reinvestment at equivalent yields were limited by the prevailing low interest rates and flatter yield curves.

The fall in income from interest-earning assets was driven by declining yields on loans and advances to customers following the Group s decision to reposition the lending portfolio towards higher quality assets. Higher yielding unsecured lending balances decreased, particularly in North America, where the run-off portfolios continued to diminish and credit card balances fell as the number of active accounts declined and repayments by customers increased. Certain higher risk portfolios were also managed down in Latin America, Asia and the Middle East and North Africa. This reduction was partly offset by commercial lending growth in CMB and GB&M, and growth in secured lending in the UK in residential mortgages.

The interest expense on debt issued by the Group fell, largely due to a decline in average balances in debt securities in issue as HSBC Finance s funding requirements continued to decrease in line with the run-off of the residual balances in Mortgage Services and Consumer Lending and the sale of the vehicle finance portfolios.

Net interest income includes the expense of the internal funding of trading assets, while related revenue is reported in trading income. The cost of funding these assets declined as a result of the low interest rates. In reporting our global business results, this cost is included within net trading income.

Net interest spread decreased due to lower yields on loans and advances to customers, partly as a result of the greater focus on secured lending. In addition, returns on financial investments and deposit spreads

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remained constrained due to low interest rates. Our net interest margin fell by a lesser amount due to the benefit from an increase in net free funds as customers held more funds in liquid non-interest bearing current accounts in the current low interest rate environment.

Net fee income

Net fee income marginally decreased compared with 2009 on both a reported and an underlying basis. The significant decrease in fee income in North America, primarily in Card and Retail Services, was mostly offset by higher investment-related fees in Asia and Europe and an increase in trade-related fee income in Asia.

The significant fall in fee income from cards occurred primarily in North America, driven by lower volumes, improved delinquency rates and the revision to charging practices following the implementation of the Credit Card Accountability, Responsibility and Disclosure Act (CARD Act).

Insurance fee income was markedly down. In the US, the decline resulted from lower sales of credit protection products associated with the cards business. In the UK, income was lower on a reported basis due to the sale of the insurance brokerage business in the first half of 2010.

Overall, underwriting fee income declined, particularly in Europe as a result of reduced capital market activity in the uncertain economic environment, although in Asia underwriting fees increased following several notable transactions.

Net fee income from sales of investment products in Asia and Europe increased, driven by a stronger investment performance in funds and improved customer sentiment which led to higher volumes.

Credit facilities fees also rose, notably in Asia, as a result of an increase in loan syndication transactions completed during the year.

Net fee income from trade finance also increased, particularly in Asia, reflecting a rise in trade activity.

Net trading income

Reported net trading income was US$7.2bn, 27% lower than in 2009. On an underlying basis, net trading income declined by 28% due to adverse movements on non-qualifying hedges and lower income from trading activities.

A US$1.1bn adverse fair value movement was reported on non-qualifying hedges compared with a

favourable fair value movement of US$954m in 2009. These instruments are derivatives entered into as part of a documented interest rate management strategy for which hedge accounting was not, or could not be, applied. They are principally cross-currency and interest rate swaps used to economically hedge fixed rate debt issued by HSBC Holdings, floating rate debt issued by HSBC Finance and certain operating leased assets. The loss recognised on non-qualifying hedges was a result of fair value losses on these instruments, driven by the decrease in long-term US interest rates relative to sterling and euro rates. In HSBC Finance, the volume of non-qualifying hedge positions also increased as the duration of the mortgage book lengthened and swaps were used to align more closely the duration of the funding liabilities. The size and direction of the changes in fair value of non-qualifying hedges which are recognised in the income statement can be volatile from year to year, but do not alter the cash flows expected as part of the documented interest rate management strategy for both the instruments and the underlying economically hedged assets and liabilities.

The remaining decline in net trading income was driven by increased competition and reduced margins across core products. European sovereign debt concerns and increased economic uncertainty resulted in less favourable market conditions compared with 2009.

In the Credit business, corporate bond trading volumes remained robust following investment in electronic trading capabilities, though revenues were affected as margins declined and credit spread movements were more favourable in 2009. This was partly offset by gains on the legacy portfolio which included a net release of write-downs on legacy positions and monoline credit exposures of US$429m. This compared with a reported write-down of US$331m in 2009.

Rates income decreased, reflecting reduced margins and increased risk aversion from customers due to economic uncertainty. Turmoil in the eurozone led to sovereign debt downgrades and falling asset prices in certain European countries, leading to lower revenues in the trading portfolio. These factors were partly offset by a small favourable fair value movement on structured liabilities, compared with an adverse movement in 2009.

Lower net trading income was driven by a US$2.0bn adverse movement on non-qualifying hedges from 2009.

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Performance in the Foreign Exchange business remained strong, although was affected by a competitive trading environment and tighter bid-offer spreads as competitors sought to rebuild their businesses. In addition, revenues fell as market volatility declined from the exceptional levels seen in early 2009.

The Equities business continued to increase market share in its target markets, following investment in the equities platform. However, core revenues fell, as overall market volumes and margins declined.

Trading income benefited from foreign exchange gains on trading assets held as economic hedges of foreign currency debt designated at fair value compared with losses on these instruments in 2009. These gains were largely offset by corresponding losses reported in Net income from financial instruments designated at fair value .

Net interest income earned on trading activities decreased by 30%, driven by reduced holdings of debt securities. The cost of internally funding these assets also declined, but this interest expense is reported under Net interest income and excluded from net trading income.

Net income from financial instruments designated at fair value

The accounting policies for the designation of financial instruments at fair value and the treatment of the associated income and expenses are described in Notes 2i and 2b on the Financial Statements, respectively.

The majority of the financial liabilities designated at fair value relate to certain fixed-rate long-term debt issues whose rate profile has been changed to floating through interest rate swaps as part of a documented interest rate management strategy. The movement in fair value of these long-term debt issues includes the effect of our credit spread changes and any ineffectiveness in the economic relationship between the related swaps and own debt. As credit spreads widen or narrow, accounting profits or losses, respectively, are booked. The size and direction of the changes in the credit spread on our debt and ineffectiveness, which are recognised in the income statement, can be volatile from year to year, but do not alter the cash flows envisaged as part of the documented interest rate management strategy. As a consequence, fair value movements arising from changes in our own credit spread on long-term debt and other fair value movements on the debt and related derivatives are not regarded internally as part of managed

performance and are therefore not allocated to global businesses, but are reported in Other . Credit spread movements on own debt are excluded from underlying results, and related fair value movements are not included in the calculation of regulatory capital.

We reported net income from financial instruments designated at fair value of US$1.2bn in 2010 compared with a net expense of US$3.5bn in 2009. On an underlying basis, the equivalent figures were income of US$1.3bn in 2010 and US$2.9bn in 2009. The difference between the reported and underlying results arises from the exclusion from the latter of the credit spread-related movements in the fair value of our own long-term debt, on which we reported adverse fair value movements of US$63m in 2010 and US$6.5bn in 2009. In North America, a small favourable fair value movement was reported in 2010 as credit spreads widened marginally, in contrast with a significant adverse fair value movement in 2009. In Europe, significantly lower adverse fair value movements were reported in 2010 as credit spreads tightened, but to a lesser extent than in the previous year.

Income arising from financial assets held to meet liabilities under insurance and investment contracts reflected lower investment gains as the growth in equity markets was less than that of 2009. This predominantly affected the value of assets held to support unit-linked contracts in the UK, Hong Kong, Singapore and Brazil and participating contracts in France.

For investment gains or losses related to assets held to back investment contracts, the corresponding movement in liabilities to customers is also recorded under Net income from financial instruments designated at fair value .

Investment gains or losses related to assets held to back insurance contracts or investment contracts with discretionary participation features (DPF) are offset by a corresponding change in Net insurance claims incurred and movement in liabilities to policyholders to reflect the extent to which unit-linked policyholders, in particular, participate in the investment performance of the associated asset portfolios.

Gains less losses from financial investments

Reported gains less losses from financial investments increased by US$448m to US$968m. On an underlying basis, excluding an accounting gain arising from the reclassification of Bao Viet as an associate following our purchase of additional shares, they increased by 69%. This was driven by

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a decrease in the level of impairments on available-for-sale equity investments as market values improved, along with an increase in gains on the disposal of equity and debt securities.

Impairments on equity investments declined markedly compared with 2009 as the improving economic situation resulted in a reduction in the level of write-downs required on private equity and other strategic equity investments.

Higher net gains were reported in Balance Sheet Management on disposals of available-for-sale debt securities, mainly in Europe and Asia. These were partly offset by a decrease in North America, where net gains realised from the sale of mortgage-backed securities and other ABSs in 2009 did not recur.

Net gains on the disposal of equity securities increased, primarily in our private equity portfolio in Europe, as the market offered greater opportunities for divestment. This was partly offset by the non-recurrence of the gain on disposal of our holdings of Visa Inc. shares in 2009.

Net earned insurance premiums

Net earned insurance premiums increased by 6% to US$11.1bn on both a reported and an underlying basis.

Growth was largely attributable to the continued strong performance of life insurance products in Asia. Successful sales campaigns and the recruitment of additional insurance sales managers increased net earned premiums in Hong Kong, particularly from deferred annuity and unit-linked products, and a life insurance product designed for high net worth individuals. Higher sales were also reported in Malaysia, Taiwan and mainland China, primarily from successful product launches and marketing campaigns.

Net earned premiums in Latin America increased marginally in the improved economic conditions, driven by higher sales in Brazil, Argentina and Mexico and repricing initiatives in Argentina.

In France, an increase in sales of investment contracts with DPF drove higher net earned premiums. Strong sales activity also led to higher net earned premiums in our UK life insurance business.

This growth was partly offset by a reduction in non-life insurance premiums, primarily due to the run-off of the legacy motor book in the UK, which was closed during the second half of 2009, and the decision taken during 2010 not to renew certain contracts in the Irish business.

Net earned premiums in North America also decreased, reflecting a decline in sales of payment protection products following the discontinuation of mortgage originations in HSBC Finance.

Other operating income

Reported other operating income of US$2.6bn was 8% lower than in 2009. Income in 2010 included gains of US$188m following the dilution of our holding in Ping An Insurance, US$107m from the sale of HSBC Insurance Brokers, US$66m from the disposal of our interest in the Wells Fargo HSBC Trade Bank and US$255m from the sale of Eversholt Rail Group. In addition, we reported a gain of US$74m resulting from the sale of HSBC Private Equity (Asia) Ltd, partly offset by a loss of US$42m on the disposal of our shareholding in British Arab Commercial Bank plc. Reported results in 2009 included a gain of US$280m from the sale of the remaining stake in the card merchant-acquiring business in the UK.

On an underlying basis, excluding the items referred to above, other operating income decreased by 23%, primarily because gains on the sale of properties in London and Hong Kong in 2009 did not recur.

Net losses recognised on assets held for sale increased, reflecting a US$207m loss on the sale of the US vehicle finance servicing operation and associated US$5.3bn loan portfolio.

Net investment valuation gains on investment properties contrasted with losses in 2009. This reflected improvements in the property markets in Hong Kong and the UK which led to net valuation gains on investment properties, compared with net valuation losses in 2009.

A loss on sale of the US vehicle finance business contributed to a fall in Other operating income.

We recognised gains of US$194m and US$56m in 2010 on the sale and leaseback of our Paris and New York headquarters buildings, respectively. These compared with more substantial underlying gains of US$667m (US$686m as reported) on the sale and leaseback of 8 Canada Square and the sale of a property in Hong Kong in 2009.

Strong sales of life insurance products, notably in Hong Kong, resulted in favourable movements in the present value of in-force (PVIF) long-term insurance business. These were offset in part by the non-recurrence of gains recognised in 2009 following the refinement of the income recognition

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methodology in HSBC Finance.

Net insurance claims incurred and movement in liabilities to policyholders

Net insurance claims incurred and movement in liabilities to policyholders decreased by 5% and 4% on a reported and an underlying basis, respectively.

Lower investment returns than in 2009, particularly in Asia, Europe and Brazil, led to a decrease in the movement in liabilities to policyholders on unit-linked insurance contracts and, to a certain extent, participating contracts, whose policyholders share in the investment performance of the assets supporting their policies. The gains or losses experienced on the financial assets designated at fair value held to support insurance contract liabilities and investment contracts with DPF are reported in Net income from financial instruments designated at fair value .

In Asia, the effect of the lower investment returns was more than offset by additional reserves established for new business written, consistent with the increase in net insurance premiums earned, particularly in Hong Kong, as a result of successful sales campaigns and the recruitment of additional insurance sales managers.

In addition, the increase in reserves in 2009 on the now closed UK motor insurance book, which reflected the rising incidence and severity of claims at that time, did not recur. The decision taken in 2010 not to renew certain contracts in our Irish business resulted in a further decrease in net insurance claims incurred and movement in liabilities to policyholders.

Loan impairment charges and other credit risk provisions

On a reported basis, loan impairment charges and other credit risk provisions were US$14bn, a decline of 47% compared with 2009 and 48% on an underlying basis. There was improvement across all regions and in all global businesses.

At 31 December 2010, the aggregate balance of customer loan impairment allowances was US$20.1bn. This represented 2.2% of gross loans and advances to customers (net of reverse repos and settlement accounts) compared with 3.0% at 31 December 2009.

We actively managed down some of our higher risk portfolios in all regions and enhanced credit quality through tighter underwriting and increased focus on the sale of secured products to customers where we already held a banking relationship. Loan impairment charges in our CMB and GB&M

businesses fell as economic conditions improved and we recognised fewer large loan impairment charges against specific clients than in 2009.

Loan impairment charges and other credit risk provisions of US$14bn were 48% or US$12.8bn lower than in 2009.

Impairments on available-for-sale debt securities declined markedly to US$472m from the US$1.5bn reported in 2009, mainly reflecting a slowing in the rate of anticipated losses in the underlying collateral pools.

The most significant decline in loan impairment charges was in our HSBC Finance portfolios in **the US**, where lending balances reduced and delinquency levels improved.

Loan impairment charges and other credit risk provisions in the US declined by 48% to US$7.9bn, the lowest level since 2006, representing 57% of the Group s total reduction compared with 2009. This mainly occurred in the US RBWM business, where loan impairment charges declined by US$6.1bn to US$8.0bn, primarily in the Card and Retail Services business of HSBC Finance and, to a lesser extent, in the run-off consumer finance portfolios.

In Cards and Retail Services, loan impairment charges declined by 57% to US$2.2bn. This improvement reflected the continuing effects of additional steps taken from the fourth quarter of 2007 to manage risk, including tightening underwriting criteria, lowering credit limits and reducing the number of active cards. An increased focus by our customers on reducing outstanding credit card debt helped improve delinquency levels.

Loan impairment charges in our Consumer Lending and Mortgage Services businesses declined by 29% to US$5.7bn, due to the continued run-off of lending balances in these portfolios and lower delinquency balances. Total loss severities on foreclosed loans improved compared with 2009, reflecting an increase in the number of properties for which we accepted a deed in lieu of foreclosure or a short sale, both of which result in lower losses compared with loans which are subject to a formal foreclosure process.

During 2010, state and federal prosecutors announced investigations into foreclosure practices of certain mortgage service providers. As a result, we expect that the scrutiny of documents will increase, and in some states additional verification of information will be required. If these trends continue there may be delays in their processing. See page 407 for more information on the investigation into US

foreclosure practices.

In HSBC Bank USA, loan impairment charges in RBWM fell by 92% to US$50m, reflecting lower lending balances and improved credit quality in the residential mortgage portfolio.

In GB&M in the US, a net release of loan impairment charges and other credit risk provisions reflected the improved credit environment and a release of impairments of available-for-sale ABSs as mentioned previously. In CMB, loan impairment charges declined by US$194m as the improved economic conditions resulted in credit upgrades on certain accounts, and fewer downgrades across all business lines.

In **the UK**, loan impairment charges in RBWM and CMB declined as economic conditions improved and interest rates remained at low levels, resulting in an improvement in delinquency levels. In RBWM, loan impairment charges fell by 35% to US$1.1bn as we actively reduced our exposure to unsecured lending, while collections increased mainly due to programmes implemented to improve performance. In the UK secured lending book, credit quality continued to be high and loan impairment charges remained at low levels. In CMB, loan impairment charges declined by US$159m due to strengthened credit risk management and improved collections, notably in the UK property, retail and service sectors.

Loan impairment charges and other credit provisions fell markedly in GB&M, reflecting the improved credit outlook, loan restructuring activity and the non-recurrence of significant charges against a small number of clients in the financial and property sectors. Credit risk provisions on certain available-for-sale ABSs also reduced.

Loan impairment charges and other credit risk provisions in **Latin America** declined by 44% to US$1.5bn. In RBWM, loan impairment charges of US$1.2bn were 45% lower, mainly in Mexico due to a reduction in balances and improved delinquency rates in our credit card portfolio. In Brazil, they also declined as we managed down the size of certain consumer finance portfolios and economic conditions improved. In 2010, initiatives taken in the region to improve the quality of the loan portfolios continued. These steps included the tightening of underwriting criteria, reducing and, in some instances, eliminating the use of higher risk, non-branch sales channels, and continued investment in our collections infrastructure. In our CMB portfolios, loan impairment charges and other credit risk provisions declined by 50% to US$293m, as improved economic conditions and credit quality resulted in lower specific impairment charges in all sectors.

In the **Middle East and North Africa**, loan impairment charges and other credit risk provisions fell by 53% to US$627m as lower loan impairment charges in both RBWM and CMB were partly offset by an increase in GB&M following restructuring activities. In our RBWM business, loan impairment charges declined by 61% to US$227m, reflecting a marked decline in delinquency levels and lower lending balances, particularly in our credit card and unsecured personal lending book, as a result of managing down higher risk portfolios. Credit limits were tightened and our customer acquisition strategy was revised in the region to concentrate on Premier and Advance customers. This resulted in an improvement in credit quality. In CMB, lower loan impairment charges reflected a reduction in collective impairment charges and fewer specific loan impairment charges as economic conditions improved.

In **Rest of Asia-Pacific**, loan impairment charges declined as the credit environment improved. In India, loan impairment charges fell by 83% to US$82m, mainly in RBWM as certain unsecured lending portfolios and the higher risk elements of the credit card portfolio were managed down, and economic conditions improved. Impairment charges also declined in CMB, due to the non-recurrence of charges against specific technology-related exposures in 2009. Partly offsetting these increases were higher specific loan impairment charges in GB&M.

In **Hong Kong**, loan impairment charges fell by 77% to US$114m, as economic conditions improved and fewer large specific loan impairment charges were reported against the CMB and GB&M portfolios. Loan impairment charges fell in RBWM too, mainly on unsecured lending as unemployment and bankruptcy levels reduced.

Operating expenses

Operating expenses increased by 10% to US$37.7bn on a reported basis and by 8% on an underlying basis. Significant one-off items included aggregate payroll taxes of US$324m levied on 2009 bonuses in the UK and France, and the curtailment of certain benefits delivered through pension schemes, which generated accounting credits of US$148m in the US and US$480m (US$499m as reported) in the UK in 2010 and 2009, respectively. Excluding these items, expenses grew by 6% as we continued to invest in our operational infrastructure, customer-facing and support staff, and GB&M s capabilities and platforms.

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Employee compensation and benefits increased by 7%, partly due to the net effect of the curtailment gains and the payroll tax referred to above.

Excluding these items, staff costs rose by 3%. Performance-related costs increased, primarily in Asia, reflecting improved business performance and increased staff numbers. While year-end staff numbers increased as the pace of recruitment accelerated in the second half of the year, average staff numbers remained below 2009 levels. The growth in staff numbers in Asia encompassed both customer-facing and back-office staff supporting business growth and increased operational capacity. In Latin America, staff costs grew following union-agreed salary increases and the recruitment of customer-facing and regional support staff, primarily in the latter part of the year. We also increased resources in our Global Service Centres as we continued to move processes there.

Staff costs declined in the US due to the non-recurrence of restructuring costs associated with the closure of the Consumer Lending branch network in 2009. Also, headcount fell due to the sale of the vehicle finance portfolio and related servicing platform. Similarly, reported staff numbers fell in Europe due to the sale of the insurance broking business in the UK and business reorganisation in France, though this was partly offset by higher numbers of customer-facing staff in the UK and Turkey.

Premises and equipment costs increased as rental costs in the UK, the US and France rose following the sale and leaseback of 8 Canada Square, London and our headquarters buildings in the US and France, combined with business expansion in Asia and Europe and refurbishment costs in Europe and Latin America. This was partly offset by lower costs in the US following the closure of the Consumer Lending branch offices and the non-recurrence of the related restructuring costs.

General and administrative expenses rose, reflecting in part higher marketing and advertising costs. These grew in North America in Card and Retail Services, partly from complying with the CARD Act. Marketing costs also rose in Asia and Latin America in support of the launch of Advance and sales campaigns for credit cards and investment products. Project costs increased from various initiatives to enhance operational capabilities, in connection with which consultancy and contractors fees rose, primarily in the UK as GB&M continued to invest in strategic initiatives to drive future revenue growth. These included the development of Prime Services and equity market capabilities, and

the expansion of the Rates and foreign exchange e-commerce platforms.

Travel costs increased as we increased our focus on international connectivity and business growth. Costs also increased due to litigation provisions in North America and Europe.

Cost efficiency ratios

Our cost efficiency ratio worsened by 3.2 percentage points on a reported basis and by 8.4 percentage points to 55.8% on an underlying basis.

In RBWM, there was a deterioration of 5.8 percentage points in the cost efficiency ratio. Operating expenses remained broadly unchanged as a rise in costs in Asia in support of business expansion was broadly offset by strict cost control across the Group and lower costs in the US. Revenue fell, largely in the run-off portfolio and in Card and Retail Services in North America.

In CMB, the cost efficiency ratio deteriorated by 2.9 percentage points as we continued to invest for future revenue growth in those markets that we see as central to international connectivity. Revenue grew in all regions, albeit at a slower pace, resulting in a deterioration in the cost efficiency ratio, with the exception of Hong Kong where strong revenue growth led to an improvement of 1.5 percentage points.

In GB&M, the cost efficiency ratio deteriorated by 11.3 percentage points reflecting the one-off payroll and bonus taxes in the UK and France. The ratio also deteriorated due to a rise in costs related to higher support costs and continued investment in strategic initiatives being undertaken to drive future revenue growth. Revenue fell during 2010 mainly due to lower net interest income in Balance Sheet Management and lower trading income.

In GPB, the cost efficiency ratio deteriorated by 5.3 percentage points as costs increased, reflecting the hiring of front-line staff, investment in systems and higher compliance costs coupled with lower revenue in the low interest rate environment.

Share of profit in associates and joint ventures

The share of profit from associates and joint ventures increased by 41% to US$2.5bn on both a reported and an underlying basis as our associates in mainland China capitalised on the improved economic conditions in region.

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Our share of profits in Ping An Insurance increased due to strong insurance sales performance, while fee income and lending growth resulted in higher profits from the Bank of Communications Co., Limited (Bank of Communciations) and from Industrial Bank Co., Limited (Industrial Bank).

These results were partly offset by a decrease in our share of profits from The Saudi British Bank as revenue declined amidst challenging economic conditions.

Tax expense

The most significant factor influencing the year on year changes to the effective tax rate is the changing geographical split of profits, including the relative proportion of tax on the share of profits in associates and joint ventures included within profit before tax. The impact of the tax on profit on associates and joint ventures included within pre-tax profits was a reduction in the effective tax rate of 3.7% in 2010 and 7.1% in 2009.

In 2010 HSBC s US operations achieved taxable profits, principally as a result of realising a taxable gain from an internal reorganisation which increased the effective tax rate by 6.4%. If this was excluded the effective tax rate would be 19.1% which is in line with the geographic profile of the Group.

Economic profit

Our internal performance measures include economic profit/(loss), a calculation which compares the return on financial capital invested in HSBC by our shareholders with the cost of that capital. We price our cost of capital internally and the difference between that cost and the post-tax profit attributable to ordinary shareholders represents the amount of

economic profit/(loss) generated. Economic profit/(loss) generated is used by management as one input in deciding where to allocate capital and other resources.

In order to concentrate on external factors rather than measurement bases, we emphasise the trend in economic profit/(loss) ahead of absolute amounts within business units. Our long-term cost of capital is reviewed annually and for 2010 it was revised to 11% from the 10% used in 2009. We use a Capital Asset Pricing Model to determine our cost of capital. The main drivers of the increase were an increase in the risk free rate and an increase in the betas used in the calculation. The following commentary is on a reported basis.

Our economic loss decreased by US$4.7bn to US$3.3bn as a result of an increase in profit attributable to shareholders. This was predominantly driven by lower loan impairment charges across all regions and customer groups, notably in the US due to lower balances and decreased delinquency rates in Card and Retail Services, and the run-off of the Consumer Lending and mortgage services portfolio.

The increase in average invested capital reflected higher retained earnings and a significant decrease in reserves representing unrealised losses on available-for-sale securities due to a slowing in the rate of anticipated losses in the underlying collateral pools.

The return on invested capital increased by 4.6 percentage points, although it remained below our benchmark cost of capital. The economic spread improved by 3.6 percentage points, the result of an increase in return on invested capital, partly offset by the rise in the cost of capital in 2010.

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Recent events

On 7 March 2012, HSBC announced an agreement to sell its general insurance businesses in Hong Kong, Singapore, Argentina and Mexico. The value of the gross assets to be sold by HSBC was US$1,228m at 31 December 2011, of which US$444m represents assets to be sold to AXA Group (AXA) and US$784m to QBE Insurance Group Limited (QBE).

Following completion of the relevant sales, new 10 year bancassurance agreements entered into with AXA and QBE will become effective. AXA and QBE, as specified in the agreements, will become the exclusive providers of, and underwrite, general insurance products distributed by HSBC Group companies to retail and commercial banking customers

in Hong Kong and Mainland China, Singapore, India, Indonesia, Mexico and Argentina. Under the 10 year bancassurance agreements, AXA and QBE will pay commissions on product sales and may make profit-related payments to HSBC Group companies.

The aggregate cash consideration payable for the acquisition of the general insurance businesses and the bancassurance agreements is approximately US$914m (US$494m by AXA and US$420m by QBE).

The transactions, which are subject to regulatory approvals, are expected to complete during the second half of 2012, although the transaction in Argentina may complete earlier.

HSBC HOLDINGS PLC

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Consolidated balance sheet

Five-year summary consolidated balance sheet and selected financial information

	At 31 December				
	2011	2010	2009	2008	2007
	US$m	US$m	US$m	US$m	US$m
ASSETS					
Cash and balances at central banks	**129,902**	57,383	60,655	52,396	21,765
Trading assets	**330,451**	385,052	421,381	427,329	445,968
Financial assets designated at fair value	**30,856**	37,011	37,181	28,533	41,564
Derivatives	**346,379**	260,757	250,886	494,876	187,854
Loans and advances to banks	**180,987**	208,271	179,781	153,766	237,366
Loans and advances to customers[37]	**940,429**	958,366	896,231	932,868	981,548
Financial investments	**400,044**	400,755	369,158	300,235	283,000
Assets held for sale	**39,558**	1,991	3,118	2,075	2,804
Other assets	**156,973**	145,103	146,061	135,387	152,397
Total assets	**2,555,579**	2,454,689	2,364,452	2,527,465	2,354,266
LIABILITIES AND EQUITY					
Liabilities					
Deposits by banks	**112,822**	110,584	124,872	130,084	132,181
Customer accounts	**1,253,925**	1,227,725	1,159,034	1,115,327	1,096,140
Trading liabilities	**265,192**	300,703	268,130	247,652	314,580
Financial liabilities designated at fair value	**85,724**	88,133	80,092	74,587	89,939
Derivatives	**345,380**	258,665	247,646	487,060	183,393
Debt securities in issue	**131,013**	145,401	146,896	179,693	246,579
Liabilities under insurance contracts	**61,259**	58,609	53,707	43,683	42,606
Liabilities of disposal groups held for sale	**22,200**	86	3		
Other liabilities	**111,971**	109,868	148,411	149,150	113,432
Total liabilities	**2,389,486**	2,299,774	2,228,791	2,427,236	2,218,850
Equity					
Total shareholders equity	**158,725**	147,667	128,299	93,591	128,160
Non-controlling interests	**7,368**	7,248	7,362	6,638	7,256
Total equity	**166,093**	154,915	135,661	100,229	135,416
Total equity and liabilities	**2,555,579**	2,454,689	2,364,452	2,527,465	2,354,266
Five-year selected financial information					
Called up share capital	**8,934**	8,843	8,705	6,053	5,915
Capital resources[38,39,40]	**170,334**	167,555	155,729	131,460	152,640
Undated subordinated loan capital	**2,779**	2,781	2,785	2,843	2,922
Preferred securities and dated subordinated loan capital[41]	**49,438**	54,421	52,126	50,307	49,472

Risk-weighted assets and capital ratios[38,39]					
Risk-weighted assets	**1,209,514**	1,103,113	1,133,168	1,147,974	1,123,782
	%	%	%	%	%
Core tier 1 ratio	**10.1**	10.5	9.4	7.0	8.1
Total capital ratio	**14.1**	15.2	13.7	11.4	13.6
Financial statistics					
Loans and advances to customers as a percentage of customer accounts	**75.0**	78.1	77.3	83.6	89.5
Average total shareholders equity to average total assets	**5.64**	5.53	4.72	4.87	5.69
Net asset value per ordinary share at year-end[42] (US$)	**8.48**	7.94	7.17	7.44	10.72
Number of US$0.50 ordinary shares in issue (millions)	**17,868**	17,686	17,408	12,105	11,829
Closing foreign exchange translation rates to US$:					
US$1: £	**0.646**	0.644	0.616	0.686	0.498
US$1:	**0.773**	0.748	0.694	0.717	0.679

For footnotes, see page 95.

A more detailed consolidated balance sheet is contained in the Financial Statements on page 281.

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Movement in 2011

Total reported assets were US$2.6 trillion, 4% higher than at 31 December 2010. Excluding the effect of currency movements, total assets increased by 6%.

Strong growth in deposits across most regions enabled us to support our customers borrowing requirements, leading to significantly higher term lending and mortgage balances in Hong Kong, Rest of Asia-Pacific and the UK. Our strong liquidity position and risk preference also led to a rise in balances at central banks. In addition, the fair value of derivative contracts increased markedly, as the deteriorating economic outlook resulted in a decline in yield curves in major currencies during the latter part of the year. This growth was offset in part by a reduction in net trading assets as we took action to manage our balance sheet more effectively, which resulted in year-end balances being lower than the average for the year.

The following commentary is based on a comparison with the balance sheet at 31 December 2010 as shown on page 35.

Assets

Cash and balances at central banks rose by 129%. The increasingly prominent role played by western central banks in the functioning of the money markets as well as our own risk preference as the eurozone crisis deepened resulted in a larger portion of our excess liquidity being held with central banks in Europe and in North America. The redeployment of funds from maturities and sales of financial investments and strong growth in deposits also contributed to the rise.

Trading assets decreased by 13%. Economic uncertainty led to a decline in market activity. As a result, we reduced our holdings of government and highly-rated corporate debt securities and equity positions, notably in Europe, and did not replace maturities in our reverse repo book. This was partly offset by higher cash collateral posted with external counterparties as the fair value of derivative liabilities rose.

Financial assets designated at fair value declined by 14% as a result of improved netting of assets and the associated non-recourse liabilities. There was a corresponding reduction in Financial liabilities designated at fair value .

Derivative assets increased by 35%, due to a significant rise in the fair value of interest rate contracts in Europe. This was driven by the downward movements of yield curves in major

currencies following the global monetary response to continued economic weakness, including quantitative easing measures. The notional value of contracts outstanding also increased, reflecting a higher number of open interest rate and foreign exchange transactions than a year ago. The increase in the fair value of derivative assets was partly offset by higher netting, which rose in line with the increase in fair values.

Loans and advances to banks declined by 11%, as funds from maturing term loans and reverse repo balances, notably in Europe, were redeployed to Cash and balances at central banks . This was offset in part by higher central bank lending in Rest of Asia-Pacific, reflecting strong deposit growth in the region.

Loans and advances to customers were broadly in line with 2010. Following the announcement of agreements for the sale of 195 non-strategic US branches and our Cards and Retail Services business, we reclassified the related loans and advances to Assets held for sale , which, for the purpose of this commentary, is reported within Other assets (see page 86). We also reclassified loans and advances relating to the planned disposals of non-strategic banking operations in Central America, the RBWM business in Thailand and our private banking business in Japan to Assets held for sale .

Excluding the above reclassifications, loans and advances to customers increased by US$30bn compared with 2010, although the pace of growth slowed in the second half of 2011. This reflected targeted loan growth in our CMB and GB&M businesses in Hong Kong and Rest of Asia-Pacific as the economic environment improved and trade flows increased, together with growth as a result of lending campaigns in CMB in the UK and Latin America. Residential mortgage balances also rose significantly in the UK, Hong Kong and Rest of Asia-Pacific due to a strong sales focus and competitive pricing, reflecting the successful implementation of our strategy to reposition RBWM towards higher quality secured lending. This growth was offset in part by a reduction in reverse repo balances in Europe and North America, as a result of lower market activity.

Financial investments were broadly in line with 2010, as Balance Sheet Management continued to hold large portfolios of highly liquid assets. In North America, financial investments rose due to the purchases of government and government agency debt securities. This was partly offset by a reduction in Europe, where a portion of the proceeds from sales and maturities of financial investments were placed at central banks.

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Report of the Directors: Operating and Financial Review (continued)

Other assets, which, for the purpose of this commentary, includes assets held for sale, increased by 34%, reflecting the reclassification of assets of disposal groups, most notably the loans and advances to customers associated with the non-strategic US branches and our Cards and Retail Services business.

Liabilities

Deposits by banks rose by 4% due to higher placements by other financial institutions with HSBC, primarily in Rest of Asia-Pacific and North America. This was partly offset by a reduction in repo balances as a result of lower market activity.

Customer accounts increased by 4% in highly competitive markets. This was driven by customer acquisition, coupled with targeted deposit gathering campaigns to support growth in lending, most notably in Hong Kong, Rest of Asia-Pacific and in Europe. This was partly offset by the reclassification of deposits of businesses, principally the US branches, to liabilities held-for-sale. Repo balances in Europe also declined, reflecting lower market activity levels, particularly during the latter part of the year.

Trading liabilities fell by 11%. Net short bond and equity positions decreased in line with the reduction in holdings of debt and equity securities, which fell as a result of lower market activity. Repo balances also declined, reflecting lower funding requirements as trading assets fell. These declines were offset in part by a rise in cash collateral posted by external counterparties in line with the increase in the fair value of derivative contracts, notably in Europe.

Financial liabilities designated at fair value were broadly in line with 2010. Debt issuances by HSBC entities in Europe were partly offset by maturities not being replaced in North America as funding requirements reduced in line with the decline in the consumer finance portfolios in run-off. Improved netting of non-recourse liabilities and associated assets led to a further

reduction in Financial liabilities designated at fair value, with a corresponding decrease in Financial assets designated at fair value.

Derivative businesses are managed within market risk limits and, as a consequence, the increase in the value of *Derivative liabilities* broadly matched that of Derivative assets.

Debt securities in issue declined by 9%, reflecting the non-replacement of maturing securities in both North America and Europe as a result of lower funding requirements relating to the continued reduction in consumer lending balances and the decline in trading assets, respectively. This was offset in part by new issuances in Latin America and Rest of Asia-Pacific to support balance sheet growth.

Liabilities under insurance contracts grew by 7%, driven by reserves established for new business premiums written, notably in Hong Kong, Brazil, France, the UK and Singapore. This was partly offset by the effect of a fall in equity markets, which resulted in a decline in the fair value of assets held to support unit-linked and investment and insurance contracts with DPF and also in the related liabilities to policyholders, together with reductions due to the non-renewal and transfer to third parties of certain contracts in our Irish businesses and the sale of the motor insurance business in the UK during 2011.

Other liabilities, which, for the purpose of this commentary, includes liabilities of disposal groups, increased by 24% as a result of the reclassification of liabilities of businesses held for sale.

Equity

Total shareholders equity increased by 9%, driven by profits generated during the year. In addition, the negative balance on the available-for-sale reserve declined from US$4.1bn at 31 December 2010 to US$3.4bn at 31 December 2011, reflecting an improvement in the market value of assets.

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Reconciliation of reported and underlying assets and liabilities

	31 December 2011 compared with 31 December 2010						
HSBC	31 Dec 10 as reported US$m	Currency translation[43] US$m	31 Dec 10 at 31 Dec 11 exchange rates US$m	Under-lying change US$m	31 Dec 11 as reported US$m	Reported change %	Under-lying change %
Cash and balances at central banks	57,383	(590)	56,793	73,109	129,902	126	129
Trading assets	385,052	(3,834)	381,218	(50,767)	330,451	(14)	(13)
Financial assets designated at fair value	37,011	(937)	36,074	(5,218)	30,856	(17)	(14)
Derivative assets	260,757	(3,765)	256,992	89,387	346,379	33	35
Loans and advances to banks	208,271	(5,661)	202,610	(21,623)	180,987	(13)	(11)
Loans and advances to customers	958,366	(12,556)	945,810	(5,381)	940,429	(2)	(1)
Financial investments	400,755	(5,219)	395,536	4,508	400,044		1
Other assets	147,094	(439)	146,655	49,876	196,531	34	34
Total assets	2,454,689	(33,001)	2,421,688	133,891	2,555,579	4	6
Deposits by banks	110,584	(1,837)	108,747	4,075	112,822	2	4
Customer accounts	1,227,725	(17,065)	1,210,660	43,265	1,253,925	2	4
Trading liabilities	300,703	(2,785)	297,918	(32,726)	265,192	(12)	(11)
Financial liabilities designated at fair value	88,133	(449)	87,684	(1,960)	85,724	(3)	(2)
Derivative liabilities	258,665	(3,710)	254,955	90,425	345,380	34	35
Debt securities in issue	145,401	(1,456)	143,945	(12,932)	131,013	(10)	(9)
Liabilities under insurance contracts	58,609	(1,501)	57,108	4,151	61,259	5	7
Other liabilities	109,954	(1,906)	108,048	26,123	134,171	22	24
Total liabilities	2,299,774	(30,709)	2,269,065	120,421	2,389,486	4	5
Total shareholders equity	147,667	(2,263)	145,404	13,321	158,725	7	9
Non-controlling interests	7,248	(29)	7,219	149	7,368	2	2
Total equity	154,915	(2,292)	152,623	13,470	166,093	7	9
Total equity and liabilities	2,454,689	(33,001)	2,421,688	133,891	2,555,579	4	6

For footnote, see page 95.

In 2011, the effect of acquisitions was not material.

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Report of the Directors: Operating and Financial Review (continued)

Reconciliation of reported and underlying loans and advances to customers and customer accounts by geographical region

	31 December 2011 compared with 31 December 2010						
	31 Dec 10 as reported US$m	Currency translation[11] US$m	31 Dec 10 at 31 Dec 11 exchange rates US$m	Underlying change US$m	31 Dec 11 as reported US$m	Reported change %	Underlying change %
Loans and advances to customers (net)							
Europe	**435,799**	**(5,510)**	**430,289**	**4,047**	**434,336**	**(0)**	**1**
Hong Kong	**140,691**	**296**	**140,987**	**16,678**	**157,665**	**12**	**12**
Rest of Asia-Pacific	**108,731**	**(1,264)**	**107,467**	**16,401**	**123,868**	**14**	**15**
Middle East and North Africa	**24,626**	**(124)**	**24,502**	**1,373**	**25,875**	**5**	**6**
North America	**190,532**	**(1,104)**	**189,428**	**(46,681)**	**142,747**	**(25)**	**(25)**
Latin America	**57,987**	**(4,850)**	**53,137**	**2,801**	**55,938**	**(4)**	**5**
	958,366	**(12,556)**	**945,810**	**(5,381)**	**940,429**	**(2)**	**(1)**
Customer accounts							
Europe	**491,563**	**(5,413)**	**486,150**	**7,254**	**493,404**	**0**	**1**
Hong Kong	**297,484**	**373**	**297,857**	**17,488**	**315,345**	**6**	**6**
Rest of Asia-Pacific	**158,155**	**(2,426)**	**155,729**	**18,283**	**174,012**	**10**	**12**
Middle East and North Africa	**33,511**	**(287)**	**33,224**	**3,198**	**36,422**	**9**	**10**
North America	**158,486**	**(1,080)**	**157,406**	**(1,424)**	**155,982**	**(2)**	**(1)**
Latin America	**88,526**	**(8,233)**	**80,293**	**(1,533)**	**78,760**	**(11)**	**(2)**
	1,227,725	**(17,066)**	**1,210,659**	**43,266**	**1,253,925**	**2**	**4**

Reconciliation of reported and underlying loans and advances to customers and customer accounts by global businesses

	31 December 2011 compared with 31 December 2010						
	31 Dec 10 as reported US$m	Currency translation[11] US$m	31 Dec 10 at 31 Dec 11 exchange rates US$m	Underlying change US$m	31 Dec 11 as reported US$m	Reported change %	Underlying change %
Loans and advances to customers (net)							
Retail Banking and Wealth Management	**390,963**	**(4,721)**	**386,242**	**(28,335)**	**357,907**	**(8)**	**(7)**
Commercial Banking	**239,286**	**(4,585)**	**234,701**	**27,338**	**262,039**	**10**	**12**
Global Banking and Markets	**284,497**	**(3,621)**	**280,876**	**(4,413)**	**276,463**	**(3)**	**(2)**
Global Private Banking	**40,665**	**(64)**	**40,601**	**1,255**	**41,856**	**3**	**3**
Other	**2,955**	**435**	**3,390**	**(1,226)**	**2,164**	**(27)**	**(36)**
	958,366	**(12,556)**	**945,810**	**(5,381)**	**940,429**	**(2)**	**(1)**

Customer accounts							
Retail Banking and Wealth Management	**525,221**	**(6,193)**	**519,028**	**9,989**	**529,017**	**1**	**2**
Commercial Banking	**286,007**	**(4,537)**	**281,470**	**24,704**	**306,174**	**7**	**9**
Global Banking and Markets	**308,416**	**(5,710)**	**302,706**	**3,748**	**306,454**	**(1)**	**1**
Global Private Banking	**107,130**	**(842)**	**106,288**	**5,526**	**111,814**	**4**	**5**
Other	**951**	**216**	**1,167**	**(701)**	**466**	**(51)**	**(60)**
	1,227,725	**(17,066)**	**1,210,659**	**43,266**	**1,253,925**	**2**	**4**

For footnote, see page 95.

In 2011, the effect of acquisitions was not material.

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Report of the Directors: Operating and Financial Review (continued)

Customer accounts by country

	At 31 December	
	2011	2010
	US$m	US$m
Europe	**493,404**	491,563
UK	**361,181**	351,522
France[44]	**55,278**	65,407
Germany	**8,738**	7,063
Malta	**5,695**	5,968
Switzerland	**45,283**	43,098
Turkey	**6,809**	6,602
Other	**10,420**	11,903
Hong Kong	**315,345**	297,484
Rest of Asia-Pacific	**174,012**	158,155
Australia	**18,802**	16,640
India	**10,227**	12,143
Indonesia	**6,490**	5,572
Mainland China	**31,570**	27,007
Malaysia	**16,970**	15,257
Singapore	**44,447**	38,951
Taiwan	**11,659**	12,131
Vietnam	**1,834**	1,256
Other	**32,013**	29,198
Middle East and North Africa (excluding Saudi Arabia)	**36,422**	33,511
Egypt	**7,047**	6,881
Qatar	**2,796**	3,069
UAE	**18,172**	16,332
Other	**8,407**	7,229
North America	**155,982**	158,486
US	**97,542**	103,007
Canada	**45,510**	45,772
Bermuda	**12,930**	9,707
Latin America	**78,760**	88,526
Argentina	**4,878**	3,983
Brazil	**42,410**	49,253
Mexico	**21,772**	21,295
Panama	**5,463**	7,429
Other	**4,237**	6,566
Total	**1,253,925**	1,227,725

For footnote, see page 95.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Average balance sheet

Average balance sheet and net interest income

Average balances and related interest are shown for the domestic operations of our principal commercial banks by geographical region. Other operations comprise the operations of our principal commerical banking and consumer finance entities outside their domestic markets and all other banking operations, including investment banking balances and transactions.

Average balances are based on daily averages for the principal areas of our banking activities with monthly or less frequent averages used elsewhere.

Balances and transactions with fellow subsidiaries are reported gross in the principal commercial banking and consumer finance entities within Other interest-earning assets and Other interest-bearing liabilities as appropriate and the elimination entries are included within Other operations in those two categories.

Net interest margin numbers are calculated by dividing net interest income as reported in the income statement by the average interest-earning assets from which interest income is reported within the Net interest income line of the income statement. Interest income and interest expense arising from trading assets and liabilities and the funding thereof is included within Net trading income in the income statement.

Assets

		2011			2010			2009		
		Average balance US$m	**Interest income US$m**	**Yield %**	Average balance US$m	Interest income US$m	Yield %	Average balance US$m	Interest income US$m	Yield %
Summary										
Total interest-earning assets (itemised below)		**1,622,658**	**63,005**	**3.88**	1,472,294	58,345	3.96	1,384,705	62,096	4.48
Trading assets and financial assets designated at fair value [70,71]		**410,038**	**8,671**	**2.11**	385,203	7,060	1.83	419,647	8,646	2.06
Impairment provisions		**(18,738)**			(22,905)			(26,308)		
Non-interest-earning assets		**752,965**			664,308			667,942		
Total assets and interest income		**2,766,923**	**71,676**	**2.59**	2,498,900	65,405	2.62	2,445,986	70,742	2.89
Short-term funds and loans and advances to banks										
Europe	HSBC Bank	**62,489**	**1,186**	**1.90**	47,741	1,290	2.70	38,455	1,379	3.59

	HSBC Private Banking Holdings (Suisse)	**1,886**	**14**	**0.74**	2,603	15	0.58	4,451	43	0.97
	HSBC France	**36,023**	**477**	**1.32**	47,094	337	0.72	37,239	440	1.18
Hong Kong	Hang Seng Bank	**17,761**	**334**	**1.88**	14,884	222	1.49	16,626	202	1.21
	The Hongkong and Shanghai Banking Corporation	**22,033**	**233**	**1.06**	16,544	117	0.71	27,903	182	0.65
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**41,692**	**920**	**2.21**	30,288	464	1.53	23,107	326	1.41
	HSBC Bank Malaysia	**6,049**	**174**	**2.88**	5,113	126	2.46	3,776	81	2.15
MENA	HSBC Bank Middle East	**4,467**	**42**	**0.94**	5,335	60	1.12	4,312	52	1.21
North America	HSBC Bank USA	**27,495**	**97**	**0.35**	28,653	103	0.36	2,338	94	4.02
	HSBC Bank Canada	**2,886**	**23**	**0.80**	3,823	16	0.42	2,934	10	0.34
Latin America	HSBC Mexico	**3,383**	**130**	**3.84**	3,238	129	3.98	3,722	149	4.00
	Brazilian operations[72]	**18,954**	**2,036**	**10.74**	16,102	1,525	9.47	10,490	1,003	9.56
	HSBC Bank Panama	**1,138**	**10**	**0.88**	959	8	0.83	1,187	10	0.84
	HSBC Bank Argentina	**341**	**33**	**9.68**	169	20	11.83	256	29	11.33
Other operations		**15,152**	**151**	**1.00**	14,196	123	0.87	15,782	199	1.26
		261,749	**5,860**	**2.24**	236,742	4,555	1.92	192,578	4,199	2.18

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Report of the Directors: Operating and Financial Review (continued)

		2011 Average balance US$m	2011 Interest income US$m	2011 Yield %	2010 Average balance US$m	2010 Interest income US$m	2010 Yield %	2009 Average balance US$m	2009 Interest income US$m	2009 Yield %
Loans and advances to customers										
Europe	HSBC Bank	**299,775**	**10,225**	**3.41**	265,163	9,761	3.68	276,602	10,898	3.94
	HSBC Private Banking Holdings (Suisse)	**14,631**	**255**	**1.74**	11,987	191	1.59	9,993	176	1.76
	HSBC France	**75,033**	**2,087**	**2.78**	66,910	1,684	2.52	71,048	1,932	2.72
	HSBC Finance	**1,486**	**98**	**6.59**	2,251	198	8.80	3,094	319	10.31
Hong Kong	Hang Seng Bank	**63,198**	**1,569**	**2.48**	51,028	1,313	2.57	42,619	1,194	2.80
	The Hongkong and Shanghai Banking Corporation	**91,209**	**1,975**	**2.17**	65,226	1,755	2.69	55,287	1,757	3.18
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**99,683**	**4,863**	**4.88**	81,080	3,928	4.84	66,262	3,668	5.54
	HSBC Bank Malaysia	**12,118**	**657**	**5.42**	9,614	531	5.52	8,113	455	5.61
MENA	HSBC Bank Middle East	**22,494**	**1,296**	**5.76**	21,193	1,303	6.15	22,612	1,593	7.04
North America	HSBC Bank USA	**67,817**	**3,226**	**4.76**	78,556	4,582	5.83	98,422	5,541	5.63
	HSBC Finance	**59,857**	**5,842**	**9.76**	78,105	7,741	9.91	101,132	9,941	9.83
	HSBC Bank Canada	**44,512**	**1,683**	**3.78**	46,360	1,643	3.54	43,072	1,499	3.48
Latin America	HSBC Mexico	**14,290**	**1,630**	**11.41**	12,309	1,571	12.76	12,185	1,708	14.02
	Brazilian operations[72]	**30,212**	**6,584**	**21.79**	23,366	5,118	21.90	18,704	4,494	24.03
	HSBC Bank Panama	**10,346**	**833**	**8.05**	9,348	815	8.72	9,302	864	9.29
	HSBC Bank Argentina	**3,320**	**524**	**15.78**	2,460	367	14.92	1,940	357	18.40
Other operations		**35,307**	**1,903**	**5.39**	33,543	1,685	5.02	29,670	1,905	6.42
		945,288	**45,250**	**4.79**	858,499	44,186	5.15	870,057	48,301	5.55
Financial investments										
Europe	HSBC Bank	**95,522**	**1,631**	**1.71**	85,206	1,725	2.02	79,763	2,321	2.91
	HSBC Private Banking Holdings (Suisse)	**13,521**	**247**	**1.83**	17,013	287	1.69	15,602	363	2.33
	HSBC France	**4,662**	**133**	**2.85**	4,017	102	2.54	5,327	141	2.65
Hong Kong	Hang Seng Bank	**26,095**	**596**	**2.28**	30,334	541	1.78	24,594	630	2.56
	The Hongkong and Shanghai Banking Corporation	**52,357**	**399**	**0.76**	65,256	477	0.73	52,965	644	1.22
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**40,033**	**1,422**	**3.55**	37,833	1,161	3.07	34,056	1,039	3.05
	HSBC Bank Malaysia	**1,013**	**33**	**3.26**	911	28	3.07	1,218	37	3.04
MENA	HSBC Bank Middle East	**10,944**	**150**	**1.37**	8,086	126	1.56	6,996	118	1.69
North America	HSBC Bank USA	**50,357**	**1,250**	**2.48**	38,541	1,156	3.00	27,253	969	3.56
	HSBC Finance	**2,956**	**104**	**3.52**	2,834	116	4.09	2,426	120	4.95
	HSBC Bank Canada	**17,821**	**307**	**1.72**	14,310	257	1.80	10,282	205	1.99
Latin America	HSBC Mexico	**9,767**	**473**	**4.84**	7,177	388	5.41	3,916	227	5.80
	Brazilian operations[72]	**10,072**	**1,206**	**11.97**	9,564	1,089	11.39	6,930	820	11.83
	HSBC Bank Panama	**1,147**	**50**	**4.36**	996	38	3.82	604	39	6.46
	HSBC Bank Argentina	**651**	**99**	**15.21**	370	58	15.68	181	35	19.34
Other operations		**47,141**	**2,129**	**4.52**	56,523	1,826	3.23	50,767	1,717	3.38
		384,059	**10,229**	**2.66**	378,971	9,375	2.47	322,880	9,425	2.92

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Assets (continued)

		2011			2010			2009		
		Average balance US$m	**Interest income US$m**	**Yield %**	Average balance US$m	Interest income US$m	Yield %	Average balance US$m	Interest income US$m	Yield %
Other interest-earning assets										
Europe	HSBC Bank	**53,394**	**101**	**0.19**	14,255	100	0.70	17,406	188	1.08
	HSBC Private Banking Holdings (Suisse)	**19,568**	**262**	**1.34**	17,738	241	1.36	21,450	360	1.68
	HSBC France	**10,037**	**160**	**1.59**	9,954	93	0.93	11,867	172	1.45
Hong Kong	Hang Seng Bank	**854**	**9**	**1.05**	1,077	13	1.21	2,618	32	1.22
	The Hongkong and Shanghai Banking Corporation	**32,917**	**383**	**1.16**	27,112	260	0.96	26,657	214	0.80
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**15,414**	**53**	**0.34**	18,476	55	0.30	19,917	106	0.53
	HSBC Bank Malaysia	**578**	**8**	**1.38**	745	14	1.88	407	6	1.47
MENA	HSBC Bank Middle East	**698**	**22**	**3.15**	1,272	46	3.62	541	46	8.50
North America	HSBC Bank USA	**15,187**	**903**	**5.95**	3,467	58	1.67	3,327	71	2.13
	HSBC Finance	**6,014**	**671**	**11.16**	2,895	7	0.24	2,995	6	0.20
	HSBC Bank Canada	**3,109**	**59**	**1.90**	1,287	20	1.55	773	9	1.16
Latin America	HSBC Mexico	**383**	**27**	**7.05**	158	9	5.70	138		
	Brazilian operations[72]	**2,031**	**54**	**2.66**	1,170	80	6.84	1,074	46	4.28
	HSBC Bank Panama	**804**	**10**	**1.24**	1,234	12	0.97	1,372	9	0.66
	HSBC Bank Argentina	**88**			87			51		
Other operations		**(129,514)**	**(1,056)**		(102,845)	(779)		(111,403)	(1,094)	
		31,562	**1,666**	**5.28**	(1,918)	229	(11.94)	(810)	171	(21.11)
Total interest-earning assets										
Europe	HSBC Bank	**511,180**	**13,143**	**2.57**	412,365	12,876	3.12	412,226	14,786	3.59
	HSBC Private Banking Holdings (Suisse)	**49,606**	**778**	**1.57**	49,341	734	1.49	51,496	942	1.83
	HSBC France	**125,755**	**2,857**	**2.27**	127,975	2,216	1.73	125,481	2,685	2.14
	HSBC Finance	**1,486**	**98**	**6.59**	2,251	198	8.80	3,094	319	10.31

Hong Kong	Hang Seng Bank	**107,908**	**2,508**	**2.32**	97,323	2,089	2.15	86,457	2,058	2.38
	The Hongkong and Shanghai Banking Corporation	**198,516**	**2,990**	**1.51**	174,138	2,609	1.50	162,812	2,797	1.72
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**196,822**	**7,258**	**3.69**	167,677	5,608	3.34	143,342	5,139	3.59
	HSBC Bank Malaysia	**19,758**	**872**	**4.41**	16,383	699	4.27	13,514	579	4.28
MENA	HSBC Bank Middle East	**38,603**	**1,510**	**3.91**	35,886	1,535	4.28	34,461	1,809	5.25
North America	HSBC Bank USA	**160,856**	**5,476**	**3.40**	149,217	5,899	3.95	131,340	6,675	5.08
	HSBC Finance	**68,827**	**6,617**	**9.61**	83,834	7,864	9.38	106,553	10,067	9.45
	HSBC Bank Canada	**68,328**	**2,072**	**3.03**	65,780	1,936	2.94	57,061	1,723	3.02
Latin America	HSBC Mexico	**27,823**	**2,260**	**8.12**	22,882	2,097	9.16	19,961	2,084	10.44
	Brazilian operations[72]	**61,269**	**9,880**	**16.13**	50,202	7,812	15.56	37,198	6,363	17.11
	HSBC Bank Panama	**13,435**	**903**	**6.72**	12,537	873	6.96	12,465	922	7.40
	HSBC Bank Argentina	**4,400**	**656**	**14.91**	3,086	445	14.42	2,428	421	17.34
Other operations		**(31,914)**	**3,127**		1,417	2,855		(15,184)	2,727	
		1,622,658	**63,005**	**3.88**	1,472,294	58,345	3.96	1,384,705	62,096	4.48

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Equity and liabilities

		2011			2010			2009		
		Average balance US$m	Interest expense US$m	Cost %	Average balance US$m	Interest expense US$m	Cost %	Average balance US$m	Interest expense US$m	Cost %
Summary										
Total interest-bearing liabilities (itemised below)		**1,433,566**	**22,343**	**1.56**	1,339,390	18,904	1.41	1,353,283	21,366	1.58
Trading liabilities and financial liabilities designated at fair value (excluding own debt issued)		**355,345**	**4,564**	**1.28**	275,804	3,780	1.37	221,358	4,280	1.93
Non-interest bearing current accounts		**162,369**			142,579			123,271		
Total equity and other non-interest bearing liabilities		**815,643**			741,127			748,074		
Total equity and liabilities		**2,766,923**	**26,907**	**0.97**	2,498,900	22,684	0.91	2,445,986	25,646	1.05
Deposits by banks[73]										
Europe	HSBC Bank	**33,764**	**529**	**1.57**	32,850	260	0.79	35,207	553	1.57
	HSBC Private Banking Holdings (Suisse)	**874**	**2**	**0.23**	964	2	0.21	1,063	1	0.09
	HSBC France	**29,329**	**396**	**1.35**	42,399	340	0.80	43,682	536	1.23
Hong Kong	Hang Seng Bank	**1,903**	**7**	**0.37**	1,456	4	0.27	1,051	5	0.48
	The Hongkong and Shanghai Banking Corporation	**8,389**	**13**	**0.15**	5,691	10	0.18	6,892	9	0.13
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**10,613**	**159**	**1.50**	9,540	131	1.37	10,710	165	1.54
	HSBC Bank Malaysia	**360**	**9**	**2.50**	164	4	2.44	110	2	1.82
MENA	HSBC Bank Middle East	**1,511**	**6**	**0.40**	762	6	0.79	773	9	1.16
North America	HSBC Bank USA	**7,730**	**18**	**0.23**	8,693	26	0.30	8,381	9	0.11
	HSBC Bank Canada	**760**	**15**	**1.97**	946	5	0.53	1,405	8	0.57
Latin America	HSBC Mexico	**1,167**	**62**	**5.31**	1,002	51	5.09	1,462	49	3.35
	Brazilian operations[72]	**6,433**	**331**	**5.15**	3,610	247	6.84	3,292	241	7.32
	HSBC Bank Panama	**802**	**18**	**2.24**	612	18	2.94	908	26	2.86
	HSBC Bank Argentina	**24**	**2**	**8.33**	17	1	5.88	12	1	8.33
Other operations		**2,440**	**24**	**0.98**	2,737	31	1.13	2,899	45	1.55
		106,099	**1,591**	**1.50**	111,443	1,136	1.02	117,847	1,659	1.41
Financial liabilities designated at fair value own debt issued[74]										
Europe	HSBC Holdings	**19,654**	**342**	**1.74**	16,577	308	1.86	17,887	369	2.06

	HSBC Bank	**26,504**	**462**	**1.74**	15,169	270	1.78	7,932	196	2.47
	HSBC France	**6,907**	**174**	**2.52**	7,154	113	1.58	5,108	128	2.51
Hong Kong	Hang Seng Bank				63			130	2	1.54
North America	HSBC Bank USA	**1,642**	**38**	**2.31**	1,721	25	1.45	1,615	30	1.86
	HSBC Finance	**17,108**	**289**	**1.69**	24,740	528	2.13	26,628	871	3.27
Other operations		**1,820**	**8**	**0.44**	1,282	27	2.11	921	(38)	(4.13)
		73,635	**1,313**	**1.78**	66,706	1,271	1.91	60,221	1,558	2.59

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Equity and liabilities (continued)

		2011 Average balance US$m	2011 Interest expense US$m	2011 Cost %	2010 Average Balance US$m	2010 Interest expense US$m	2010 Cost %	2009 Average balance US$m	2009 Interest expense US$m	2009 Cost %
Customer accounts[75]										
Europe	HSBC Bank	**306,060**	**2,387**	**0.78**	275,153	2,042	0.74	274,949	2,407	0.88
	HSBC Private Banking Holdings (Suisse)	**22,025**	**163**	**0.74**	20,530	144	0.70	27,250	256	0.94
	HSBC France	**49,363**	**650**	**1.32**	50,096	377	0.75	61,465	645	1.05
Hong Kong	Hang Seng Bank	**83,220**	**342**	**0.41**	76,708	205	0.27	71,140	200	0.28
	The Hongkong and Shanghai Banking Corporation	**177,336**	**231**	**0.13**	160,794	146	0.09	150,520	211	0.14
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**121,237**	**2,277**	**1.88**	104,648	1,696	1.62	92,305	1,494	1.62
	HSBC Bank Malaysia	**13,326**	**299**	**2.24**	11,213	220	1.96	9,658	191	1.98
MENA	HSBC Bank Middle East	**17,484**	**237**	**1.36**	15,906	284	1.79	18,726	432	2.31
North America	HSBC Bank USA	**83,988**	**340**	**0.40**	85,946	540	0.63	85,007	975	1.15
	HSBC Bank Canada	**44,833**	**358**	**0.80**	41,153	304	0.74	35,051	385	1.10
Latin America	HSBC Mexico	**18,139**	**538**	**2.97**	14,127	398	2.82	11,636	391	3.36
	Brazilian operations[72]	**41,194**	**4,471**	**10.85**	36,727	3,502	9.54	28,605	2,946	10.30
	HSBC Bank Panama	**8,915**	**294**	**3.30**	8,771	321	3.66	8,592	353	4.11
	HSBC Bank Argentina	**3,149**	**200**	**6.35**	2,538	97	3.82	2,151	99	4.60
Other operations		**68,057**	**669**	**0.98**	58,303	502	0.86	63,863	361	0.57
		1,058,326	**13,456**	**1.27**	962,613	10,778	1.12	940,918	11,346	1.21
Debt securities in issue										
Europe	HSBC Bank	**79,670**	**982**	**1.23**	62,735	1,130	1.80	72,955	1,305	1.79
	HSBC France	**18,043**	**260**	**1.44**	20,686	160	0.77	25,065	330	1.32
Hong Kong	Hang Seng Bank	**1,424**	**13**	**0.91**	1,034	13	1.26	1,220	21	1.72
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**7,918**	**263**	**3.32**	5,558	218	3.92	5,409	218	4.03
	HSBC Bank Malaysia	**568**	**18**	**3.17**	389	15	3.86	403	16	3.97

MENA	HSBC Bank Middle East	**3,870**	**77**	**1.99**	3,940	63	1.60	2,988	62	2.07
North America	HSBC Bank USA	**12,535**	**395**	**3.15**	12,680	375	2.96	20,968	590	2.81
	HSBC Finance	**40,629**	**1,413**	**3.48**	48,561	1,766	3.64	63,563	2,510	3.95
	HSBC Bank Canada	**12,061**	**392**	**3.25**	13,205	343	2.60	12,825	322	2.51
Latin America	HSBC Mexico	**1,074**	**57**	**5.31**	922	51	5.53	1,460	67	4.59
	Brazilian operations[72]	**6,825**	**708**	**10.37**	2,112	151	7.15	1,568	86	5.48
	HSBC Bank Panama	**601**	**29**	**4.83**	771	40	5.19	487	34	6.98
	HSBC Bank Argentina	**66**	**11**	**16.67**	4			1		
Other operations		**(3,802)**	**642**	**(16.89)**	17,301	606	3.50	16,745	340	2.03
		181,482	**5,260**	**2.90**	189,898	4,931	2.60	225,657	5,901	2.62

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		2011			2010			2009		
		Average balance US$m	Interest expense US$m	Cost %	Average balance US$m	Interest expense US$m	Cost %	Average balance US$m	Interest expense US$m	Cost %
Other interest-bearing liabilities										
Europe	HSBC Bank	**66,449**	**595**	**0.90**	28,269	434	1.54	50,247	655	1.30
	HSBC Private Banking Holdings (Suisse)	**3,006**	**8**	**0.27**	2,921	7	0.24	3,892	18	0.46
	HSBC France	**20,294**	**170**	**0.84**	16,668	78	0.47	24,699	187	0.76
	HSBC Finance	**828**	**6**	**0.72**	1,595	15	0.94	2,363	59	2.50
Hong Kong	Hang Seng Bank	**1,422**	**25**	**1.76**	829	5	0.60	789	5	0.63
	The Hongkong and Shanghai Banking Corporation	**12,759**	**72**	**0.56**	8,580	55	0.64	12,815	105	0.82
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**35,562**	**361**	**1.02**	34,027	248	0.73	19,447	177	0.91
	HSBC Bank Malaysia	**1,121**	**17**	**1.52**	706	8	1.13	266	2	0.75
MENA	HSBC Bank Middle East	**1,506**	**50**	**3.32**	1,496	63	4.21	1,748	68	3.89
North America	HSBC Bank USA	**23,431**	**820**	**3.50**	14,669	609	4.15	9,754	368	3.77
	HSBC Finance	**4,345**	**29**	**0.67**	3,487	102	2.93	4,051	102	2.52
	HSBC Bank Canada	**360**	**2**	**0.56**	1,806	3	0.17	1,149	6	0.52
	HSBC Markets Inc	**2,193**	**40**	**1.82**	1,266	25	1.97	1,716	36	2.10
Latin America	HSBC Mexico	**1,379**	**22**	**1.60**	804	13	1.62	301	11	3.65
	Brazilian operations[72]	**4,223**	**335**	**7.93**	2,803	316	11.27	1,496	130	8.69
	HSBC Bank Panama	**717**	**14**	**1.95**	108	1	0.93	192	2	1.04
	HSBC Bank Argentina	**15**	**1**	**6.67**	4			36	1	2.78
Other operations		**(165,586)**	**(1,844)**		(111,308)	(1,194)		(126,321)	(1,030)	
		14,024	**723**	**5.16**	8,730	788	9.03	8,640	902	10.44
Total interest-bearing liabilities										
Europe	HSBC Bank	**512,447**	**4,955**	**0.97**	414,176	4,136	1.00	441,290	5,116	1.16
	HSBC Private Banking Holdings (Suisse)	**25,905**	**173**	**0.67**	24,415	153	0.63	32,205	275	0.85
	HSBC France	**123,936**	**1,650**	**1.33**	137,003	1,068	0.78	160,019	1,826	1.14
	HSBC Finance	**828**	**6**	**0.72**	1,595	15	0.94	2,363	59	2.50

Hong Kong	Hang Seng Bank	**87,969**	**387**	**0.44**	80,090	227	0.28	74,330	233	0.31
	The Hongkong and Shanghai Banking Corporation	**198,484**	**316**	**0.16**	175,065	211	0.12	170,227	325	0.19
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**175,330**	**3,060**	**1.75**	153,773	2,293	1.49	127,871	2,054	1.61
	HSBC Bank Malaysia	**15,375**	**343**	**2.23**	12,472	247	1.98	10,437	211	2.02
MENA	HSBC Bank Middle East	**24,371**	**370**	**1.52**	22,104	416	1.88	24,235	571	2.36
North America	HSBC Bank USA	**129,326**	**1,611**	**1.25**	123,709	1,575	1.27	125,725	1,972	1.57
	HSBC Finance	**62,082**	**1,731**	**2.79**	76,788	2,396	3.12	94,242	3,483	3.70
	HSBC Bank Canada	**58,014**	**767**	**1.32**	57,110	655	1.15	50,430	721	1.43
	HSBC Markets Inc	**2,193**	**40**	**1.82**	1,266	25	1.97	1,716	36	2.10
Latin America	HSBC Mexico	**21,759**	**679**	**3.12**	16,855	513	3.04	14,859	518	3.49
	Brazilian operations[72]	**58,675**	**5,845**	**9.96**	45,252	4,216	9.32	34,961	3,403	9.73
	HSBC Bank Panama	**11,035**	**355**	**3.22**	10,262	379	3.69	10,179	415	4.08
	HSBC Bank Argentina	**3,254**	**217**	**6.67**	2,563	98	3.82	2,200	101	4.59
Other operations		**(77,417)**	**(162)**		(15,108)	281		(24,006)	47	
		1,433,566	**22,343**	**1.56**	1,339,390	18,904	1.41	1,353,283	21,366	1.58

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Net interest margin[76]

		2011 %	2010 %	2009 %
Total		**2.51**	2.68	2.94
Europe	HSBC Bank	**1.60**	2.12	2.35
	HSBC Private Banking Holdings (Suisse)	**1.22**	1.18	1.30
	HSBC France	**0.96**	0.90	0.68
	HSBC Finance	**6.19**	8.13	8.40
Hong Kong	Hang Seng Bank	**1.97**	1.91	2.11
	The Hongkong and Shanghai Banking Corporation	**1.35**	1.38	1.52
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**2.13**	1.98	2.15
	HSBC Bank Malaysia	**2.68**	2.76	2.72
MENA	HSBC Bank Middle East	**2.95**	3.12	3.59
North America	HSBC Bank USA	**2.40**	2.90	3.58
	HSBC Finance	**7.10**	6.52	6.18
	HSBC Bank Canada	**1.91**	1.95	1.76
Latin America	HSBC Mexico	**5.68**	6.92	7.85
	Brazilian operations[72]	**6.59**	7.16	7.96
	HSBC Bank Panama	**4.08**	3.94	4.07
	HSBC Bank Argentina	**9.98**	11.24	13.18

Distribution of average total assets

		2011 %	2010 %	2009 %
Europe	HSBC Bank	**41.5**	37.5	36.7
	HSBC Private Banking Holdings (Suisse)	**2.1**	2.2	2.3
	HSBC France	**10.3**	12.9	15.0
	HSBC Finance	**0.1**	0.1	
Hong Kong	Hang Seng Bank	**4.5**	4.5	4.2
	The Hongkong and Shanghai Banking Corporation	**11.0**	10.7	10.5
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**10.6**	9.4	8.5
	HSBC Bank Malaysia	**0.8**	0.7	0.6
MENA	HSBC Bank Middle East	**1.6**	1.6	1.6
North America	HSBC Bank USA	**9.7**	9.7	11.0
	HSBC Finance	**2.7**	3.6	4.5
	HSBC Bank Canada	**3.0**	3.0	2.7
Latin America	HSBC Mexico	**1.5**	1.4	1.4
	Brazilian operations[72]	**3.0**	2.6	2.1
	HSBC Bank Panama	**0.5**	0.6	0.6
	HSBC Bank Argentina	**0.2**	0.2	0.2
Other operations (including consolidation adjustments)		**(3.1)**	(0.7)	(1.9)
		100.0	100.0	100.0

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Analysis of changes in net interest income and net interest expense

The following tables allocate changes in net interest income and net interest expense between volume and rate for 2011 compared with 2010, and for 2010 compared with 2009.

Interest income

			Increase/(decrease) in 2011 compared with 2010			Increase/(decrease) in 2010 compared with 2009		
		2011	**Volume**	**Rate**	2010	Volume	Rate	2009
		US$m	**US$m**	**US$m**	US$m	US$m	US$m	US$m
Short-term funds and loans and advances to banks								
Europe	HSBC Bank	**1,186**	**398**	**(502)**	1,290	333	(422)	1,379
	HSBC Private Banking Holdings (Suisse)	**14**	**(4)**	**3**	15	(18)	(10)	43
	HSBC France	**477**	**(80)**	**220**	337	116	(219)	440
Hong Kong	Hang Seng Bank	**334**	**43**	**69**	222	(21)	41	202
	The Hongkong and Shanghai Banking Corporation	**233**	**39**	**77**	117	(74)	9	182
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**920**	**174**	**282**	464	101	37	326
	HSBC Bank Malaysia	**174**	**23**	**25**	126	29	16	81
MENA	HSBC Bank Middle East	**42**	**(10)**	**(8)**	60	12	(4)	52
North America	HSBC Bank USA	**97**	**(4)**	**(2)**	103	1,058	(1,049)	94
	HSBC Bank Canada	**23**	**(4)**	**11**	16	3	3	10
Latin America	HSBC Mexico	**130**	**6**	**(5)**	129	(19)	(1)	149
	Brazilian operations[72]	**2,036**	**270**	**241**	1,525	537	(15)	1,003
	HSBC Bank Panama	**10**	**1**	**1**	8	(2)		10
	HSBC Bank Argentina	**33**	**20**	**(7)**	20	(10)	1	29
Other operations		**151**	**8**	**20**	123	(20)	(56)	199
		5,860	**480**	**825**	4,555	963	(607)	4,199
Loans and advances to customers								
Europe	HSBC Bank	**10,225**	**1,274**	**(810)**	9,761	(451)	(686)	10,898
	HSBC Private Banking Holdings (Suisse)	**255**	**42**	**22**	191	35	(20)	176
	HSBC France	**2,087**	**205**	**198**	1,684	(113)	(135)	1,932
	HSBC Finance	**98**	**(67)**	**(33)**	198	(87)	(34)	319
Hong Kong	Hang Seng Bank	**1,569**	**313**	**(57)**	1,313	235	(116)	1,194
	The Hongkong and Shanghai Banking Corporation	**1,975**	**699**	**(479)**	1,755	316	(318)	1,757
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**4,863**	**900**	**35**	3,928	821	(561)	3,668

	HSBC Bank Malaysia	**657**	**138**	**(12)**	531	84	(8)	455
MENA	HSBC Bank Middle East	**1,296**	**80**	**(87)**	1,303	(100)	(190)	1,593
North America	HSBC Bank USA	**3,226**	**(626)**	**(730)**	4,582	(1,118)	159	5,541
	HSBC Finance	**5,842**	**(1,808)**	**(91)**	7,741	(2,264)	64	9,941
	HSBC Bank Canada	**1,683**	**(65)**	**105**	1,643	114	30	1,499
Latin America	HSBC Mexico	**1,630**	**253**	**(194)**	1,571	17	(154)	1,708
	Brazilian operations[72]	**6,584**	**1,499**	**(33)**	5,118	1,120	(496)	4,494
	HSBC Bank Panama	**833**	**87**	**(69)**	815	4	(53)	864
	HSBC Bank Argentina	**524**	**128**	**29**	367	96	(86)	357
Other operations		**1,903**	**89**	**129**	1,685	249	(469)	1,905
		45,250	**4,470**	**(3,406)**	44,186	(641)	(3,474)	48,301

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Interest income (continued)

			Increase/(decrease) in 2011 compared with 2010			Increase/(decrease) in 2010 compared with 2009		
		2011		**Rate**	2010		Rate	2009
		US$m	**Volume US$m**	**US$m**	US$m	Volume US$m	US$m	US$m
Financial investments								
Europe	HSBC Bank	**1,631**	**208**	**(302)**	1,725	158	(754)	2,321
	HSBC Private Banking Holdings (Suisse)	**247**	**(59)**	**19**	287	33	(109)	363
	HSBC France	**133**	**16**	**15**	102	(35)	(4)	141
Hong Kong	Hang Seng Bank	**596**	**(75)**	**130**	541	147	(236)	630
	The Hongkong and Shanghai Banking Corporation	**399**	**(94)**	**16**	477	150	(317)	644
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**1,422**	**68**	**193**	1,161	115	7	1,039
	HSBC Bank Malaysia	**33**	**3**	**2**	28	(9)		37
MENA	HSBC Bank Middle East	**150**	**45**	**(21)**	126	18	(10)	118
North America	HSBC Bank USA	**1,250**	**354**	**(260)**	1,156	402	(215)	969
	HSBC Finance	**104**	**5**	**(17)**	116	20	(24)	120
	HSBC Bank Canada	**307**	**63**	**(13)**	257	80	(28)	205
Latin America	HSBC Mexico	**473**	**140**	**(55)**	388	189	(28)	227
	Brazilian operations[72]	**1,206**	**58**	**59**	1,089	312	(43)	820
	HSBC Bank Panama	**50**	**6**	**6**	38	25	(26)	39
	HSBC Bank Argentina	**99**	**44**	**(3)**	58	37	(14)	35
Other operations		**2,129**	**(303)**	**606**	1,826	195	(86)	1,717
		10,229	**126**	**728**	9,375	1,638	(1,688)	9,425

For footnotes, see page 95.

Interest expense

	Increase/(decrease) in 2011 compared with 2010			Increase/(decrease) in 2010 compared with 2009		
2011		**Rate**	2010		Rate	2009

		US$m	**Volume US$m**	**US$m**	US$m	Volume US$m	US$m	US$m
Deposits by banks								
Europe	HSBC Bank	**529**	**7**	**262**	260	(37)	(256)	553
	HSBC Private Banking Holdings (Suisse)	**2**			2		1	1
	HSBC France	**396**	**(105)**	**161**	340	(16)	(180)	536
Hong Kong	Hang Seng Bank	**7**	**1**	**2**	4	2	(3)	5
	The Hongkong and Shanghai Banking Corporation	**13**	**5**	**(2)**	10	(2)	3	9
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**159**	**15**	**13**	131	(18)	(16)	165
	HSBC Bank Malaysia	**9**	**5**		4	1	1	2
MENA	HSBC Bank Middle East	**6**	**6**	**(6)**	6		(3)	9
North America	HSBC Bank USA	**18**	**(3)**	**(5)**	26		17	9
	HSBC Bank Canada	**15**	**(1)**	**11**	5	(3)		8
Latin America	HSBC Mexico	**62**	**8**	**3**	51	(15)	17	49
	Brazilian operations[72]	**331**	**193**	**(109)**	247	23	(17)	241
	HSBC Bank Panama	**18**	**6**	**(6)**	18	(8)		26
	HSBC Bank Argentina	**2**		**1**	1			1
Other operations		**24**	**(3)**	**(4)**	31	(3)	(11)	45
		1,591	**(55)**	**510**	1,136	(90)	(433)	1,659

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			Increase/(decrease) in 2011 compared with 2010			Increase/(decrease) in 2010 compared with 2009		
		2011	**Volume**	**Rate**	2010	Volume	Rate	2009
		US$m	**US$m**	**US$m**	US$m	US$m	US$m	US$m
Customer accounts								
Europe	HSBC Bank	**2,387**	**229**	**116**	2,042	2	(367)	2,407
	HSBC Private Banking Holdings (Suisse)	**163**	**10**	**9**	144	(63)	(49)	256
	HSBC France	**650**	**(5)**	**278**	377	(119)	(149)	645
Hong Kong	Hang Seng Bank	**342**	**18**	**119**	205	16	(11)	200
	The Hongkong and Shanghai Banking Corporation	**231**	**15**	**70**	146	14	(79)	211
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**2,277**	**269**	**312**	1,696	200	2	1,494
	HSBC Bank Malaysia	**299**	**41**	**38**	220	31	(2)	191
MENA	HSBC Bank Middle East	**237**	**28**	**(75)**	284	(65)	(83)	432
North America	HSBC Bank USA	**340**	**(12)**	**(188)**	540	11	(446)	975
	HSBC Bank Canada	**358**	**27**	**27**	304	67	(148)	385
Latin America	HSBC Mexico	**538**	**113**	**27**	398	84	(77)	391
	Brazilian operations[72]	**4,471**	**426**	**543**	3,502	837	(281)	2,946
	HSBC Bank Panama	**294**	**5**	**(32)**	321	7	(39)	353
	HSBC Bank Argentina	**200**	**23**	**80**	97	18	(20)	99
Other operations		**669**	**84**	**83**	502	(32)	173	361
		13,456	**1,072**	**1,606**	10,778	263	(831)	11,346
Financial liabilities designated at fair value own debt issued		**1,313**	**132**	**(90)**	1,271	168	(455)	1,558
Debt securities in issue								
Europe	HSBC Bank	**982**	**305**	**(453)**	1,130	(183)	8	1,305

	HSBC France	**260**	**(20)**	**120**	160	(58)	(112)	330
Hong Kong	Hang Seng Bank	**13**	**5**	**(5)**	13	(3)	(5)	21
Rest of Asia-Pacific	The Hongkong and Shanghai Banking Corporation	**263**	**93**	**(48)**	218	6	(6)	218
	HSBC Bank Malaysia	**18**	**7**	**(4)**	15	(1)		16
MENA	HSBC Bank Middle East	**77**	**(1)**	**15**	63	20	(19)	62
North America	HSBC Bank USA	**395**	**(4)**	**24**	375	(233)	18	590
	HSBC Finance	**1,413**	**(289)**	**(64)**	1,766	(593)	(151)	2,510
	HSBC Bank Canada	**392**	**(30)**	**79**	343	10	11	322
Latin America	HSBC Mexico	**57**	**8**	**(2)**	51	(25)	9	67
	Brazilian operations[72]	**708**	**337**	**220**	151	30	35	86
	HSBC Bank Panama	**29**	**(9)**	**(2)**	40	20	(14)	34
	HSBC Bank Argentina	**11**		**11**				
Other operations		**642**	**(739)**	**775**	606	11	255	340
		5,260	**(219)**	**548**	4,931	(937)	(33)	5,901

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Short-term borrowings

We include short-term borrowings within customer accounts, deposits by banks and debt securities in issue and do not show short-term borrowings separately on the balance sheet. Short-term borrowings are defined by the US Securities and

Exchange Commission as Federal funds purchased and securities sold under agreements to repurchase, commercial paper and other short-term borrowings. Our only significant short-term borrowings are securities sold under agreements to repurchase and certain debt securities in issue. Additional information on these is provided in the table below.

Repos and short-term bonds

	2011 US$m	2010 US$m	2009 US$m
Securities sold under agreements to repurchase			
Outstanding at 31 December	**135,239**	159,256	152,218
Average amount outstanding during the year	**236,290**	175,955	170,671
Maximum quarter-end balance outstanding during the year	**202,305**	193,319	157,778
Weighted average interest rate during the year	**0.6%**	0.5%	0.8%
Weighted average interest rate at the year-end	**1.0%**	0.9%	0.4%
Short-term bonds			
Outstanding at 31 December	**35,415**	44,152	38,776
Average amount outstanding during the year	**40,679**	37,981	33,010
Maximum quarter-end balance outstanding during the year	**42,785**	44,152	38,776
Weighted average interest rate during the year	**1.9%**	2.9%	3.2%
Weighted average interest rate at the year-end	**2.2%**	4.5%	0.6%

Contractual obligations

The table below provides details of our material contractual obligations as at 31 December 2011.

Payments due by period				
Total US$m	**Less than 1 year US$m**	**1 3 years US$m**	**3 5 years US$m**	**More than 5 years US$m**
225,851	**67,107**	**44,345**	**46,839**	**67,560**

Long-term debt obligations					
Term deposits and certificates of deposit	**204,376**	**186,220**	**8,296**	**8,468**	**1,392**
Capital (finance) lease obligations	**676**	**98**	**182**	**34**	**362**
Operating lease obligations	**6,318**	**1,148**	**1,561**	**1,113**	**2,496**
Purchase obligations	**715**	**356**	**186**	**173**	
Short positions in debt securities and equity shares	**64,355**	**48,355**	**1,827**	**2,013**	**12,160**
Current tax liability	**2,117**	**2,117**			
Pension/healthcare obligation	**17,890**	**1,371**	**2,920**	**3,255**	**10,344**
	522,298	**306,772**	**59,317**	**61,895**	**94,314**

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Loan maturity and interest sensitivity analysis

At 31 December 2011, the geographical analysis of loan maturity and interest sensitivity by loan type on a contractual repayment basis was as follows:

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
Maturity of 1 year or less							
Loans and advances to banks	51,768	32,895	46,381	8,197	14,339	17,677	171,257
Commercial loans to customers							
Manufacturing and international trade and services	72,711	28,998	38,573	9,406	7,513	15,400	172,601
Real estate and other property related	14,519	10,901	6,090	1,884	6,007	2,100	41,501
Non-bank financial institutions	57,610	2,354	1,965	825	8,487	839	72,080
Governments	2,355	139	654	1,056	407	329	4,940
Other commercial	28,737	3,684	7,973	2,237	6,188	3,364	52,183
	175,932	46,076	55,255	15,408	28,602	22,032	343,305
Hong Kong Government Home Ownership Scheme		344					344
Residential mortgages and other personal loans	29,634	16,681	12,705	1,887	13,619	9,271	83,797
Loans and advances to customers	205,566	63,101	67,960	17,295	42,221	31,303	427,446
	257,334	95,996	114,341	25,492	56,560	48,980	598,703
Maturity after 1 year but within 5 years							
Loans and advances to banks	2,538	1,415	892	302	482	885	6,514
Commercial loans to customers							
Manufacturing and international trade and services	28,098	8,355	7,414	2,412	9,401	6,443	62,123
Real estate and other property related	18,145	19,607	8,978	794	4,213	1,441	53,178
Non-bank financial institutions	4,909	786	947	331	3,226	987	11,186
Governments	330	2,195	227	452	234	757	4,195
Other commercial	14,634	6,389	5,900	1,525	2,682	3,087	34,217
	66,116	37,332	23,466	5,514	19,756	12,715	164,899
Hong Kong Government Home Ownership Scheme		1,128					1,128
Residential mortgages and other personal loans	34,843	12,010	8,502	1,392	21,714	5,499	83,960
Loans and advances to customers	100,959	50,470	31,968	6,906	41,470	18,214	249,987
	103,497	51,885	32,860	7,208	41,952	19,099	256,501
Interest rate sensitivity of loans and advances to banks and commercial loans to customers							
Fixed interest rate	13,308	100	1,551	1,563	5,389	3,869	25,780
Variable interest rate	55,346	38,647	22,807	4,253	14,849	9,731	145,633
	68,654	38,747	24,358	5,816	20,238	13,600	171,413
Maturity after 5 years							
Loans and advances to banks	100	849	36	72	10	2,274	3,341
Commercial loans to customers							
Manufacturing and international trade and services	9,427	717	527	363	1,684	1,321	14,039

Real estate and other property related	**7,030**	**7,687**	**865**	**94**	**2,578**	**547**	**18,801**
Non-bank financial institutions	**794**	**52**	**25**	**6**	**1,104**	**28**	**2,009**
Governments	**458**	**584**	**81**	**55**	**15**	**751**	**1,944**
Other commercial	**13,674**	**2,617**	**851**	**880**	**853**	**443**	**19,318**
	31,383	**11,657**	**2,349**	**1,398**	**6,234**	**3,090**	**56,111**
Hong Kong Government Home Ownership Scheme		**1,829**					**1,829**
Residential mortgages and other personal loans	**101,670**	**31,189**	**22,373**	**1,990**	**60,003**	**5,342**	**222,567**
Loans and advances to customers	**133,053**	**44,675**	**24,722**	**3,388**	**66,237**	**8,432**	**280,507**
	133,153	**45,524**	**24,758**	**3,460**	**66,247**	**10,706**	**283,848**
Interest rate sensitivity of loans and advances to banks and commercial loans to customers							
Fixed interest rate	**6,661**	**867**	**94**	**1,154**	**1,600**	**665**	**11,041**
Variable interest rate	**24,822**	**11,639**	**2,291**	**316**	**4,644**	**4,699**	**48,411**
	31,483	**12,506**	**2,385**	**1,470**	**6,244**	**5,364**	**59,452**

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Deposits

The following tables summarise the average amount of bank deposits, customer deposits and certificates of deposit (CD s) and other money market instruments (which are included within Debt securities in issue in the balance sheet), together

with the average interest rates paid thereon for each of the past three years. The geographical analysis of average deposits is based on the location of the office in which the deposits are recorded and excludes balances with HSBC companies. The Other category includes securities sold under agreements to repurchase.

Deposits by banks

	2011		2010		2009	
	Average balance US$m	**Average rate %**	Average balance US$m	Average rate %	Average balance US$m	Average rate %
Europe	**75,890**		85,973		87,677	
Demand and other non-interest bearing	**10,788**		8,298		6,415	
Demand interest bearing	**16,492**	**0.8**	13,783	0.6	14,259	1.0
Time	**19,893**	**2.2**	28,337	0.9	30,367	1.6
Other	**28,717**	**1.3**	35,555	0.8	36,636	1.3
Hong Kong	**13,222**		10,000		10,725	
Demand and other non-interest bearing	**3,047**		2,860		2,975	
Demand interest bearing	**6,052**	**0.1**	4,787	0.2	5,526	0.1
Time	**3,347**	**0.3**	1,803	0.3	1,637	0.3
Other	**776**	**0.1**	550	0.7	587	0.5
Rest of Asia-Pacific	**13,650**		11,476		12,467	
Demand and other non-interest bearing	**2,535**		1,746		1,605	
Demand interest bearing	**5,802**	**1.2**	4,937	1.2	4,097	1.2
Time	**4,218**	**1.6**	3,626	1.5	4,682	1.9
Other	**1,095**	**3.0**	1,167	2.0	2,083	1.4
Middle East and North Africa	**2,060**		1,250		1,317	
Demand and other non-interest bearing	**548**		484		539	
Demand interest bearing	**20**		9		18	
Time	**1,424**	**0.4**	685	0.6	691	1.2
Other	**68**	**1.6**	72	1.2	69	1.4
North America	**11,904**		13,324		13,203	
Demand and other non-interest bearing	**2,367**		2,493		1,755	
Demand interest bearing	**3,849**	**0.1**	3,386	0.1	4,770	0.1
Time	**4,797**	**0.4**	4,716	0.4	5,422	0.2

Other	**891**	**1.3**	2,729	0.5	1,256	0.7
Latin America	**8,819**		5,523		5,959	
Demand and other non-interest bearing	**161**		222		212	
Demand interest bearing	**545**	**3.7**	322	4.3	219	0.9
Time	**4,924**	**4.3**	2,246	5.5	4,171	5.0
Other	**3,189**	**6.0**	2,733	6.6	1,357	8.1
Total	**125,545**		127,546		131,348	
Demand and other non-interest bearing	**19,446**		16,103		13,501	
Demand interest bearing	**32,760**	**0.7**	27,224	0.6	28,889	0.7
Time	**38,603**	**2.0**	41,413	1.1	46,970	1.7
Other	**34,736**	**1.7**	42,806	1.3	41,988	1.6

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Report of the Directors: Operating and Financial Review (continued)

Customer accounts

	2011		2010		2009	
	Average balance US$m	**Average rate %**	Average balance US$m	Average rate %	Average balance US$m	Average rate %
Europe	**467,393**		424,561		440,450	
Demand and other non-interest bearing	**72,743**		62,869		55,751	
Demand interest bearing	**220,314**	**0.4**	203,727	0.4	212,178	0.4
Savings	**57,070**	**1.7**	51,793	1.8	57,344	2.2
Time	**67,499**	**1.5**	60,140	1.2	67,045	1.4
Other	**49,767**	**0.7**	46,032	0.5	48,132	0.8
Hong Kong	**307,513**		280,733		261,703	
Demand and other non-interest bearing	**31,694**		27,412		22,056	
Demand interest bearing	**219,581**		202,330		171,846	0.1
Savings	**38,283**	**0.7**	37,119	0.5	45,537	0.6
Time	**16,910**	**1.0**	12,793	0.7	20,901	0.6
Other	**1,045**	**0.3**	1,079	0.2	1,363	0.1
Rest of Asia-Pacific	**170,008**		142,807		126,144	
Demand and other non-interest bearing	**19,283**		16,418		13,425	
Demand interest bearing	**74,636**	**1.1**	63,033	1.0	53,108	0.8
Savings	**63,500**	**2.8**	51,757	2.4	46,137	2.5
Time	**11,815**	**1.0**	10,734	0.9	12,542	1.2
Other	**774**	**2.2**	865	2.2	932	1.8
Middle East and North Africa	**36,105**		32,747		33,211	
Demand and other non-interest bearing	**13,016**		11,873		9,865	
Demand interest bearing	**9,887**	**0.6**	6,315	1.5	6,364	1.4
Savings	**12,596**	**3.2**	13,774	2.8	15,005	3.4
Time	**530**	**2.5**	604	2.6	1,424	2.7
Other	**76**		181	0.1	553	0.2
North America	**165,779**		157,361		145,820	
Demand and other non-interest bearing	**26,524**		22,235		18,350	
Demand interest bearing	**35,440**	**0.3**	28,569	0.2	25,870	0.2
Savings	**75,866**	**0.8**	78,040	0.8	69,296	1.4
Time	**13,835**	**0.4**	17,975	0.8	25,164	1.3
Other	**14,114**	**0.1**	10,542	0.6	7,140	0.8
Latin America	**89,603**		77,618		63,635	
Demand and other non-interest bearing	**14,815**		12,407		10,598	
Demand interest bearing	**8,374**	**1.7**	6,270	1.2	4,734	1.1
Savings	**47,197**	**9.8**	41,784	8.5	33,091	8.5
Time	**16,567**	**3.9**	15,716	3.9	14,244	4.8
Other	**2,650**	**7.2**	1,441	7.5	968	6.4
Total	**1,236,401**		1,115,827		1,070,963	
Demand and other non-interest bearing	**178,075**		153,214		130,045	

Demand interest bearing	**568,232**	**0.4**	510,244	0.3	474,100	0.3
Savings	**294,512**	**2.9**	274,267	2.5	266,410	2.6
Time	**127,156**	**1.6**	117,962	1.4	141,320	1.6
Other	**68,426**	**0.9**	60,140	0.7	59,088	0.9

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Certificates of deposit and other money market instruments

	2011		2010		2009	
	Average balance US$m	Average rate %	Average balance US$m	Average rate %	Average balance US$m	Average rate %
Europe	**46,641**	**0.6**	57,018	0.4	65,151	0.9
Hong Kong	**932**	**1.0**	213	3.8	278	3.6
Rest of Asia-Pacific	**3,951**	**3.4**	3,529	3.4	3,536	3.7
Middle East and North Africa			68	0.5	265	6.4
North America	**10,936**	**0.5**	10,607	0.5	14,218	1.1
Latin America	**5,499**	**9.2**	1,126	4.0	1,227	3.6
	67,959	**1.4**	72,561	0.6	84,675	1.2

Certificates of deposit and other time deposits

The maturity analysis of certificates of deposit (CD s) and other wholesale time deposits is expressed by remaining maturity. The majority of CDs and time deposits are in amounts of US$100,000 and over or the equivalent in other currencies.

	At 31 December 2011				
	3 months or less US$m	After 3 months but within 6 months US$m	After 6 months but within 12 months US$m	After 12 months US$m	Total US$m
Europe	**92,468**	**13,230**	**8,352**	**12,234**	**126,284**
Certificates of deposit	**14,622**	**6,050**	**189**		**20,861**
Time deposits:					
banks	**23,990**	**565**	**546**	**8,731**	**33,832**
customers	**53,856**	**6,615**	**7,617**	**3,503**	**71,591**
Hong Kong	**17,221**	**1,491**	**1,336**	**1,565**	**21,613**
Certificates of deposit	**205**	**3**	**547**	**829**	**1,584**
Time deposits:					
banks	**3,563**	**64**	**25**		**3,652**
customers	**13,453**	**1,424**	**764**	**736**	**16,377**
Rest of Asia-Pacific	**17,836**	**970**	**906**	**1,926**	**21,638**
Certificates of deposit	**2,133**	**541**	**232**	**1,054**	**3,960**
Time deposits:					
banks	**4,102**	**93**	**187**	**32**	**4,414**
customers	**11,601**	**336**	**487**	**840**	**13,264**

Middle East and North Africa	**1,738**	**116**	**94**	**85**	**2,033**
Time deposits:					
banks	**1,485**	**28**			**1,513**
customers	**253**	**88**	**94**	**85**	**520**
North America	**11,565**	**1,208**	**1,264**	**1,004**	**15,041**
Time deposits:					
banks	**5,034**	**40**	**2**	**198**	**5,274**
customers	**6,531**	**1,168**	**1,262**	**806**	**9,767**
Latin America	**12,396**	**1,961**	**2,069**	**1,341**	**17,767**
Certificates of deposit	**349**	**73**	**226**	**559**	**1,207**
Time deposits:					
banks	**1,588**	**1,004**	**938**	**213**	**3,743**
customers	**10,459**	**884**	**905**	**569**	**12,817**
Total	**153,224**	**18,976**	**14,021**	**18,155**	**204,376**
Certificates of deposit	**17,309**	**6,667**	**1,194**	**2,442**	**27,612**
Time deposits:					
banks	**39,762**	**1,794**	**1,698**	**9,174**	**52,428**
customers	**96,153**	**10,515**	**11,129**	**6,539**	**124,336**

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Economic profit/(loss)

Our internal performance measures include economic profit/(loss), a calculation which compares the return on financial capital invested in HSBC by our shareholders with the cost of that capital. We price our cost of capital internally and the difference between that cost and the post-tax profit attributable to ordinary shareholders represents the amount of economic profit/(loss) generated. In order to concentrate on external factors rather than measurement bases, we emphasise the trend in economic profit/(loss) ahead of absolute amounts.

Our long-term cost of capital is reviewed annually and is 11% for 2011; this remains unchanged from 2010. The following commentary is on a reported basis.

The return on invested capital increased by 1.5 percentage points to 10.2%, which was 0.8 percentage points lower than our benchmark cost of capital. Our economic loss was US$1.3bn, US$2.0bn less than the loss at 31 December 2010, reflecting an increase in profit attributable to shareholders. This was predominantly driven by a significant increase in the fair value of own debt and a lower tax charge.

The increase in average invested capital reflected higher retained earnings and an increase in average foreign exchange reserves, primarily due to the effect of euro and sterling exchange rate movements on our underlying assets.

	2011		2010	
	US$m	%[45]	US$m	%[45]
Average total shareholders equity	**156,129**		138,224	
Adjusted by:				
Goodwill previously amortised or written off	**8,123**		8,123	
Property revaluation reserves	**(914)**		(813)	
Reserves representing unrealised losses on effective cash flow hedges	**287**		100	
Reserves representing unrealised losses on available-for-sale securities	**3,379**		6,129	
Preference shares and other equity instruments	**(7,256)**		(5,473)	
Average invested capital[46]	**159,748**		146,290	
Return on invested capital[47]	**16,224**	**10.2**	12,746	8.7
Benchmark cost of capital	**(17,572)**	**(11.0)**	(16,092)	(11.0)
Economic loss and spread	**(1,348)**	**(0.8)**	(3,346)	(2.3)

For footnotes, see page 95.

Reconciliation of RoRWA measures

In addition to measuring return on average risk weighted assets (RoRWA) we measure our performance internally using underlying RoRWA, which is underlying profit before tax as a percentage of average risk weighted assets (RWA s) adjusted for the effects of foreign currency translation differences. Underlying RoRWA adjusts performance for certain items which distort year-on-year performance as explained on page

16.

We also present underlying RoRWA adjusted for the effect of legacy credit in GB&M (the legacy credit portfolio is described on page 23) and the US consumer finance business (the Cards and Retail Services business along with the run-off portfolio disclosed on page 88); together, the legacy businesses. This excludes the results and RWAs related to operations which are not regarded as contributing to the longer-term performance of the Group.

	2011			2010		
	Pre-tax return US$m	**Average RWAs US$bn**	**RoRWA %**	Pre-tax return US$m	Average RWAs US$bn	RoRWA %
Reported	**21,872**	**1,154**	**1.9**	19,037	1,098	1.7
Underlying	**17,696**	**1,154**	**1.5**	18,925	1,108	1.7
Legacy businesses	**(2,847)**	**222**	**(1.3)**	(1,871)	215	(0.9)
Legacy credit in GB&M	**(436)**	**33**	**(1.3)**	226	23	1.0
US consumer finance business	**(2,411)**	**189**	**(1.3)**	(2,097)	192	(1.1)
Underlying (excluding legacy businesses)	**20,543**	**932**	**2.2**	20,796	893	2.3

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Ratio of earnings to fixed charges

	2011 US$m	2010 US$m	2009 US$m	2008 US$m	2007 US$m
Profit before tax	**21,872**	19,037	7,079	9,307	24,212
Dividends received from associates	**304**	441	414	655	363
Share of profit in associates and joint ventures	**(3,264)**	(2,517)	(1,781)	(1,661)	(1,503)
Fixed charges	**27,768**	23,246	26,201	60,654	67,461
interest on deposits	**24,786**	20,465	23,328	56,822	63,924
rental expense and other charges[1]	**2,982**	2,781	2,873	3,832	3,537
Earnings[2]					
excluding interest on deposits	**21,894**	19,742	8,585	12,133	26,609
including interest on deposits	**46,680**	40,207	31,913	68,955	90,533
Preference share dividends[3]	**699**	574	374	255	288
Combined fixed charges and preference share dividends					
excluding interest on deposits	**3,681**	3,355	3,247	4,087	3,825
including interest on deposits	**28,467**	23,820	26,575	60,909	67,749
Ratio of earnings to fixed charges					
excluding interest on deposits	**7.34**	7.10	2.99	3.17	7.52
including interest on deposits	**1.68**	1.73	1.22	1.14	1.34
Ratio of earnings to combined fixed charges and preference share dividends					
excluding interest on deposits	**5.95**	5.89	2.64	2.97	6.96
including interest on deposits	**1.64**	1.69	1.20	1.13	1.34

1 *Includes an estimate of the interest in rental expense, charges incurred in respect of subordinated liabilities and interest on preference shares.*
2 *Includes profit before tax, dividends received from associates, and fixed charges, less: share of profit in associates and joint ventures.*
3 *Dividends on preference shares and other equity instruments.*

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Critical accounting policies

(Audited)

Introduction

The results of HSBC are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of our consolidated financial statements. The significant accounting policies are described in Note 2 on the Financial Statements.

When preparing the financial statements, it is the Directors responsibility under UK company law to select suitable accounting policies and to make judgements and estimates that are reasonable and prudent. The accounting policies that are deemed critical to our results and financial position, in terms of the materiality of the items to which the policies are applied and the high degree of judgement involved, including the use of assumptions and estimation, are discussed below.

Impairment of loans and advances

Our accounting policy for losses arising from the impairment of customer loans and advances is described in Note 2g on the Financial Statements. Loan impairment allowances represent management s best estimate of losses incurred in the loan portfolios at the balance sheet date.

Management is required to exercise judgement in making assumptions and estimates when calculating loan impairment allowances on both individually and collectively assessed loans and advances. Of the Group s total loans and advances to customers before impairment allowances of US$958bn (2010: US$978bn), US$17bn or 2% (2010: US$16bn; 2%) were individually assessed for impairment, and US$941bn or 98% (2010: US$962bn; 98%) were collectively assessed for impairment.

The most significant judgemental area is the calculation of collective impairment allowances. The geographical area with most exposure subject to this judgement is North America. Collective impairment allowances in North America were US$7bn, representing 62% (2010: US$9bn; 64%) of the total collectively assessed loan impairment allowance.

The methods used to calculate collective impairment allowances on homogeneous groups of loans and advances that are not considered individually significant are disclosed in Note 2g on the Financial Statements. They are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis because of the large number of individually insignificant loans in the portfolio.

The methods involve the use of statistically assessed historical information which is supplemented with significant management judgement to assess whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience. In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio. Sometimes, however, it provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, when there have been changes in economic, regulatory or behavioural conditions which result in the most recent trends in portfolio risk factors being not fully reflected in the statistical models. In these circumstances, the risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

Risk factors include loan portfolio growth, product mix, unemployment rates, bankruptcy trends, geographical concentrations, loan product features, economic conditions such as national and local trends in housing markets, the level of interest rates, portfolio seasoning, account management policies and practices, changes in laws and regulations, and other influences on customer payment patterns. Different factors are applied in different regions and countries to reflect local economic conditions, laws and regulations. The methodology and the assumptions used

in calculating impairment losses are reviewed regularly in the light of differences between loss estimates and actual loss experience. For example, roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

Under certain specified conditions, the Group provides loan forbearance to borrowers experiencing financial difficulties by agreeing to modify the contractual payment terms of loans in order to improve the management of customer relationships, maximise collection opportunities and, if possible, avoid default or repossession. Where forbearance activities are significant, higher levels of judgement and estimation uncertainty are involved in determining their effects on loan impairment allowances. Forbearance activities take place in both retail and wholesale loan portfolios, but the Group s largest concentration is in the US, in HSBC Finance s CML portfolio. A detailed review of the CML portfolio was carried out during 2011 to improve the risk differentiation in the segmentation of the portfolio. The review involved extensive

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statistical analysis of actual default experience in the portfolio. Amongst other improvements, this review resulted in changes to further differentiate the credit characteristics of forbearance cases, including those which return to performing status following forbearance. As part of this review, the application of the Group accounting policies for the determination of impairment allowances for the CML portfolio was considered, in particular regarding the effect of the large proportion of renegotiated loans in this portfolio. The consequent changes did not result in a material change to impairment allowances recorded by HSBC Finance under IFRSs. Further information regarding forbearance activities is disclosed on page 129.

The exercise of judgement requires the use of assumptions which are highly subjective and very sensitive to the risk factors, in particular to changes in economic and credit conditions across a large number of geographical areas. Many of the factors have a high degree of interdependency and there is no single factor to which our loan impairment allowances as a whole are sensitive. They are particularly sensitive to general economic and credit conditions in North America, however. For example, a 10% increase in impairment allowances on collectively assessed loans and advances in North America would increase loan impairment allowances by US$0.7bn at 31 December 2011 (2010: US$0.9bn).

It is possible that the outcomes within the next financial year could differ from the assumptions built into the models, resulting in a material adjustment to the carrying amount of loans and advances.

Goodwill impairment

Our accounting policy for goodwill is described in Note 2p on the Financial Statements. Note 24 on the Financial Statements lists our cash generating units (CGU s) by geographical region and global business. HSBC s total goodwill amounted to US$21bn at 31 December 2011 (2010: US$22bn).

The review of goodwill impairment reflects management s best estimate of the following factors:

- the future cash flows of the CGUs are sensitive to the cash flows projected for the periods for which detailed forecasts are available and to assumptions regarding the long-term pattern of sustainable cash flows thereafter. Forecasts are compared with actual performance and verifiable economic data, but they necessarily and appropriately reflect management s view of future business prospects at the time of the assessment; and
- the rates used to discount future expected cash flows are based on the costs of capital assigned to individual CGUs and can have a significant effect on their valuation. The cost of capital percentage is generally derived from a Capital Asset Pricing Model, which incorporates inputs reflecting a number of financial and economic variables, including the risk-free interest rate in the country concerned and a premium for the inherent risk of the business being evaluated. These variables are subject to fluctuations in external market rates and economic conditions beyond our control and are consequently subject to uncertainty and require the exercise of significant judgement.

A decline in a CGU s expected cash flows and/or an increase in its cost of capital reduces the CGU s estimated recoverable amount. If this is lower than the carrying value of the CGU, a charge for impairment of goodwill is recognised in our income statement for the year.

The accuracy of forecast cash flows is subject to a high degree of uncertainty in volatile market conditions. In such market conditions, management retests goodwill for impairment more frequently than annually to ensure that the assumptions on which the cash flow forecasts are based continue to reflect current market conditions and management s best estimate of future business prospects.

During 2011, no impairment of goodwill was identified (2010: nil). In addition to the annual impairment test which was performed as at 1 July 2011, management reviewed the current and expected performance of the CGUs as at 31 December 2011 and determined that there was no indication of potential impairment of the goodwill allocated to them, except for the GB&M Europe CGU, which experienced significantly reduced profitability in the second half of 2011. The reduced forecast profitability resulted in a reduction in the recoverable amount of the CGU

when compared to its carrying amount. Consequently, the results of the goodwill impairment testing for this CGU are more sensitive to key assumptions used. Management retested the goodwill for this CGU and concluded that there was no impairment.

Note 24 on the Financial Statements includes details of the CGUs with significant balances of goodwill, states the key assumptions used to assess the goodwill in each of those CGUs for impairment and provides a discussion of the sensitivity of the carrying value of goodwill to changes in key assumptions.

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Valuation of financial instruments

Our accounting policy for determining the fair value of financial instruments is described in Note 2d on the Financial Statements.

The best evidence of fair value is a quoted price in an actively traded market. In the event that the market for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable market data and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable. Valuation techniques that rely to a greater extent on unobservable inputs require a higher level of management judgement to calculate a fair value than those based wholly on observable inputs.

Valuation techniques used to calculate fair values are discussed in Note 16 on the Financial Statements. The main assumptions and estimates which management consider when applying a model with valuation techniques are:

- the likelihood and expected timing of future cash flows on the instrument. These cash flows are estimated based on the terms of the instrument, and judgement may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt. Future cash flows may be sensitive to changes in market rates;

- selecting an appropriate discount rate for the instrument. The determination of this rate is based on an assessment of what a market participant would regard as the appropriate spread of the rate for the instrument over the appropriate risk-free rate; and

- judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products.

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

there is some market data available on which to base a determination of fair value, for example historical data, and the fair values of most financial instruments are based on some market observable inputs even when unobservable inputs are significant.

The value of financial assets and liabilities measured at fair value using a valuation technique was US$665bn (2010: US$599bn) and US$569bn (2010: US$499bn), respectively or 61% (2010: 56%) of total financial assets and 82% (2010: 77%) of total financial liabilities measured at fair value.

Disclosures of the types and amounts of adjustments made in determining the fair value of financial instruments measured at fair value using valuation techniques, and a sensitivity analysis of fair values for financial instruments with significant unobservable inputs to reasonably possible alternative assumptions, can be found in Note 16 on the Financial Statements. Given the uncertainty and subjective nature of valuing financial instruments at fair value, it is possible that the outcomes in the next financial year could differ from the assumptions used, and this could result in a material adjustment to the carrying amount of financial instruments measured at fair value.

Impairment of available-for-sale financial assets

Our accounting policy for impairment of available-for-sale financial assets is described in Note 2j on the Financial Statements.

At 31 December 2011, our total available-for-sale financial assets amounted to US$379bn (2010: US$381bn), of which US$372bn or 98% (2010: US$373bn; 98%) were debt securities. The available-for-sale fair value reserve relating to debt securities amounted to a deficit of US$4.9bn (2010: deficit of US$6.2bn). A deficit in the available-for-sale fair value reserve occurs on debt securities when the fair value of a relevant security is less than its acquisition cost (net of any principal repayments and amortisation) after deducting any impairment losses recognised.

Management is required to exercise judgement in determining whether there is objective evidence that an impairment loss has occurred. Once an impairment has been identified, the amount of impairment loss is measured with reference to the fair value of the asset. More information on assumptions and estimates requiring management judgement relating to the determination of fair values of financial instruments is provided above in Valuation of financial instruments .

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Deciding whether an available-for-sale debt security is impaired requires objective evidence of both the occurrence of a loss event and a related change in estimated future cash flows. The degree of judgement involved is less when cash flows are readily determinable, but increases when estimating future cash flows requires consideration of a number of variables, some of which may be unobservable in current market conditions.

There is no single factor to which the Group s charge for impairment of available-for-sale debt securities is particularly sensitive, because of the various types of securities we hold, the range of geographical areas in which those securities are held, and the wide range of factors which can affect the occurrence of loss events and the cash flows of securities, including different types of collateral.

The most significant judgements concern more complex instruments, such as asset-backed securities (ABS s), where it is necessary to consider factors such as the estimated future cash flows on underlying pools of collateral including prepayment speeds, the extent and depth of market price declines and changes in credit ratings. The review of estimated future cash flows on underlying collateral is subject to uncertainties when the assessment is based on historical information on pools of assets, and judgement is required to determine whether historical performance remains representative of current economic and credit conditions.

Further details of the nature and extent of our exposures to ABSs classified as available-for-sale and a more detailed description of the assumptions and estimates used in assessing these securities for impairment, together with a discussion of those assets which are most sensitive to possible future impairment, are provided in Securitisation exposures and other structured products on page 149.

It is possible that outcomes in the next financial year could be different from those modelled when seeking to identify impairment on available-for-sale debt securities. In this event, impairment may be identified in available-for-sale debt securities which had previously been determined not to be impaired, potentially resulting in the recognition of material impairment losses in the next financial year.

Deferred tax assets

Our accounting policy for the recognition of deferred tax assets is described in Note 2s on the Financial Statements. The recognition of a deferred tax asset relies on an assessment of the probability and sufficiency of future taxable profits, future reversals

of existing taxable temporary differences and ongoing tax planning strategies.

The most significant judgements concern the US deferred tax asset, given the recent history of losses in our US operations. The net US deferred tax asset amounted to US$5.2bn or 68% (2010: US$4bn; 58%) of deferred tax assets recognised on the Group s balance sheet.

Recognition of the US deferred tax asset is based on the evidence available about conditions at the balance sheet date, and requires significant judgements to be made regarding projections of loan impairment charges and the timing of recovery in the US economy. These judgements take into consideration the effect of both positive and negative evidence, including historical financial performance, projections of future taxable income, future reversals of existing taxable temporary differences, tax planning strategies and the availability of loss carrybacks.

Projections of future taxable income in the US are based on business plans, future capital requirements and ongoing tax planning strategies. These projections include assumptions about future house prices, US economic conditions including unemployment levels and their impact on loan impairment charges, and capital support from HSBC Holdings. These forecasts are consistent with the assumption that it is probable that the results of future operations will generate sufficient taxable income to support the deferred tax assets. In management s judgement, recent market conditions, which have resulted in losses being incurred in the US, will create significant downward pressure and volatility regarding the profit or loss before tax in the next few years. To reflect this, the assessment of recoverability of the deferred tax assets in the US significantly discounts any future expected taxable income and relies to a greater extent on capital support to the US operations from HSBC Holdings, including tax planning strategies implemented in relation to such support.

The most significant tax planning strategy is the retention of capital in our US operations to ensure the realisation of the deferred tax assets. Management expects that, with this strategy, the US operations will generate sufficient future profits to support the recognition of the deferred tax assets. If HSBC Holdings were to decide not to provide this ongoing support, the full recovery of the deferred tax asset may no longer be probable and could result in a significant reduction of the deferred tax asset which would be recognised as a charge in the income statement.

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These strategies remain unaffected by the proposed sale of the Group s US credit card and private label credit card business and 195 non-strategic branches. The incremental capital generated as a result of these disposals will reduce the capital support required from HSBC Holdings, but capital support from HSBC Holdings will continue to be relied on to the extent necessary to support the recoverability of our deferred tax assets.

Provisions for liabilities

The accounting policy for provision for liabilities is described in Note 2w on the Financial Statements. Note 33 on the Financial Statements discloses the major categories of provisions recognised. The closing balance of provisions amounted to US$3.3bn (2010: US$2.1bn), of which US$1.5bn (2010: US$1.0bn) relates to legal proceedings and regulatory matters and US$1.1bn (2010: US$0.4bn) relates to customer remediation.

Provisions are liabilities of uncertain timing or amount, and are recognised when there is a present obligation as a result of a past event, the outflow of economic benefit is probable and the outflow can be estimated reliably. Judgement is involved in determining whether an obligation exists, and in estimating the probability, timing and amount of any outflows. Professional expert advice is taken on litigation provisions, taxation provisions, property provisions including onerous contracts and similar liabilities.

Provisions for legal proceedings and regulatory matters typically require a higher degree of judgement than other types of provisions. When cases are at an early stage, accounting judgements can be difficult because of the high degree of uncertainty associated with determining whether a present obligation exists as a result of a past event, estimating the probability of outflows and making estimates of the amount of any outflows that may arise. As matters progress through various stages of development, management together with legal advisers evaluate on an ongoing basis whether provisions should be recognised, and the estimated amounts of any such provisions, revising previous judgements and estimates as appropriate. At more advanced stages, it is typically possible to make judgements and estimates around a better defined set of possible outcomes, however such judgements can be very difficult and the amount of any provision can be very sensitive to the assumptions used. There could be a wide range of possible outcomes for any pending legal proceedings, investigations or

inquiries. As a result, it is often not practicable to quantify a range of possible outcomes for individual matters. It is also not practicable to meaningfully quantify ranges of potential outcomes in aggregate for these types of provisions because of the diverse nature and circumstances of such matters and the wide range of uncertainties involved. For a detailed description of the nature of uncertainties and assumptions and the effect on the amount and timing of possible cash outflows on material matters, see Note 44, Legal proceedings and regulatory matters on the Financial Statements.

Provisions for customer remediation also require significant levels of estimation and judgement. The amounts of provisions recognised depend on a number of different assumptions, for example, the number of customer complaints expected to be received, the response rates from customers who are contacted as part of customer outreach activities, the uphold rate for complaints and the amounts payable in respect of compensation and costs of conducting reviews. These assumptions are revised over time as additional information becomes available.

In view of the inherent uncertainties and the high level of subjectivity involved in the recognition and measurement of provisions, it is possible that the outcomes in the next financial year could differ from those on which management s estimates are based, resulting in a material change in the amounts of provisions recognised, and outflows of economic benefits which are materially different to those estimated by management for the purposes of the 2011 financial statements.

Basis of preparation

(Unaudited)

The results of global businesses and geographical regions are presented in accordance with the accounting policies used in the preparation of HSBC s consolidated financial statements.

Our operations are closely integrated and, accordingly, the presentation of global business data includes internal allocations of certain items of income and expense. These allocations include the costs of certain support services and global functions, to the extent that these can be meaningfully attributed to operational business lines. While such allocations have been made on a systematic and consistent basis, they necessarily involve a degree of subjectivity.

Where relevant, income and expense amounts presented include the results of inter-segment funding as well as inter-company and inter-business line transactions. All such transactions are undertaken on arm s length terms.

The expense of the UK bank levy is included in the Europe geographical region as HSBC regards the levy as a cost of being headquartered in the UK. For the purposes of the segmentation by global business, the cost of the levy is included in Other .

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Global businesses

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Summary

HSBC s senior management reviews operating activity on a number of bases, including by geographical region and by global business, as presented on page 59.

RBWM was previously known as Personal Financial Services (PFS). With effect from 1 March 2011, our Global Asset Management business was moved from GB&M to RBWM. This resulted in reallocations between the two of US$321m and US$219m in profit before tax in 2010 and 2009, respectively, and in total assets of US$3.3bn and US$2.8bn at the end of 2010 and 2009, respectively. The presentation of both years has been adjusted accordingly.

The commentaries below present global businesses followed by geographical regions. Performance is discussed in this order because certain strategic themes, business initiatives and trends affect more than one geographical region. All commentaries are on an underlying basis (see page 16) unless stated otherwise.

Profit/(loss) before tax

	2011		2010		2009	
	US$m	**%**	US$m	%	US$m	%
Retail Banking and Wealth Management[17]	**4,270**	**19.6**	3,839	20.2	(1,846)	(26.1)
Commercial Banking	**7,947**	**36.3**	6,090	32.0	4,275	60.4
Global Banking and Markets[17]	**7,049**	**32.2**	9,215	48.4	10,262	145
Global Private Banking	**944**	**4.3**	1,054	5.5	1,108	15.6
Other[48]	**1,662**	**7.6**	(1,161)	(6.1)	(6,720)	(94.9)
	21,872	**100.0**	19,037	100.0	7,079	100.0

Total assets[49]

	At 31 December			
	2011		2010	
	US$m	%	US$m	%
Retail Banking and Wealth Management[17]	**540,548**	**21.2**	530,970	21.6
Commercial Banking	**334,966**	**13.1**	296,797	12.1
Global Banking and Markets[17]	**1,877,627**	**73.5**	1,755,043	71.5
Global Private Banking	**119,839**	**4.7**	116,846	4.8
Other	**180,126**	**7.0**	161,458	6.6
Intra-HSBC items	**(497,527)**	**(19.5)**	(406,425)	(16.6)
	2,555,579	**100.0**	2,454,689	100.0

Risk-weighted assets[50]

	At 31 December			
	2011		2010	
	US$bn	%	US$bn	%
Total	**1,209.5**		1,103.1	
Retail Banking and Wealth Management[17]	**351.2**	**29.0**	357.0	32.4
Commercial Banking	**382.9**	**31.7**	334.4	30.3
Global Banking and Markets[17,51]	**423.0**	**35.0**	353.2	32.0
Global Private Banking	**22.5**	**1.9**	24.9	2.3
Other	**29.9**	**2.4**	33.6	3.0

For footnotes, see page 95.

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Products and services

Retail Banking and Wealth Management

RBWM offers its products and services to customers based on their individual needs. Premier and Advance services are targeted at mass affluent and emerging affluent customers who value international connectivity and benefit from our global reach and scale. For customers who have simpler everyday banking needs, we offer a full range of banking products and services reflecting local requirements.

In addition, we are one of the largest card issuers in the world, offering HSBC branded cards, co-branded cards with selected partners and private label (store) cards.

Typically, customer offerings include personal banking products (current and savings accounts, mortgages and personal loans, credit cards, debit cards and local and international payment services) and wealth management services (insurance and investment products and financial planning services).

HSBC Premier provides preferential banking services and global recognition to our mass affluent customers and their immediate families with a dedicated relationship manager, specialist wealth advice and tailored solutions. Customers can access emergency travel assistance, priority telephone banking and an online global view of their Premier accounts around the world.

HSBC Advance provides a range of preferential products and services customised to meet local needs. With a dedicated telephone service, access to wealth advice and online tools to support financial planning, it gives customers an online global view of their Advance accounts.

Wealth Solutions & Financial Planning: a financial planning process designed around individual customer needs to help our clients to protect, grow and manage their wealth through investment and wealth insurance products manufactured by Global Asset Management, Global Markets and HSBC Insurance and by selected third-party providers.

Global Asset Management offers investment solutions to individual investors, financial intermediaries and institutions globally.

Customers can transact with the bank via a range of channels such as internet banking and self-service terminals in addition to traditional and automated branches and telephone service centres.

Commercial Banking

Lending: we offer a broad range of domestic and cross-border financing, including overdrafts, term loans and syndicated, leveraged, acquisition and project finance. Asset finance is also offered in selected countries.

We segment our CMB business into Corporate, to serve both corporate and mid-market companies with more sophisticated financial needs, and Business Banking, to serve small and medium-sized enterprises (SME s). This enables the development of tailored customer propositions while adopting a broader view of the entire commercial banking sector, from sole traders to large corporations. This allows us to provide continuous support to companies as they grow both domestically and internationally, and ensures a clear focus on internationally aspirant customers, who are typically key to innovation and growth in market economies.

We place particular emphasis on international connectivity to meet the needs of our business customers. We aim to be recognised as the Leading international trade and business bank by focusing on faster-growing markets, enhancing collaboration with GB&M, capturing growth in international SMEs and driving efficiency gains through adopting a global operating model.

International trade and receivables financewe provide buyers and suppliers with products and services such as documentary credits and collections, import and export finance, guarantees and forfaiting to facilitate trade payments, finance the trade cycle and help mitigate risk throughout the supply chain. Our Receivables Finance proposition for domestic and international customers is offered through an extensive network.

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

GB&M: our CMB franchise represents a key client base for GB&M products and services, including foreign exchange and interest rate products, together with capital raising on debt and equity markets and advisory services.

Commercial cardscard issuing helps customers enhance cash management, credit control and purchasing. Card acquiring services enable merchants to accept credit and debit card payments in person or remotely.

Insurance: we offer business and financial protection, trade insurance, employee benefits, corporate wealth management and a variety of other commercial risk insurance products.

Report of the Directors: Operating and Financial Review (continued)

Global Banking and Markets

GB&M provides tailored financial solutions to major government, corporate and institutional clients and private investors worldwide. Managed as a global business, GB&M operates a long-term relationship management approach to build a full understanding of clients financial requirements. Sector-focused client service teams comprising relationship managers and product specialists develop financial solutions to meet individual client needs. With a presence in over 60 countries/territories and access to HSBC s worldwide presence and capabilities, this business serves subsidiaries and offices of our clients on a global basis.

GB&M is managed as two principal business lines: Global Markets and Global Banking. This structure allows us to focus on relationships and sectors that best fit the Group s footprint and facilitate seamless delivery of our products and services to clients.

Global Markets operations consist of treasury and capital markets services. Products include foreign exchange; currency, interest rate, bond, credit, equity and other derivatives; government and non-government fixed income and money market instruments; precious metals and exchange-traded futures; equity services; distribution of capital markets instruments; and securities services, including custody and clearing services and funds administration to both domestic and cross-border investors.

Global Banking offers financing, advisory and transaction services. Products include:

capital raising, advisory services, bilateral and syndicated lending, leveraged and acquisition finance, structured and project finance, lease finance and non-retail deposit taking;

international, regional and domestic payments and cash management services; and trade services for large corporate clients.

Global Private Banking

HSBC Private Bank is the principal marketing name of our private banking business, GPB. Utilising the most suitable products from the marketplace, GPB works with high net worth clients to offer both traditional and innovative ways to manage and preserve wealth while optimising returns.

GPB has a global presence with major centres in Hong Kong, Singapore, London, Switzerland, Monaco, New York and Miami to identify opportunities which meet clients needs and investment strategies.

Private Banking services comprise multi-currency deposit accounts and fiduciary deposits, credit and specialist lending, treasury trading services, cash management, securities custody and clearing. GPB works to ensure that its clients have full access to other products and services available in HSBC such as credit cards, internet banking, corporate banking and investment banking.

Investment Management comprises both advisory and discretionary investment services. A wide range of investment vehicles is covered, including bonds, equities, derivatives, options, futures, structured products, mutual funds and alternatives (hedge funds, private equity and real estate).

Trust Solutions comprises inheritance planning, trustee and other fiduciary services designed to protect wealth and preserve it for future generations through structures tailored to meet the individual needs of each family. Areas

of expertise include trusts, foundation and company administration, charitable trusts and foundations, insurance, family office advisory and philanthropy.

Corporate Finance Solutions helps provide clients with cross-border solutions for their companies, working in conjunction with GB&M.

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HSBC HOLDINGS PLC

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Retail Banking and Wealth Management

RBWM provides banking and wealth management services to individual customers across our principal geographic markets.

	2011 US$m	2010 US$m	2009 US$m
Net interest income	24,101	24,166	25,099
Net fee income	8,226	8,397	9,138
Other income	1,206	1,048	2,060
Net operating income[52]	33,533	33,611	36,297
Impairment charges[53]	(9,319)	(11,259)	(19,902)
Net operating income	24,214	22,352	16,395
Total operating expenses	(21,202)	(19,539)	(18,976)
Operating profit/(loss)	3,012	2,813	(2,581)
Income from associates[54]	1,258	1,026	735
Profit/(loss) before tax	4,270	3,839	(1,846)
RoRWA[55]	1.2%	1.1%	(0.5%)

Strong revenue growth in

faster-growing regions

Run-off portfolio balances reduced by

US$8.9bn

Best Wealth Management House,

Hong Kong

(The Asset Triple A Investment Awards 2011)

Strategic direction

RBWM s aim is to provide consistent and high quality retail banking and wealth management services to our customers.

We will provide retail banking services in markets where we already have scale or where scale can be built over time and we will implement standardised distribution and service models to ensure we can deliver them more efficiently. As wealth creation continues to grow in both developed and faster-growing markets, we will leverage our global propositions such as Premier and our bancassurance and asset management capabilities to deepen our existing customer relationships and the penetration of our wealth management services.

We focus on three strategic imperatives:

- developing world class wealth management for retail customers;
- leveraging global expertise in retail banking; and
- portfolio management to drive superior returns.

For footnotes, see page 95.

Review of performance

RBWM reported a profit before tax of US$4.3bn, 11% higher than 2010 and 6% higher on an underlying basis, most notably in Rest of Asia-Pacific and Latin America, where the increased profitability reflected strong business and revenue growth.

The pre-tax profit of RBWM was significantly affected by the US Card and Retail Services business, of which we announced the pending sale, and the US run-off portfolios.

RBWM profit/(loss) before tax

	2011 US$m	2010 US$m	2009 US$m
US Card and Retail Services	**2,061**	1,979	498
US run-off portfolios	**(4,472)**	(4,076)	(5,065)
Rest of RBWM	**6,681**	5,936	2,721
	4,270	3,839	(1,846)

Revenue was marginally lower than 2010, with strong growth in Latin America (9%) and Rest of Asia-Pacific (8%) and modest growth in Hong Kong (3%) more than offset by lower revenues in North America from the continued run-off in the CML portfolios, lower balances in US Card and Retail Services and an increase in adverse fair value movements on non-qualifying hedges.

In Latin America, revenue growth reflected increased average lending and higher sales of unit-linked pensions and credit protection products in Brazil, together with business growth in Argentina on the back of favourable economic conditions. Gains on the sale and leaseback of branches in Mexico contributed US$36m to revenue growth.

Revenue in Rest of Asia-Pacific increased, primarily as a result of significant lending growth in mortgages, notably in Australia and Singapore due to competitive product offerings and strong property markets, and increased deposit spreads in a number of countries such as

mainland China and India. This was partly offset by narrower asset spreads reflecting competitive pressures.

In Hong Kong, revenues increased from sales of wealth management products, notably from insurance, reflecting successful sales activity and higher demand. This was partly offset by narrower asset spreads, reflecting a shift in the product mix to lower yielding, HIBOR-linked mortgages and competitive pressures.

Report of the Directors: Operating and Financial Review (continued)

Loan impairment charges and other credit risk provisions fell by 18% to US$9.3bn with a significant decline in North America as we continued to run off the CML portfolios, and as balances fell and delinquency rates improved in the Card and Retail Services business. Excluding our US Card and Retail Services and US run-off portfolios, loan impairment charges decreased by US$650m reflecting lower delinquency rates in the UK due to improved collections, and the managing down of unsecured lending portfolios in Rest of Asia-Pacific and the Middle East, which more than offset increases in Latin America resulting from lending growth.

Operating expenses increased by 6% to US$21.2bn. Increased costs included US$875m of provisions relating to UK customer redress programmes, including a charge in respect of the possible mis-selling of PPI in the UK in previous years. This was partly offset by a US$264m credit resulting from a change in the inflation measure used to calculate the defined benefit obligation for deferred pensions, also in the UK. Restructuring costs were incurred during 2011 as we drove organisational change to reduce the cost base and exited certain markets or non-strategic lines of business. In North America, costs increased reflecting US mortgage foreclosure and servicing costs (US$257m) and increased litigation costs.

Costs were higher in Latin America, Rest of Asia-Pacific and Hong Kong as a result of wage inflation and higher average headcount to support business growth.

Share of profit from associates and joint ventures rose by 17%, reflecting higher profits from Ping An as a result of strong growth in sales in its insurance business and a rise in income from its banking business following the acquisition of Shenzhen Development Bank in July 2011.

Strategic imperatives

Developing world class wealth management for retail customers

We aim to increase Wealth Management revenues by US$4bn in the medium term, against which target we made modest progress in 2011 with revenue growth of some US$300m. Notably, we had strong sales of insurance products in Hong Kong, Latin America and Rest of Asia-Pacific, while revenue from distribution of investment products to our clients and Global Asset Management was broadly unchanged, reflecting difficult market conditions, particularly in the second half of the year.

Growth in our insurance operations was largely driven by strong sales of unit-linked and deferred annuity products in Hong Kong and sales of unit-linked products in Brazil. We also benefited from a refinement to the calculation of the PVIF asset. Favourable trends during the first half of the year were partly offset by weaker investment returns in the second half of 2011.

During the year, 62% of the qualifying population of HSBC Global Asset Management Funds ranked in the top half based on past performance against their peer and sector groups over a 3 year period, up from 47% in 2010. Global Asset Management also successfully launched an Asian High Yield Bond Fund raising US$1.2bn in 2011.

Our World Selection global investment offering continued to attract new assets as a core wealth solution for customers, resulting in total FuM of US$8.6bn at 31 December 2011 compared with US$7.2bn at 31 December 2010. During 2011 we launched the Global Investment

Centre in the UK, which will complement our existing services and deliver significant efficiencies to the way we are able to serve our Wealth Management customers.

Good progress was made in developing our Wealth Management infrastructure. In 2011 we implemented multi-channel financial simulators in the UK, a funds platform in Taiwan and the UK, and bond trading in mainland China and further deployed our foreign currency web-enabled Get Rate programme. These deployments are all part of the strategic focus to provide expanded Wealth Management services utilising common technology.

Leveraging global expertise in retail banking

During 2011, we extended our mobile banking offering to 11 new markets. We launched our global cards platform in five new markets in Asia, with deployment in Brazil and Mexico due to be completed during 2012. We also introduced renminbi-denominated deposits in nine new markets.

Report of the Directors: Operating and Financial Review (continued)

In Hong Kong, we retained our position of having the largest market share in residential mortgages in 2011. We were also market leaders in life insurance.

For 2011 we set an aggressive goal to achieve our target customer recommendation of 75% by revenue weighting of the 16 markets surveyed, against which we met the target in five markets, or 35% by revenue weighting. The shortfall resulted mainly from a challenging environment in many of our large markets, with strong local competitors improving their service performance, and a negative reaction to some portfolio management activity, particularly in the US and Canada. We had a very strong fourth quarter, with 77% of the markets by revenue weighting meeting target, driven in part by traction from service quality programmes implemented in Mexico, the UK and the UAE, and we finished the year ranked first in five of the six markets surveyed in Asia.

Portfolio management to drive superior returns

During 2011, we embarked on a process to improve our return on capital using the five filters analysis to determine portfolio rationalisation initiatives. As a result, we completed the sale of our Mexican pension administration business (HSBC Afore), our UK motor insurance business and our Canadian brokerage business. We announced the closure of our retail banking businesses in Poland, Russia, Georgia, and Kuwait, the sale of our operations in Chile, Central America (Costa Rica, El Salvador and Honduras) and, most recently, the disposal of our retail operations in Thailand. We also announced the cessation of life insurance manufacturing in the US, the sale of the Card and Retail Services business and upstate New York branches in the US.

The North American business has continued to focus on managing down the residual balances in our US run-off portfolios.

Commercial Banking

CMB offers a full range of commercial financial services and tailored propositions to over 3.6m customers ranging from sole proprietors to publicly quoted companies in 65 countries.

	2011 US$m	2010 US$m	2009 US$m
Net interest income	**9,931**	8,487	7,883
Net fee income	**4,291**	3,964	3,702
Other income	**1,389**	1,383	1,268
Net operating income[52]	**15,611**	13,834	12,853
Impairment charges[53]	**(1,738)**	(1,805)	(3,282)
Net operating income	**13,873**	12,029	9,571
Total operating expenses	**(7,221)**	(6,831)	(5,963)
Operating profit	**6,652**	5,198	3,608
Income from associates[54]	**1,295**	892	667

Profit before tax	**7,947**	6,090	4,275
RoRWA[55]	**2.2%**	2.0%	1.4%

Record annual profit before tax

US$7.9bn

Revenue growth of

12%

ahead of cost growth of 4%

on an underlying basis

Number one trade finance

bank in the world

(Oliver Wyman Global Transaction Banking Survey 2011)

Strategic direction

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

We focus on four strategic imperatives:

- focus on faster-growing markets while connecting revenue and investment flows with developed markets;
- enhance collaboration with GB&M, providing capital market access and a wider range of sophisticated risk management and liquidity products to the growing mid-market corporates;
- capture growth in international small and medium-sized enterprises; and
- drive efficiency gains through adopting a global operating model.

For footnotes, see page 95.

Report of the Directors: Operating and Financial Review (continued)

Review of performance

CMB reported a record profit before tax of US$7.9bn in 2011, 31% higher than in 2010. On an underlying basis, profit before tax increased by 30%, driven by increased net interest income, a higher share of profits from associates in mainland China and lower loan impairment charges. Our 20 priority markets generated more than 90% of our profit before tax, benefiting from our strong international network and long-term approach to customer relationships.

Revenue grew by 12%, despite increasing economic, political and regulatory headwinds. This was largely driven by higher net interest income from lending activities and from growth in customer account balances. Net interest income from lending benefited from the strong customer loan growth achieved in 2010 which continued into 2011, albeit at a slower pace during the latter part of the year. Loans and advances to customers rose by 12% to US$262bn as a result of increased demand for credit in Hong Kong, Rest of Asia-Pacific, Latin America and Europe. Average customer account balances also rose, reflecting successful marketing campaigns, notably in Hong Kong and Rest of Asia-Pacific as part of a targeted strategy to support growth in customer lending. Customer account balances grew by 9% to US$306bn during 2011.

Net fee income and *net trading income* benefited from the strong collaboration with GB&M, particularly in foreign exchange and interest rate management products. Net fee income also rose, reflecting strong volumes and market share in our trade and payments businesses in Hong Kong, Rest of Asia-Pacific and Latin America.

Loan impairment charges and other credit risk provisions declined by 6% as credit quality remained strong despite the economic challenges. Specific impairments decreased, notably in North America, reflecting improved credit quality and in Business Banking lower delinquency levels, partly offset by a specific provision relating to a single commercial customer in Latin America. Collective impairment charges rose reflecting strong lending growth, notably in Latin America.

Operating expenses increased by 4%. This was driven by a rise in costs to support business growth, along with restructuring costs, partly offset by a credit of US$212m resulting from a change in the inflation measure used to calculate the defined benefit obligation for deferred pensions in the UK. Our cost efficiency ratio improved, reflecting our ability to manage our cost base and rising inflationary pressures while continuing to invest in key markets for ongoing expansion.

Income from associates increased by 41%. The contribution from BoCom was driven by strong lending growth, wider deposit spreads following interest rate rises in mainland China and higher fee income, including revenue earned from investment banking, settlements and cards. Income from Industrial Bank also increased as a result of strong growth in customer lending and a rise in fee-based revenue.

Strategic imperatives

Focus on faster-growing markets while connecting with developed markets

In line with our strategy to focus and invest in faster-growing markets, our operations in Rest of Asia-Pacific, Latin America, Hong Kong and the Middle East and North Africa expanded more quickly than in developed markets. Revenue from faster growing regions grew by 20% to US$8.5bn, representing 54% of the CMB total, driven by Brazil, Hong Kong, mainland China, Mexico, Argentina and Singapore. Customer lending growth was almost twice that of Europe and North America, and accounted for 50% of CMB s total lending.

Total trade and receivables finance revenues increased by 22% to US$2.6bn, of which 75% was generated from the faster-growing regions. Our businesses in these markets expanded more quickly than in developed regions as we leveraged our international capabilities to support our customers.

Making it easy for customers to do business with HSBC is at the heart of our approach. During 2011, we merged our Trade and Supply Chain and Receivables Finance businesses to enable us to streamline our product proposition. It will also help us to expand our Receivables Finance offering beyond its current locations and achieve our goal of doubling trade revenue over the medium term. We also rolled out our Commodity and Structured Trade Finance service, strengthening our sales teams in Europe and Asia and enhancing our infrastructure.

Revenue from our Payments and Cash Management products rose by 15%, as they facilitated increased levels of cross-border transactions. We continued to roll out the award

Report of the Directors: Operating and Financial Review (continued)

winning ClientSphere platform in the regions to help simplify our customers cash management.

Successful cross-border referrals within CMB increased by 12% compared with 2010, with a total transaction value in 2011 of more than US$20bn. A significant proportion of this increase came from mainland China as Chinese companies looked to expand internationally.

We maintained our position as a leading international bank for renminbi products with services offered in over 50 countries. Our geographical coverage of renminbi cross-border trade services is the widest of all foreign banks in mainland China. We continue to develop new products in the currency, including renminbi structured deposits, renminbi cashier orders and the renminbi business card in Hong Kong.

Strong partnership with GB&M

Our customers benefit significantly from our partnership with GB&M. By working with our colleagues in the GB&M product teams we are able to provide customers with financing solutions, including access to capital markets and risk management products, as they expand internationally. Revenues from sales of GB&M products to CMB customers, which are shared between the two global businesses, grew strongly in all regions, increasing by more than US$500m compared with 2010. This was primarily from foreign exchange activity but also interest rate management products, leveraged and acquisition finance and debt capital markets.

In collaboration with GB&M, we have successfully completed our first global US dollar/renminbi cross-currency swap. We are also able to benefit from our market leading status in offshore renminbi bonds.

We continued to work closely with the other global businesses. CMB referred 43% of the total net new money generated from internal referrals to GPB in 2011, and successful internal premier account referrals from CMB to RBWM increased by 27%.

Capture growth in international SMEs

At the end of 2011, we had over 3.4m customers worldwide in Business Banking, which represented 54% of CMB s total deposits.

To optimise our Business Banking portfolio performance, we are reshaping our business portfolio based on the five filters and accelerating investment to enhance our international connectivity, notably in those markets such as Brazil, Mexico, mainland China, the US, Malaysia, Indonesia, Singapore and Turkey which we see as core to providing opportunities for growth.

We are repositioning Business Banking to focus on attracting and better serving the growing number of internationally aspirant SMEs. In the UK we invested in International Commercial Managers (ICM s) who focus exclusively on international customers and we will continue to invest in ICMs in other markets in 2012.

Partnerships with leading international businesses are helping to position HSBC as the bank of choice for international SMEs. In the US, we signed a partnership agreement with the Export-Import Bank in the US and in the UAE we entered into partnerships with a number of Free Trade Zones to provide improved access to banking services for internationally-oriented SMEs.

We exceeded our 2011 lending intentions under Project Merlin in the UK, both in terms of total and SME facilities.

Drive efficiency gains through adopting a global operating model

During the second half of 2011 and continuing in 2012, we are rolling out a globally consistent business model across all CMB countries to realise cost efficiencies through greater standardisation of key processes and practices. This includes the deployment of streamlined cross-border account opening, trade processing and credit approval processes which will reduce the time it takes to bring new customers on board. We are also undertaking an organisational effectiveness review to align and standardise our business structures across countries, which will result in a reduction in staff numbers and will allow us to redeploy resources towards our key growth markets.

We continued to develop our direct banking solutions to enhance accessibility and service for our customers. HSBCnet, our internet banking platform, now has over 400,000 users with access from more than 200 countries worldwide. Following a successful pilot in the first half of 2011, HSBCnet Mobile was launched in more than 60 countries. In addition, over 200,000 customers have downloaded our iApp, which is now live in five countries.

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Global Banking and Markets

GB&M is a global business which provides tailored financial solutions to major government, corporate and institutional clients worldwide.

	2011	2010	2009
	US$m	US$m	US$m
Net interest income	**7,263**	7,343	8,618
Net fee income	**3,227**	3,664	3,463
Net trading income[56]	**5,204**	5,830	6,867
Other income	**1,363**	2,075	1,990
Net operating income[52]	**17,057**	18,912	20,938
Impairment charges[53]	**(984)**	(990)	(3,168)
Net operating income	**16,073**	17,922	17,770
Total operating expenses	**(9,722)**	(9,228)	(7,853)
Operating profit	**6,351**	8,694	9,917
Income from associates[54]	**698**	521	345
Profit before tax	**7,049**	9,215	10,262
RoRWA[55]	**1.8%**	2.5%	2.6%

Resilient financial performance

despite eurozone uncertainty

Strong growth in Latin America

and Rest of Asia-Pacific

Bookrunner in six of the 10

largest IPOs in Hong Kong in 2011

Strategic direction

GB&M continues to pursue its well established emerging markets-led and financing-focused strategy, with the objective of being a leading global wholesale bank. This strategy has evolved to include a greater emphasis on connectivity, leveraging the Group s extensive distribution network.

We focus on four strategic imperatives:

reinforce client coverage and client-led solutions for major government, corporate and institutional clients;

continue to selectively invest in the business to support the delivery of an integrated suite of products and services;

enhance collaboration with other global businesses, particularly CMB, to deliver incremental revenues; and

focus on business re-engineering to optimise operational efficiency and reduce costs.

Review of performance

GB&M reported profit before tax of US$7.0bn, 24% lower than in 2010 as eurozone debt concerns continued to dominate European market sentiment. On an underlying basis, profit before tax declined by 23% as a result of lower revenues in Credit, Rates and Balance Sheet Management. Notwithstanding the difficult trading conditions, revenue grew strongly in over half of our lines of business, including Global Banking, Foreign Exchange and Equities, and particularly in the faster-growing regions of Rest of Asia-Pacific and Latin America.

Overall, *revenue* fell by 10%. This was primarily due to significantly lower trading revenues in Credit and Rates, notably in Europe, despite higher gains on structured liabilities from widening credit spreads, as turmoil in eurozone sovereign debt markets escalated, particularly in the second half of 2011, resulting in trading losses as increased risk aversion and limited client activity led to a significant widening of spreads on certain eurozone sovereign and corporate bonds. Balance Sheet Management reported lower revenues and revenues from our legacy credit portfolio also declined (see page 23).

Loan impairment charges and other credit risk provisions of US$984m in 2011 were broadly in line with 2010. Loan impairment charges declined by US$62m as specific impairments taken in 2010 following the restructuring of exposures of a small number of large clients in the Middle East and North Africa did not recur. Credit risk provisions on the available-for-sale portfolio were slightly higher than in 2010. A US$145m charge in respect of available-for-sale Greek sovereign debt was offset in part by a reduction in credit risk provisions on ABSs within our legacy credit portfolio from US$444m reported in 2010 to US$409m, as losses arising in underlying collateral pools generated lower impairment charges on ABSs.

Operating expenses increased by 4%, reflecting a rise in costs incurred in strengthening our compliance resources, predominantly in the US; targeted investment, including selective recruitment of senior hires and development of our trading and sales platforms; and restructuring in the form of various organisational efficiency initiatives. Performance-related awards were substantially lower than in 2010, reflecting the decline in net operating

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Management view of total operating income

	2011 US$m	2010 US$m	2009 US$m
Global Markets[57]	**8,098**	9,173	10,364
Credit	**335**	1,649	2,330
Rates	**1,341**	2,052	2,648
Foreign Exchange	**3,272**	2,752	2,979
Equities	**961**	755	641
Securities Services	**1,673**	1,511	1,420
Asset and Structured Finance	**516**	454	346
Global Banking	**5,401**	4,621	4,630
Financing and Equity Capital Markets	**3,233**	2,852	3,070
Payments and Cash Management[58]	**1,534**	1,133	1,053
Other transaction services[59]	**634**	636	507
Balance Sheet Management[60]	**3,488**	4,102	5,390
Principal Investments	**209**	319	42
Other[61]	**(139)**	697	512
Total operating income	**17,057**	18,912	20,938

Comparative information has been adjusted to reflect the current management view.

For footnotes, see page 95.

income, although this was mostly offset by higher amortisation charges for previous years performance shares and accelerated expense recognition of current year deferred bonus awards. Cost growth was partly offset by a credit of US$111m in 2011 arising from a change in the inflation measure used to calculate the defined benefit obligation for deferred pensions in the UK, together with the non-recurrence of payroll and bonus taxes in the UK and France in 2010.

Global Markets delivered full year revenues of US$8.1bn in a very challenging trading environment. As noted above, the decline was driven by significantly lower Credit and Rates trading revenues in Europe. A sharp reduction in revenues from our legacy credit portfolio, which decreased from US$848m reported in 2010 to US$165m in 2011, also contributed to the decline in Credit. This reflected a non-recurrence of the price appreciation in 2010 and lower holdings as a result of maturities and disposals aimed at reducing capital consumption, together with a reduction in effective yields and lower income from management services generated from the securities investment conduits. This was partly offset by resilient Rates trading revenues in Hong Kong, North America and Latin America as client flows increased, coupled with higher primary market revenues in the Rates business in most regions as we increased our market share of
global bond issuances. Fair value gains on structured liabilities also increased, mainly in Rates, as credit spreads widened more significantly than in 2010, resulting in a gain of US$458m compared with a reported gain of US$23m in 2010.

Other parts of Global Markets performed strongly. In our Equities business, revenues rose as investment in platforms improved our competitive positioning and helped capture increased client flows, notably in the first half of the year in Europe and Hong Kong. Foreign Exchange also delivered a strong performance in the year, driven by increased client activity in Hong Kong, Rest of Asia-Pacific, North

America and Latin America. Market volatility during 2011, caused by geopolitical tensions, ongoing eurozone concerns and interventions by central banks, resulted in an improved trading environment for Foreign Exchange compared with 2010. In addition, increased client demand and a rally in precious metal prices led to significant revenue growth in our metals business, also reported within Foreign Exchange. Securities Services revenues increased as interest income benefited from higher spreads in Rest of Asia-Pacific and Latin America. Fee income also rose, reflecting higher transaction volumes along with a rise in average assets under custody and administration.

Global Banking delivered a strong performance as we continued to focus on key client relationships. Higher revenues in Financing and Equity Capital Markets reflected a rise in average corporate lending balances, continued new business origination in project and export finance and lower losses on portfolio hedges compared with 2010. Revenues in the advisory business within Financing and Equity Capital Markets also increased, notably in Europe, driven by success in cross-border transactions. Payments and Cash Management revenue rose by 32%, despite the prolonged low interest rate environment in many developed markets, as robust growth in liability balances led to higher net interest income. The Rest of Asia-Pacific region performed particularly strongly, reflecting a combination of strong sales activity and interest rate rises in some Asian markets, notably in mainland China.

Revenues in Balance Sheet Management declined, driven by the maturity of higher yielding positions, limited opportunities for reinvestment in the prevailing low interest rate environment, and flattening yield curves.

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On a reported basis, the decline in Other reflected the non-recurrence of gains resulting from the sale of Eversholt Rail Group and HSBC Private Equity (Asia) Ltd in 2010. On an underlying basis, the reduction was driven by higher allocated funding costs, mainly in Europe, reflecting debt issuances during the year.

Principal Investments reported lower revenues as the deterioration in market confidence resulted in fewer disposal opportunities and lower gains on sale.

Strategic imperatives

Reinforce client coverage and client-led solutions

Investment in selective recruitment across our client coverage groups is key to delivering our strategy. Since June 2011, we have announced a number of key appointments to lead our global coverage teams and relocated a Co-Head of Global Banking to Asia to maintain our focus on growth markets.

We also established the Corporate Treasury Solutions Group, which brought together our fixed income, currency, commodities, debt financing and risk management capabilities in Europe, Middle East and North Africa. This enabled our client-facing teams to provide integrated, cross-product solutions to our corporate clients.

We continued to leverage our unique geographical franchise and global connectivity through our multinational proposition. Cross-border desks established in 2010 in Rest of Asia-Pacific, Latin America and the Middle East and North Africa to capitalise on growing international trade flows in South-South trade corridors generated strong growth in revenues from these markets in 2011.

Enhance core product strengths and selectively develop new capabilities

We continued to invest in e-commerce platforms to enhance our product offerings in foreign exchange. The first phase of our new e-FX platform is complete and it is live internally in Hong Kong, Dubai, London, Toronto and New York. Get Rate, which provides customers with live dealable exchange rates, is now available in 11 countries through various channels. These developments have contributed to a 43% increase in electronic volumes and a 16% rise in foreign exchange revenues in 2011.

Prime Services, which offers a fully integrated set of services including custody, financing solutions and reporting to alternative fund managers, is now live in Europe and Asia and a significant number of hedge fund managers are in the process of on-boarding.

We also upgraded our equity execution and research platforms in 2011 in response to client demand, focusing on selected European countries and faster growing markets where we have a natural advantage. Our Equity Capital Markets team achieved Top 10 league table positions in six out of nine target countries, as well as significant market share improvement in Asia and other key locations. We also strengthened our Equity Research team which, together with targeted client interaction, enabled us to move into the top 10 of equity research houses for the first time.

Collaborate with other global businesses to deliver incremental revenues

In order to further enhance our collaboration with CMB, we appointed heads of Coverage and Distribution to coordinate the specialist CMB sales teams and dedicated execution desks within GB&M. Revenues from the sale of GB&M products to CMB customers, which are shared between the two global businesses, grew by more than US$500m, primarily from foreign exchange and interest rate management products. In addition, we secured lead roles in a number of event deals with CMB clients in 2011, utilising our expertise in equity and debt capital markets, leveraged and acquisition finance and advisory.

We extended the Wealth Solutions Group model from Europe, Middle East and North Africa into Asia and the US to increase the sales of GB&M s wealth-related products, including foreign exchange, structured products and securities execution, through RBWM channels. We also developed new products aligned to customer needs, including Protected World Selection funds and mortgage protection products in the UK, which have led to growth in revenues from our RBWM distribution network.

Strategic re-engineering to deliver sustainable cost savings

We continued to reshape our business with the aim of lowering the future cost base of our operations. We undertook an organisational effectiveness review, which resulted in a reduction in staff numbers as we aligned our client coverage model and implemented productivity measures.

We focused on generating efficiency gains from the better use of technology and continued to rationalise and standardise our operational and trading platforms across asset classes and markets. This will enable ongoing investment in people and infrastructure to support our strategic priorities while minimising cost growth.

Report of the Directors: Operating and Financial Review (continued)

Global Private Banking

GPB serves high net worth individuals and families with complex and international needs.

	2011 US$m	2010 US$m	2009 US$m
Net interest income	**1,439**	1,345	1,474
Net fee income	**1,382**	1,299	1,236
Other income	**471**	449	402
Net operating income[52]	**3,292**	3,093	3,112
Impairment (charges)/ recoveries[53]	**(86)**	12	(128)
Net operating income	**3,206**	3,105	2,984
Total operating expenses	**(2,266)**	(2,035)	(1,884)
Operating profit	**940**	1,070	1,100
Income from associates[54]	**4**	(16)	8
Profit before tax	**944**	1,054	1,108
RoRWA[55]	**3.9%**	4.1%	4.0%

Net new money inflows of

US$13bn

2010: US$13bn; 2009: US$(7)bn

Continued investment in front-line

capabilities in line with strategy

Best Private Banking in Asia

(Euromoney 2011 Private Banking Survey)

Strategic direction

GPB works with high net worth clients to manage and preserve their wealth while connecting them to global opportunities. We focus on four strategic imperatives:

further expand our business in domestic and faster-growing markets and deliver emerging markets products to clients in developed markets;

continue to leverage our intra-Group connectivity with CMB, GB&M and RBWM to deliver the full suite of HSBC products and services to clients;

increase our managed assets, and build on our expertise in alternative investments, foreign exchange and trust and estate planning; and

continue to invest in front-office client systems with strong data security, while maintaining a focus on risk management and cost control.

Review of performance

Reported profit before tax of US$944m was 10% lower than in 2010 and 11% lower on an underlying basis, as revenue growth was offset by higher operating expenses and increased loan impairment charges.

Revenue increased by 5%, primarily driven by growth in Europe and, to a lesser extent, in Rest of Asia-Pacific. Net interest income increased due to higher average lending resulting from continued client demand and, particularly in the UK, improved asset spreads. Net fee income benefited from a significant increase in transaction volumes related to higher market volatility and net new money inflows of US$13bn in part driven by the recruitment of additional front line staff particularly in faster-growing markets.

Loan impairment charges and other credit risk provisions increased as a result of an impairment recorded in respect of available-for-sale Greek sovereign debt securities. Loan impairment charges also increased in Europe against a small number of individual customers.

The increase in *operating expenses* was mainly driven by the appreciation of the Swiss franc, which accounts for a significant proportion of our cost base, (see footnote 62). In addition we incurred higher regulatory compliance costs. We also recruited front office staff to cover faster-growing markets which resulted in higher staff costs, coupled with restructuring costs to drive operational efficiencies.

Client assets

	2011 US$bn	2010 US$bn
At 1 January	**390**	367
Net new money	**13**	13
Value change	**(20)**	13
Exchange and other	**(6)**	(3)
At 31 December	**377**	390

Client assets (see footnote 63), which include funds under management and cash deposits, declined as net new money inflows were offset by adverse movements in financial markets and negative movements in foreign exchange, primarily in the second half of the year.

Total client assets , the equivalent to many industry definitions of assets under management which include some non-financial assets held in client trusts, decreased marginally to US$496bn at 31 December 2011.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Strategic imperatives

Expand in faster-growing markets

Progress was made in implementing key strategic initiatives, including developing the faster-growing markets business through investment in front line staff and systems. The majority of net new money in 2011 has originated from faster-growing markets.

Grow annuity revenue

Product capabilities were enhanced with the launch of renminbi-based products and further development of our alternative investment offerings and trust and estate planning products.

Leverage intra-Group strengths

Intra-Group referrals contributed net new money of US$6.3bn or 49% of total net new money.

Referrals from GB&M for institutional private clients grew significantly, and benefited from the continued success of the Family Office advisory scheme.

Invest in platform while controlling costs

The global roll-out of the front-office systems programme continued in order to improve operational efficiency and client service, and information security standards were enhanced. Progress was made in rationalising the business, through the use of the five filters analysis, with the closure of operations in Russia and sale of our operations in Japan. A restructuring exercise is also underway in line with our targets to improve operational effectiveness, reflected in a 4% reduction in staff numbers in the second half of 2011.

Other

Other contains the results of certain property transactions, unallocated investment activities, centrally held investment companies, movements in fair value of own debt, central support and functional costs with associated recoveries, HSBC s holding company and financing operations.

	2011 US$m	2010 US$m	2009 US$m
Net interest expense	**(911)**	(998)	(1,035)
Net trading income/ (expense)	**(355)**	(311)	279

Change in credit spread on long-term debt	**4,161**	(258)	(6,247)
Other changes in fair value	**78**	42	(196)
Net income/(expense) from financial instruments designated at fair value	**4,239**	(216)	(6,443)
Other income	**6,172**	6,185	5,176
Net operating income/ (expense)[52]	**9,145**	4,660	(2,023)
Impairment (charges)/ recoveries[53]		3	(8)
Net operating income/ (expense)	**9,145**	4,663	(2,031)
Total operating expenses	**(7,492)**	(5,918)	(4,715)
Operating profit/(loss)	**1,653**	(1,255)	(6,746)
Income from associates[54]	**9**	94	26
Profit/(loss) before tax	**1,662**	(1,161)	(6,720)

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Report of the Directors: Operating and Financial Review (continued)

Notes

Reported profit before tax of US$1.7bn compared with a loss before tax of US$1.2bn in 2010. This included favourable movements of US$3.9bn on the fair value of HSBC s own debt attributable to a widening in credit spreads compared with adverse fair value movements of US$63m in 2010. In addition, reported profits included a gain of US$62m on the reclassification of Bao Viet as an associate in 2010 and accounting gains of US$188m and US$181m in 2010 and 2011, respectively, arising from the dilution of our shareholding in Ping An following its issue of share capital to third parties. We also reported a re-measurement loss of US$48m relating to Ping An s acquisition of its associate, Shenzhen Development Bank and a dilution gain of US$27m as a result of the reduction in our holding in HSBC Saudi Arabia Limited following its merger with SABB Securities Limited in 2011. On an underlying basis, the loss before tax increased by US$1.1bn to US$2.4bn. This was primarily driven by the UK bank levy, restructuring provisions and the non-recurrence of gains from the sale and leaseback of buildings in 2010. For a description of the main items reported under Other , see footnote 61.

Net trading expense rose, driven by adverse fair value movements on derivatives relating to certain provident funds in Hong Kong as long-term investment returns fell. This was partly offset by lower adverse fair value movements on non-qualifying hedges of US$276m in 2011 compared with adverse fair value movements of US$304m in 2010. These mainly related to cross-currency swaps used to economically hedge fixed rate long-term debt issued by HSBC Holdings.
Net income from financial instruments designated at fair value of US$304m in 2011 compared with net expense from financial instruments designated at fair value in 2010 as favourable fair value movements from interest and exchange rate ineffectiveness in the hedging of long-term debt designated at fair value issued by HSBC Holdings and our European and North American subsidiaries compared with adverse fair value movements in 2010.

Other operating income increased as a result of higher intra-group recharges in line with the increase in costs from centralised operational and migrated activities described below. This was partly offset by the non-recurrence of gains of US$250m recognised from the sale and leaseback of our Paris and New York headquarters in 2010.

Operating expenses increased by 26% to US$7.5bn. Costs in 2011 included a charge of US$570m in relation to the UK bank levy and a charge of US$217m, primarily relating to impairment of intangibles and staff related costs, to restructure our regional and country support functions in Latin America as measures were taken to streamline processes and lower the future cost base of our operations. A rise in centralised operational and migrated activities, in line with our Global Resourcing model, also contributed to higher costs in the period. These costs are recorded in Other and charged to global businesses through a recharge mechanism with income reported as Other operating income .

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Reconciliation of reported and underlying profit/(loss) before tax

Retail Banking and Wealth Management

2011 compared with 2010[17]

	2010 as reported US$m	2010 adjust-ments[10] US$m	Currency translation[11] US$m	2010 at 2011 exchange rates[12] US$m	2011 as reported US$m	2011 adjust-ments[10] US$m	2011 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	**24,166**		**424**	**24,590**	**24,101**		**24,101**	**(0)**	**(2)**
Net fee income	**8,397**	**(2)**	**154**	**8,549**	**8,226**		**8,226**	**(2)**	**(4)**
Other income[15]	**1,048**	**(3)**	**36**	**1,081**	**1,206**	**(83)**	**1,123**	**15**	**4**
Net operating income[16]	**33,611**	**(5)**	**614**	**34,220**	**33,533**	**(83)**	**33,450**	**(0)**	**(2)**
Loan impairment charges and other credit risk provisions	**(11,259)**		**(113)**	**(11,372)**	**(9,319)**		**(9,319)**	**17**	**18**
Net operating income	**22,352**	**(5)**	**501**	**22,848**	**24,214**	**(83)**	**24,131**	**8**	**6**
Operating expenses	**(19,539)**	**2**	**(421)**	**(19,958)**	**(21,202)**		**(21,202)**	**(9)**	**(6)**
Operating profit	**2,813**	**(3)**	**80**	**2,890**	**3,012**	**(83)**	**2,929**	**7**	**1**
Income from associates	**1,026**		**46**	**1,072**	**1,258**		**1,258**	**23**	**17**
Profit before tax	**3,839**	**(3)**	**126**	**3,962**	**4,270**	**(83)**	**4,187**	**11**	**6**

2010 compared with 2009[17]

	2009 as reported US$m	2009 adjust-ments[10] US$m	Currency translation[11] US$m	2009 at 2010 exchange rates[18] US$m	2010 as reported US$m	2010 adjust-ments[10] US$m	2010 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	25,099		418	25,517	24,166	(8)	24,158	(4)	(5)
Net fee income	9,138	(8)	123	9,253	8,397	(1)	8,396	(8)	(9)
Other income[15]	2,060		98	2,158	1,048	(5)	1,043	(49)	(52)
Net operating income[16]	36,297	(8)	639	36,928	33,611	(14)	33,597	(7)	(9)

Loan impairment charges and other credit risk provisions	(19,902)		(271)	(20,173)	(11,259)		(11,259)	43	44
Net operating income	16,395	(8)	368	16,755	22,352	(14)	22,338	36	33
Operating expenses	(18,976)	6	(442)	(19,412)	(19,539)	4	(19,535)	(3)	(1)
Operating profit/(loss)	(2,581)	(2)	(74)	(2,657)	2,813	(10)	2,803		
Income from associates	735		7	742	1,026		1,026	40	38
Profit/(loss) before tax	(1,846)	(2)	(67)	(1,915)	3,839	(10)	3,829		

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Report of the Directors: Operating and Financial Review (continued)

Commercial Banking

2011 compared with 2010

	2010 as reported US$m	2010 adjust- ments[10] US$m	Currency translation[11] US$m	2010 at 2011 exchange rates[12] US$m	2011 as reported US$m	2011 adjust- ments[10] US$m	2011 under- lying US$m	Re- ported change[13] %	Under- lying change[13] %
Net interest income	**8,487**	**(1)**	**194**	**8,680**	**9,931**		**9,931**	**17**	**14**
Net fee income	**3,964**	**(37)**	**99**	**4,026**	**4,291**		**4,291**	**8**	**7**
Other income[15]	**1,383**	**(119)**	**19**	**1,283**	**1,389**		**1,389**	**1**	**8**
Net operating income[16]	**13,834**	**(157)**	**312**	**13,989**	**15,611**		**15,611**	**13**	**12**
Loan impairment charges and other credit risk provisions	**(1,805)**		**(49)**	**(1,854)**	**(1,738)**		**(1,738)**	**4**	**6**
Net operating income	**12,029**	**(157)**	**263**	**12,135**	**13,873**		**13,873**	**15**	**14**
Operating expenses	**(6,831)**	**38**	**(165)**	**(6,958)**	**(7,221)**		**(7,221)**	**(6)**	**(4)**
Operating profit	**5,198**	**(119)**	**98**	**5,177**	**6,652**		**6,652**	**28**	**29**
Income from associates	**892**		**28**	**920**	**1,295**		**1,295**	**45**	**41**
Profit before tax	**6,090**	**(119)**	**126**	**6,097**	**7,947**		**7,947**	**31**	**30**

2010 compared with 2009

	2009 as reported US$m	2009 adjust- ments[10] US$m	Currency translation[11] US$m	2009 at 2010 exchange rates[18] US$m	2010 as reported US$m	2010 adjust- ments[10] US$m	2010 under- lying US$m	Re- ported change[13] %	Under- lying change[13] %
Net interest income	7,883	(1)	193	8,075	8,487	(20)	8,467	8	5
Net fee income	3,702	(164)	51	3,589	3,964	(2)	3,962	7	10
Other income[15]	1,268	(283)	12	997	1,383	(124)	1,259	9	26
Net operating income[16]	12,853	(448)	256	12,661	13,834	(146)	13,688	8	8
Loan impairment charges and other credit risk provisions	(3,282)		(73)	(3,355)	(1,805)		(1,805)	45	46
Net operating income	9,571	(448)	183	9,306	12,029	(146)	11,883	26	28
Operating expenses	(5,963)	143	(122)	(5,942)	(6,831)	13	(6,818)	(15)	(15)
Operating profit	3,608	(305)	61	3,364	5,198	(133)	5,065	44	51
Income from associates	667	(1)	3	669	892		892	34	33

Profit before tax	4,275	(306)	64	4,033	6,090	(133)	5,957	42	48

For footnotes, see page 95.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Global Banking and Markets

2011 compared with 2010[17]

	2010 as reported US$m	2010 adjust-ments[10] US$m	Currency translation[11] US$m	2010 at 2011 exchange rates[12] US$m	2011 as reported US$m	2011 adjust-ments[10] US$m	2011 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	7,343	49	176	7,568	7,263		7,263	(1)	(4)
Net fee income	3,664	(16)	82	3,730	3,227		3,227	(12)	(13)
Net trading income	5,830	243	179	6,252	5,204		5,204	(11)	(17)
Other income[15]	2,075	(718)	54	1,411	1,363		1,363	(34)	(3)
Net operating income[16]	18,912	(442)	491	18,961	17,057		17,057	(10)	(10)
Loan impairment charges and other credit risk provisions	(990)		(41)	(1,031)	(984)		(984)	1	5
Net operating income	17,922	(442)	450	17,930	16,073		16,073	(10)	(10)
Operating expenses	(9,228)	180	(266)	(9,314)	(9,722)		(9,722)	(5)	(4)
Operating profit	8,694	(262)	184	8,616	6,351		6,351	(27)	(26)
Income from associates	521		14	535	698		698	34	30
Profit before tax	9,215	(262)	198	9,151	7,049		7,049	(24)	(23)

2010 compared with 2009[17]

	2009 as reported US$m	2009 adjust-ments[10] US$m	Currency translation[11] US$m	2009 at 2010 exchange rates[18] US$m	2010 as reported US$m	2010 adjust-ments[10] US$m	2010 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	8,618		61	8,679	7,343	(3)	7,340	(15)	(15)
Net fee income	3,463	(38)	12	3,437	3,664		3,664	6	7
Net trading income	6,867		106	6,973	5,830		5,830	(15)	(16)
Other income[15]	1,990			1,990	2,075	(341)	1,734	4	(13)
Net operating income[16]	20,938	(38)	179	21,079	18,912	(344)	18,568	(10)	(12)
Loan impairment charges and other credit risk provisions	(3,168)		13	(3,155)	(990)		(990)	69	69

Net operating income	17,770	(38)	192	17,924	17,922	(344)	17,578	1	(2)
Operating expenses	(7,853)	51	(23)	(7,825)	(9,228)	2	(9,226)	(18)	(18)
Operating profit	9,917	13	169	10,099	8,694	(342)	8,352	(12)	(17)
Income from associates	345		1	346	521		521	51	51
Profit before tax	10,262	13	170	10,445	9,215	(342)	8,873	(10)	(15)

For footnotes, see page 95.

Report of the Directors: Operating and Financial Review (continued)

Balance sheet data significant to Global Banking and Markets

	Europe	Hong Kong	Rest of Asia-Pacific	MENA	North America	Latin America	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
At 31 December 2011							
Trading assets[78]	**180,790**	**38,637**	**19,167**	**938**	**69,568**	**14,370**	**323,470**
Derivative assets[79]	**272,756**	**25,203**	**23,056**	**1,275**	**86,619**	**4,825**	**413,734**
Trading liabilities	**157,934**	**8,282**	**3,781**	**757**	**70,288**	**5,014**	**246,056**
Derivative liabilities[79]	**274,803**	**25,186**	**23,877**	**1,245**	**86,697**	**4,469**	**416,277**
At 31 December 2010							
Trading assets[78]	232,918	32,023	18,256	958	87,120	6,459	377,734
Derivative assets[79]	199,654	21,644	17,135	832	65,153	3,955	308,373
Trading liabilities	178,861	8,650	3,846	122	91,980	2,702	286,161
Derivative liabilities[79]	199,751	22,622	17,121	845	66,323	3,913	310,575
At 31 December 2009							
Trading assets[78]	294,951	25,742	15,960	511	67,466	6,283	410,913
Derivative assets[79]	190,900	16,937	15,660	668	61,192	2,820	288,177
Trading liabilities	169,814	10,720	3,040	13	69,302	2,875	255,764
Derivative liabilities[79]	191,480	16,619	15,500	651	60,178	3,270	287,698

For footnotes, see page 95.

Report of the Directors: Operating and Financial Review (continued)

Global Private Banking

2011 compared with 2010

	2010 as reported US$m	2010 adjust-ments[10] US$m	Currency translation[11] US$m	2010 at 2011 exchange rates[12] US$m	2011 as reported US$m	2011 adjust-ments[10] US$m	2011 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	**1,345**		**13**	**1,358**	**1,439**		**1,439**	**7**	**6**
Net fee income	**1,299**		**15**	**1,314**	**1,382**		**1,382**	**6**	**5**
Other income[15]	**449**		**2**	**451**	**471**		**471**	**5**	**4**
Net operating income[16]	**3,093**		**30**	**3,123**	**3,292**		**3,292**	**6**	**5**
Loan impairment (charges)/recoveries and other credit risk provisions	**12**		**(1)**	**11**	**(86)**		**(86)**		
Net operating income	**3,105**		**29**	**3,134**	**3,206**		**3,206**	**3**	**2**
Operating expenses	**(2,035)**		**(23)**	**(2,058)**	**(2,266)**		**(2,266)**	**(11)**	**(10)**
Operating profit	**1,070**		**6**	**1,076**	**940**		**940**	**(12)**	**(13)**
Income from associates	**(16)**			**(16)**	**4**		**4**		
Profit before tax	**1,054**		**6**	**1,060**	**944**		**944**	**(10)**	**(11)**

2010 compared with 2009

	2009 as reported US$m	2009 adjust-ments[10] US$m	Currency translation[11] US$m	2009 at 2010 exchange rates[18] US$m	2010 as reported US$m	2010 adjust-ments[10] US$m	2010 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	1,474		(2)	1,472	1,345		1,345	(9)	(9)
Net fee income	1,236		(1)	1,235	1,299		1,299	5	5
Other income[15]	402			402	449	1	450	12	12
Net operating income[16]	3,112		(3)	3,109	3,093	1	3,094	(1)	
Loan impairment (charges)/recoveries and other credit risk provisions	(128)		1	(127)	12		12		
Net operating income	2,984		(2)	2,982	3,105	1	3,106	4	4
Operating expenses	(1,884)		3	(1,881)	(2,035)		(2,035)	(8)	(8)
Operating profit	1,100		1	1,101	1,070	1	1,071	(3)	(3)
Income from associates	8			8	(16)		(16)		

Profit before tax	1,108	1	1,109	1,054	1	1,055	(5)	(5)

For footnotes, see page 95.

Report of the Directors: Operating and Financial Review (continued)

Other

2011 compared with 2010

	2010 as reported US$m	2010 adjust- ments[10] US$m	Currency translation[11] US$m	2010 at 2011 exchange rates[12] US$m	2011 as reported US$m	2011 adjust- ments[10] US$m	2011 under- lying US$m	Re- ported change[13] %	Under- lying change[13] %
Net interest expense	(998)		(41)	(1,039)	(911)		(911)	9	12
Net fee income	31		(1)	30	34		34	10	13
Changes in fair value[14]	(63)	63			3,933	(3,933)			
Other income[15]	5,690	(250)	65	5,505	6,089	(208)	5,881	7	7
Net operating income[16]	**4,660**	**(187)**	**23**	**4,496**	**9,145**	**(4,141)**	**5,004**	**96**	**11**
Loan impairment recoveries and other credit risk provisions	3		(2)	1					
Net operating income	**4,663**	**(187)**	**21**	**4,497**	**9,145**	**(4,141)**	**5,004**	**96**	**11**
Operating expenses	(5,918)		(24)	(5,942)	(7,492)		(7,492)	(27)	(26)
Operating profit/(loss)	**(1,255)**	**(187)**	**(3)**	**(1,445)**	**1,653**	**(4,141)**	**(2,488)**	**232**	**(72)**
Income from associates	94		6	100	9	48	57	(90)	(43)
Profit/(loss) before tax	**(1,161)**	**(187)**	**3**	**(1,345)**	**1,662**	**(4,093)**	**(2,431)**	**243**	**(81)**

2010 compared with 2009

	2009 as reported US$m	2009 adjust- ments[10] US$m	Currency translation[11] US$m	2009 at 2010 exchange rates[18] US$m	2010 as reported US$m	2010 adjust- ments[10] US$m	2010 under- lying US$m	Re- ported change[13] %	Under- lying change[13] %
Net interest expense	(1,035)		21	(1,014)	(998)		(998)	4	2
Net fee income	125		(3)	122	31		31	(75)	(75)
Changes in fair value[14]	(6,533)	6,533			(63)	63		99	
Other income[15]	5,420		29	5,449	5,690	(250)	5,440	5	
Net operating income/ (expense)[16]	(2,023)	6,533	47	4,557	4,660	(187)	4,473		(2)
Loan impairment (charges)/recoveries and other credit risk provisions	(8)			(8)	3		3		
Net operating income/ (expense)	(2,031)	6,533	47	4,549	4,663	(187)	4,476		(2)
Operating expenses	(4,715)		(50)	(4,765)	(5,918)		(5,918)	(26)	(24)

Operating loss	(6,746)	6,533	(3)	(216)	(1,255)	(187)	(1,442)	81	(568)
Income from associates	26			26	94		94	262	262
Loss before tax	(6,720)	6,533	(3)	(190)	(1,161)	(187)	(1,348)	83	(609)

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Report of the Directors: Operating and Financial Review (continued)

Analysis by global business

HSBC profit/(loss) before tax and balance sheet data

	2011						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other[48] US$m	Inter-segment elimination[64] US$m	Total US$m
Profit before tax							
Net interest income/(expense)	24,101	9,931	7,263	1,439	(911)	(1,161)	40,662
Net fee income	8,226	4,291	3,227	1,382	34		17,160
Trading income/(expense) excluding net interest income	(562)	565	3,306	415	(441)		3,283
Net interest income on trading activities	43	19	1,898	16	86	1,161	3,223
Net trading income/(expense)[56]	(519)	584	5,204	431	(355)	1,161	6,506
Changes in fair value of long- term debt issued and related derivatives					4,161		4,161
Net income/(expenses) from other financial instruments designated at fair value	(761)	33	(72)		78		(722)
Net income/(expense) from financial instruments designated at fair value	(761)	33	(72)		4,239		3,439
Gains less losses from financial investments	124	20	761	3	(1)		907
Dividend income	27	15	75	7	25		149
Net earned insurance premiums	10,882	1,956	47		(13)		12,872
Other operating income	907	483	577	30	6,127	(6,358)	1,766
Total operating income	42,987	17,313	17,082	3,292	9,145	(6,358)	83,461
Net insurance claims[65]	(9,454)	(1,702)	(25)				(11,181)
Net operating income[52]	33,533	15,611	17,057	3,292	9,145	(6,358)	72,280
Loan impairment charges and other credit risk provisions	(9,319)	(1,738)	(984)	(86)			(12,127)
Net operating income	24,214	13,873	16,073	3,206	9,145	(6,358)	60,153
Employee expenses[66]	(6,538)	(2,184)	(4,196)	(1,351)	(6,897)		(21,166)
Other operating expenses	(14,664)	(5,037)	(5,526)	(915)	(595)	6,358	(20,379)
Total operating expenses	(21,202)	(7,221)	(9,722)	(2,266)	(7,492)	6,358	(41,545)

Operating profit	**3,012**	**6,652**	**6,351**	**940**	**1,653**		**18,608**
Share of profit in associates and joint ventures	**1,258**	**1,295**	**698**	**4**	**9**		**3,264**
Profit before tax	**4,270**	**7,947**	**7,049**	**944**	**1,662**		**21,872**
	%	**%**	**%**	**%**	**%**		**%**
Share of HSBC s profit before tax	**19.6**	**36.3**	**32.2**	**4.3**	**7.6**		**100.0**
Cost efficiency ratio	**63.2**	**46.3**	**57.0**	**68.8**	**81.9**		**57.5**

Balance sheet data[49]

	US$m	**US$m**	**US$m**	**US$m**	**US$m**		**US$m**
Loans and advances to customers (net)	**357,907**	**262,039**	**276,463**	**41,856**	**2,164**		**940,429**
Total assets	**540,548**	**334,966**	**1,877,627**	**119,839**	**180,126**	**(497,527)**	**2,555,579**
Customer accounts	**529,017**	**306,174**	**306,454**	**111,814**	**466**		**1,253,925**

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Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax and balance sheet data (continued)

	2010						
	Retail Banking and Wealth Manage-ment[17] US$m	Commercial Banking US$m	Global Banking and Markets[17] US$m	Global Private Banking US$m	Other[48] US$m	Inter-segment elimination[64] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	24,166	8,487	7,343	1,345	(998)	(902)	39,441
Net fee income	8,397	3,964	3,664	1,299	31		17,355
Trading income/(expense) excluding net interest income	(106)	427	4,326	391	(358)		4,680
Net interest income on trading activities	28	28	1,504	21	47	902	2,530
Net trading income/(expense)[56]	(78)	455	5,830	412	(311)	902	7,210
Changes in fair value of long- term debt issued and related derivatives					(258)		(258)
Net income from other financial instruments designated at fair value	1,210	190	36		42		1,478
Net income/(expense) from financial instruments designated at fair value	1,210	190	36		(216)		1,220
Gains less losses from financial investments	(24)	(1)	863	(6)	136		968
Dividend income	27	12	48	5	20		112
Net earned insurance premiums	9,737	1,379	41		(11)		11,146
Other operating income	684	585	1,113	38	6,005	(5,863)	2,562
Total operating income	44,119	15,071	18,938	3,093	4,656	(5,863)	80,014
Net insurance claims[65]	(10,508)	(1,237)	(26)		4		(11,767)
Net operating income[52]	33,611	13,834	18,912	3,093	4,660	(5,863)	68,247
Loan impairment (charges)/ recoveries and other credit risk provisions	(11,259)	(1,805)	(990)	12	3		(14,039)
Net operating income	22,352	12,029	17,922	3,105	4,663	(5,863)	54,208
Employee expenses[66]	(5,770)	(2,153)	(4,353)	(1,237)	(6,323)		(19,836)
Other operating expenses	(13,769)	(4,678)	(4,875)	(798)	405	5,863	(17,852)
Total operating expenses	(19,539)	(6,831)	(9,228)	(2,035)	(5,918)	5,863	(37,688)
Operating profit/(loss)	2,813	5,198	8,694	1,070	(1,255)		16,520
Share of profit/(loss) in associates and joint ventures	1,026	892	521	(16)	94		2,517

Profit/(loss) before tax	3,839	6,090	9,215	1,054	(1,161)		19,037
	%	%	%	%	%		%
Share of HSBC s profit before tax	20.2	32.0	48.4	5.5	(6.1)		100.0
Cost efficiency ratio	58.1	49.4	48.8	65.8	127.0		55.2

Balance sheet data[49]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	390,963	239,286	284,497	40,665	2,955		958,366
Total assets	530,970	296,797	1,755,043	116,846	161,458	(406,425)	2,454,689
Customer accounts	525,221	286,007	308,416	107,130	951		1,227,725

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Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax and balance sheet data (continued)

	2009						
	Retail Banking and Wealth Manage-ment[17] US$m	Commercial Banking US$m	Global Banking and Markets[17] US$m	Global Private Banking US$m	Other[48] US$m	Inter-segment elimination[64] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	25,099	7,883	8,618	1,474	(1,035)	(1,309)	40,730
Net fee income	9,138	3,702	3,463	1,236	125		17,664
Trading income excluding net interest income	645	332	4,693	322	244		6,236
Net interest income on trading activities	65	22	2,174	22	35	1,309	3,627
Net trading income[56]	710	354	6,867	344	279	1,309	9,863
Changes in fair value of long- term debt issued and related derivatives					(6,247)		(6,247)
Net income/(expense) from other financial instruments designated at fair value	2,339	100	473		(196)		2,716
Net income/(expense) from financial instruments designated at fair value	2,339	100	473		(6,443)		(3,531)
Gains less losses from financial investments	181	23	308	5	3		520
Dividend income	29	8	72	5	12		126
Net earned insurance premiums	9,534	886	54		(3)		10,471
Other operating income	838	739	1,117	48	5,042	(4,996)	2,788
Total operating income/(expense)	47,868	13,695	20,972	3,112	(2,020)	(4,996)	78,631
Net insurance claims[65]	(11,571)	(842)	(34)		(3)		(12,450)
Net operating income/(expense)[52]	36,297	12,853	20,938	3,112	(2,023)	(4,996)	66,181
Loan impairment charges and other credit risk provisions	(19,902)	(3,282)	(3,168)	(128)	(8)		(26,488)
Net operating income/(expense)	16,395	9,571	17,770	2,984	(2,031)	(4,996)	39,693
Employee expenses[66]	(6,450)	(2,072)	(3,954)	(1,198)	(4,790)		(18,464)
Other operating expenses	(12,526)	(3,891)	(3,899)	(686)	75	4,996	(15,931)
Total operating expenses	(18,976)	(5,963)	(7,853)	(1,884)	(4,715)	4,996	(34,395)
Operating profit/(loss)	(2,581)	3,608	9,917	1,100	(6,746)		5,298
Share of profit in associates and joint ventures	735	667	345	8	26		1,781
Profit/(loss) before tax	(1,846)	4,275	10,262	1,108	(6,720)		7,079

	%	%	%	%	%		%
Share of HSBC s profit before tax	(26.1)	60.4	145.0	15.6	(94.9)		100.0
Cost efficiency ratio	52.3	46.4	37.5	60.5	(233.1)		52.0

Balance sheet data[49]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	399,468	199,674	256,948	37,031	3,110		896,231
Total assets	556,827	251,143	1,680,919	116,148	150,983	(391,568)	2,364,452
Customer accounts	499,124	267,388	284,712	106,533	1,277		1,159,034

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Summary

Additional information on results in 2011 may be found in the Financial Summary on pages 16 to 42.

In the analysis of profit by geographical regions that follows, operating income and operating expenses include intra-HSBC items of US$3,421m (2010: US$3,125m; 2009: US$2,756m).

Profit/(loss) before tax

	2011		2010		2009	
	US$m	**%**	US$m	%	US$m	%
Europe	**4,671**	**21.3**	4,302	22.6	4,009	56.7
Hong Kong	**5,823**	**26.6**	5,692	29.9	5,029	71.0
Rest of Asia-Pacific	**7,471**	**34.2**	5,902	31.0	4,200	59.3
Middle East and North Africa	**1,492**	**6.8**	892	4.7	455	6.4
North America	**100**	**0.5**	454	2.4	(7,738)	(109.3)
Latin America	**2,315**	**10.6**	1,795	9.4	1,124	15.9
	21,872	**100.0**	19,037	100.0	7,079	100.0

Total assets[49]

	At 31 December			
	2011		2010	
	US$m	**%**	US$m	%
Europe	**1,281,945**	**50.3**	1,249,527	50.9
Hong Kong	**473,024**	**18.5**	429,565	17.5

Rest of Asia-Pacific	**317,816**	**12.4**	278,062	11.3
Middle East and North Africa	**57,464**	**2.2**	52,757	2.1
North America	**504,302**	**19.7**	492,487	20.1
Latin America	**144,889**	**5.7**	139,938	5.7
Intra-HSBC items	**(223,861)**	**(8.8)**	(187,647)	(7.6)
	2,555,579	**100.0**	2,454,689	100.0

Risk-weighted assets[67]

	At 31 December			
	2011		2010	
	US$bn	**%**	US$bn	%
Total	**1,209.5**		1,103.1	
Europe	**340.2**	**27.8**	301.6	27.2
Hong Kong	**105.7**	**8.6**	106.9	9.7
Rest of Asia-Pacific	**279.3**	**22.8**	217.5	19.6
Middle East and North Africa	**58.9**	**4.8**	54.1	4.9
North America	**337.3**	**27.6**	330.7	29.9
Latin America	**102.3**	**8.4**	95.9	8.7

For footnotes, see page 95.

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Europe

Our principal banking subsidiaries in Europe are HSBC Bank plc in the UK, HSBC France S.A., HSBC Bank A.S. in Turkey, HSBC Bank Malta p.l.c., HSBC Private Bank (Suisse) S.A. and HSBC Trinkaus & Burkhardt AG. Through these subsidiaries we provide a wide range of banking, treasury and financial services to personal, commercial and corporate customers across Europe.

	2011	2010	2009
	US$m	US$m	US$m
Net interest income	11,001	11,250	12,268
Net fee income	6,236	6,371	6,267
Net trading income	2,161	2,863	5,459
Other income/(expense)	4,848	2,266	(450)
Net operating income[52]	24,246	22,750	23,544
Impairment charges[53]	(2,512)	(3,020)	(5,568)
Net operating income	21,734	19,730	17,976
Total operating expenses	(17,069)	(15,445)	(13,988)
Operating profit	4,665	4,285	3,988
Income from associates[54]	6	17	21
Profit before tax	4,671	4,302	4,009
Cost efficiency ratio	70.4%	67.9%	59.4%
RoRWA[55]	1.5%	1.3%	1.2%
Year-end staff numbers	74,892	75,698	76,703

Credit and Rates

revenues within GB&M

adversely affected by

eurozone uncertainty

Best Debt House in Western Europe

(Euromoney Awards for Excellence 2011)

53%

reduction in RBWM

loan impairment charges

For footnotes, see page 95.

The commentary on Europe is on an underlying basis unless stated otherwise.

Economic background

After growing by 2.1% in 2010, **UK** gross domestic product (GDP) growth eased to 0.9% in 2011. The unemployment rate rose to 8.4% in December 2011. Despite the weakness in the domestic economy, an increase in the rate of value added tax and rising oil prices early in the year pushed the annual rate of consumer price index (CPI) inflation to 5.2% in September 2011 before moderating to 3.6% in December 2011. The Bank of England maintained the Bank Rate at 0.5% throughout the year and expanded the size of its Asset Purchase Programme by £75bn (US$120bn) to £275bn (US$440bn) in October 2011.

The **eurozone** economy grew by 1.5% in 2011, on the back of a recovery in global trade in the first half of 2011 and domestic fixed investment growth. Within the region, Germany saw the strongest recovery with GDP growing by 3%. The German unemployment rate, as measured by the International Labour Organisation, fell during the year, touching 5.5% in December but, for the eurozone as a whole, unemployment rose further to 10.4% in December. Concerns about sovereign debt sustainability persisted in 2011, leading to banking sector strains. The European Central Bank cut interest rates to 1% and introduced several new measures to ease strains in the banking sector including long-term refinancing operations of 36 months maturity and easing of commercial banks collateral requirements for use in these liquidity operations.

Review of performance

Our European operations reported a pre-tax profit of US$4.7bn, 9% higher than in 2010. These results included favourable fair value movements of US$2.9bn in 2011 due to the change in credit spreads on the Group s own debt held at fair value, compared with adverse fair value movements of US$198m in 2010. In addition, 2010 included gains of US$107m and US$255m on the disposal of HSBC Insurance Brokers Limited and Eversholt Rail Group, respectively.

Underlying profit before tax, excluding these items, decreased by 61% as turmoil in eurozone sovereign debt markets dominated European market sentiment, resulting in markedly lower revenues in GB&M.

During the year, we began to reshape our business portfolio and announced the closure of our retail banking businesses in Poland and Russia, the exit of operations from Georgia and the disposal of our UK motor insurance business. In order to

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Profit/(loss) before tax by country within global businesses

	Retail Banking and Wealth Management[17] US$m	Commercial Banking US$m	Global Banking and Markets[17] US$m	Global Private Banking US$m	Other US$m	Total US$m
2011						
UK	**1,330**	**1,227**	**(265)**	**192**	**1,037**	**3,521**
France[44]	**69**	**192**	**(194)**	**16**	**18**	**101**
Germany	**36**	**69**	**203**	**28**	**16**	**352**
Malta	**31**	**72**	**21**			**124**
Switzerland		**(8)**		**225**		**217**
Turkey	**7**	**62**	**87**	**2**		**158**
Other	**(151)**	**73**	**225**	**94**	**(43)**	**198**
	1,322	**1,687**	**77**	**557**	**1,028**	**4,671**
2010						
UK	1,181	827	1,772	223	(1,605)	2,398
France[44]	138	135	376	18	26	693
Germany	36	32	231	30	4	333
Malta	37	56	17			110
Switzerland		(5)		265		260
Turkey	64	80	105	1		250
Other	(144)	80	202	103	17	258
	1,312	1,205	2,703	640	(1,558)	4,302
2009						
UK	331	1,026	3,078	252	(2,561)	2,126
France[44]	67	102	881	3	(429)	624
Germany	34	21	221	32	(18)	290
Malta	33	58	9			100
Switzerland			5	448	(3)	450
Turkey	43	97	119	2		261
Other	(183)	(12)	219	117	17	158
	325	1,292	4,532	854	(2,994)	4,009

For footnotes, see page 95.

improve cost efficiency and organisational effectiveness, we took measures to streamline our processes with the aim of lowering the future cost base of our operations while maintaining high standards of service. As a result of these initiatives, total restructuring costs of US$404m were incurred across the region in 2011.

In RBWM, further progress was made in implementing our strategy of building long-term sustainable relationships with Premier customers. The Wealth Management business continued to develop with HSBC World Selection assets under management increasing by 21% during 2011 to £2.5bn (US$3.8bn) as a result of a strategic focus and continued marketing. The Global Investment Centre service was successfully launched in October 2011, enabling investors to hold and trade a wide range of third party and HSBC funds on-line.

We continued to support the UK housing market during 2011, achieving strong growth in mortgage balances driven by successful marketing campaigns. Our share of new lending increased to 10% in 2011, while maintaining a conservative loan to value ratio

of 53% on new lending. To support our customers through the prevailing economic conditions, we committed to make available £350m (US$542m) to UK mortgage borrowers with deposits of 15% or less. In addition, an increase in the customer base of 5% contributed to a growth in our UK deposit balances of 4%.

In CMB, we made further progress on our strategy of becoming the leading international trade and business bank with a significant increase in the number of international customers, resulting in strong income growth from our trade-related business. We continue to strengthen our partnership with GB&M with a focus on driving product income growth, particularly in strategic financing and treasury risk management products. We also achieved strong growth in UK lending, reflecting our continued support to UK businesses during the difficult economic conditions. We exceeded our 2011 lending intentions under the Project Merlin agreement with the UK Government, both in terms of total and SME facilities.

Report of the Directors: Operating and Financial Review (continued)

In Continental Europe, we experienced strong demand in term lending and significant growth in our deposit base in both RBWM and CMB, reflecting marketing and pricing initiatives. Our Trade and Supply Chain business performed strongly across the region, following the launch of our export initiative during 2011. In Europe we now have 18 countries with full renminbi functionality with the ability to settle trade transactions via either Shanghai or Hong Kong.

We won several awards in GB&M including Best Debt House in Western Europe and the UK from *Euromoney* Awards for Excellence in 2011. We continued to invest in technology platforms including Equities and Prime Services and are therefore well positioned to capture medium-term opportunities in the region. We also continued to focus on cross-border initiatives to position ourselves to take advantage of trade flows. In Payments & Cash Management, enhanced network capabilities together with innovative liquidity, channel and payables solutions allowed us to win substantial business across the corporate and financial institution business segments.

In GPB, revenue growth was driven by increased client activity as we leveraged our global businesses strengths and connectivity. GPB continues to build on its expertise in alternative investments, emerging markets and foreign exchange.

The pace of regulatory reform is expected to gain momentum. This will include forthcoming legislation arising from the UK Independent Commission on Banking which is likely to require us to make significant changes to our corporate structure and business activities conducted through our UK banking subsidiary, HSBC Bank (see page 101).

Net interest income decreased by 6%, reflecting the decline in Balance Sheet Management revenues as higher-yielding positions matured and opportunities for reinvestment at similar yields were limited by the prevailing low interest rate environment. This was coupled with a fall in Credit and Lending net interest income as a result of lower balances, coupled with a decrease in effective yields and lower asset holdings in our legacy credit portfolio as a result of maturities and disposals aimed at reducing capital consumption. The above factors were partly offset by higher net interest income in CMB, driven by an increase in term lending balances in the UK and Continental Europe as a result of targeted campaigns during 2010 and 2011. Net interest income also benefited from strong mortgage balance growth in the UK along with

strong deposit growth across the region, mainly driven by marketing campaigns, although offset in part by strong competition for deposits resulting in lower deposit spreads, notably in RBWM in the UK.

Net fee income declined by 4% as management services income generated from the securities investment conduits within our legacy credit portfolio was lower, along with higher intercompany fees payable on intra-group referrals. In addition, overdraft fees declined due to reduced customer appetite for debt in the current market conditions. This was partly offset by higher levels of client activity in GPB due to an increase in transaction volumes related to higher market volatility.

Net trading income decreased by 33%, due to significantly lower trading revenues in Credit and Rates as turmoil in eurozone sovereign debt markets escalated in the second half of 2011. Increased risk aversion and limited client activity led to a significant widening of spreads on certain eurozone sovereign and corporate bonds, resulting in losses in our Credit and Rates businesses. In addition, legacy credit revenues fell due to the non-recurrence of the price appreciation on legacy assets in 2010. Lower favourable foreign exchange movements were also reported on trading assets held as economic hedges of foreign currency debt designated at fair value. These offset lower adverse foreign exchange movements on the foreign currency debt which are reported in Net expense from financial instruments designated at fair value .

Trading income included a favourable fair value movement of US$391m from structured liabilities, mainly in Rates, as credit spreads widened compared with adverse fair value movements of US$29m in 2010. In our Equities business, revenues rose as investment in platforms improved our competitive positioning and helped capture increased client flows. This was coupled with lower losses on portfolio hedges in Global Banking compared with the previous year.

Net expense from financial instruments designated at fair value was US$479m, reflecting net investment losses during 2011 on assets held by our insurance business to meet liabilities under insurance and investment contracts as equity markets fell, notably in the second half of 2011,

compared with gains reported in 2010. To the extent that these losses were attributable to policyholders holding unit-linked insurance policies and insurance or investment contracts with DPF, there was a corresponding decrease in Net insurance claims incurred and movement in liabilities to policyholders . These losses were partly offset by

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lower adverse foreign exchange movements on foreign currency debt designated at fair value, issued as part of our overall funding strategy, with an offset reported in Net trading income .

Gains less losses from financial investments were broadly in line with 2010. Net gains from the disposal of available-for-sale debt securities increased as part of normal portfolio management activities. These were offset by lower gains from the disposal of available-for-sale equity securities as a deterioration in market confidence resulted in fewer disposal opportunities and lower gains from the disposal of private equity investments. In addition, there were write-downs of our equity investments in real estate companies.

Net earned insurance premiums decreased by 3%, resulting from the non-renewal and transfer to third parties of certain contracts in our Irish business and the continued run-off and subsequent disposal of our motor insurance business in the UK. This was partly offset by an increase in premiums as we launched targeted sales campaigns, notably for investment contracts with DPF in France, and expanded distribution channels for unit-linked products in the UK.

Other operating income decreased by 15%, driven by the non-recurrence of a gain on the sale and leaseback of our Paris headquarters in 2010. In addition, there was a reduction in the PVIF asset from net experience and assumption updates and a higher unwind of cash flows related to the growing in-force book, compared with 2010. This reduction was partly offset by a rise in the PVIF asset as a result of higher life insurance sales and a positive impact from a refinement to the PVIF calculation during 2011.

Net insurance claims incurred and movement in liabilities to policyholders decreased by 28% as a result of investment losses experienced in 2011 on unit-linked insurance policies and insurance and investment contracts with DPF as equity markets declined, which contrasted with investment gains in 2010. Also, the non-renewal and transfer to third parties of certain contracts in the Irish business and the continued run-off and subsequent disposal of our legacy motor business in the UK resulted in a decrease in net insurance claims incurred and movement in liabilities to policyholders. Partly offsetting these declines were increases in liabilities to policyholders established for new business written.

Loan impairment charges and other credit risk provisions decreased by 20% to US$2.5bn. This mainly reflected a range of successful initiatives taken to mitigate credit risk within RBWM including a focus on monitoring and identifying customers facing financial hardship. This resulted in lower delinquency rates across both the secured and unsecured lending portfolios. In CMB, loan impairment charges declined as the non-recurrence of specific provisions in the UK was partly offset by higher specific provisions related to a small number of customers in Greece. In GB&M, we recorded a charge of US$145m to write down to market value available-for-sale Greek sovereign debt now judged to be impaired. In addition, impairments of US$46m were included in our GPB and insurance businesses in relation to Greek available-for-sale debt securities. These were partly offset by lower credit risk provisions on ABSs as the losses arising in the underlying collateral pools generated lower charges on ABSs.

*Operating expense*s increased by 9%. This included provisions of US$898m relating to UK customer redress programmes, including a charge in respect of possible mis-selling of PPI in previous years, a cost of US$570m in respect of the UK bank levy and restructuring provisions of US$404m. These were partly offset by a credit of US$587m resulting from a change in the inflation measure used to calculate the defined benefit obligation for deferred pensions in the UK. Costs in 2010 included one-off payroll and bonus taxes of US$354m (US$324m as reported) in the UK and France. Excluding these items, operating expenses rose as we incurred higher regulatory and compliance costs, along with an increase in expenses as a result of the strengthening of the Swiss franc, which accounts for a significant proportion of the GPB cost base. In GB&M, performance-related awards were substantially lower than in 2010, reflecting the decline in revenues, although this was mostly offset by higher amortisation charges for previous years performance shares and an acceleration in the expense recognition of current-year deferred bonus awards. Notwithstanding these factors, we have achieved about US$300m of sustainable savings during 2011. This has enabled the funding of investment in strategic initiatives, including the development of Prime Services and equity market capabilities and the expansion of the Rates and Foreign Exchange e-commerce platforms.

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Report of the Directors: Operating and Financial Review (continued)

2010 compared with 2009

Economic background

After falling by 4.9% in 2009, **UK** Gross Domestic Product (GDP) only partially recovered in 2010, rising 1.4%. This revival in activity was not reflected in a corresponding rise in employment, and the unemployment rate remained at 7.9% in the three months to November. Despite the general economic weakness, the annual rate of Consumer Price Index (CPI) inflation rose during 2010, reaching 3.7% in December, partly because of the rise in value added tax to 17.5% in January, and increases in the price of food and energy following rapid gains in global commodity prices. Wage growth remained subdued, however, with average earnings rising just 2.0% in the year to December. The Bank of England chose to maintain Bank Rate at 0.5% throughout 2010.

The **eurozone** economy also partially recovered during the year, with GDP rising 1.7% in 2010 compared to 2009. The region benefited from the pick-up in the world economy and some improvement in domestic demand. Within the region, Germany recorded the strongest growth rate with its GDP rising 3.5% in the year as a whole. The unemployment rate in the eurozone increased slightly to 10.0% by the end of 2010. The large increases in government debt that emerged in certain parts of the region in recent years began to put upward pressure on government bond yields during 2010, and some governments encountered funding difficulties. In response, a temporary European support fund, the 440bn European Financial Stability Facility was created, and the EU set aside 60bn in a package named the European Financial Stabilisation Mechanism. Greece received a 110bn aid package provided jointly by the International Monetary Fund and eurozone governments. Ireland also drew on international assistance in December. The European Central Bank left its key interest rate at 1.0% throughout the year.

Review of performance

Our European operations reported a pre-tax profit of US$4.3bn, compared with US$4.0bn in 2009, an increase of 7%. In 2010, this included adverse fair value movements of US$198m due to the change in credit spreads on the Group s own debt held at fair value, compared with adverse fair value movements of US$2.8bn in 2009. In addition, we made gains of US$107m on the disposal of the HSBC Insurance Brokers business and US$255m on the sale of Eversholt Rail Group. In 2009, we recorded a gain on the sale of the residual stake in our UK card merchant acquiring business. Excluding these items,

underlying pre-tax profits decreased by 35%, largely due to lower income from GB&M, whose exceptional results of 2009 were not repeated, and an unfavourable year on year movement in certain non-qualifying hedges of US$1.1bn.

GB&M results remained strong by historical standards. However, revenues decreased in 2010 due to less favourable market conditions caused by the impact of the European sovereign debt crisis, particularly in the second half of the year, and lower revenues, as forecast, in Balance Sheet Management.

In RBWM, we continued to build long-term relationships through our Premier and Advance offerings, focusing on wealth management and secured lending. We increased our total UK mortgage market share to 5.2%, while maintaining a conservative new lending loan to value ratio of 54%.

In CMB, we made further progress on our strategy of becoming the leading international business bank. We also expanded our business in Germany and launched in Switzerland. In the UK, we increased new lending to SMEs by 19% in 2010.

Net interest income decreased by 7%. Balance Sheet Management revenues declined, as higher-yielding positions matured, interest rates remained low and yield curves flattened in 2010. In Global Banking, tighter spreads in the lending business and lower average lending balances as customers reduced their debt also contributed to the decrease. Customer deposit spreads were adversely affected by the low interest rate environment and competition for deposits. These reductions were offset in part by growth in mortgage lending in the UK and improved asset spreads in both RBWM and CMB.

Net fee income increased by 7%, reflecting higher management fees due to an increase in the average value of funds under management, which arose from net inflows and higher market performance. Fees were also received for management services we provided to certain of our Structured Investment Conduits. Partly offsetting these increases were reductions in the levels of debt and equity issuance in the market, compared with the significant volumes seen in 2009.

Net trading income decreased by 47% to US$2.9bn. Less favourable market conditions caused by the impact of the European sovereign debt crisis adversely affected Credit and Rates income. Spread compression from increased competition similarly affected foreign exchange revenues. In addition, net interest income earned on trading activities decreased, driven by reduced holdings of debt securities. These decreases were offset in part by lower net adverse fair value movements on structured liabilities.

Report of the Directors: Operating and Financial Review (continued)

Net trading income also included adverse fair value movements of US$304m on non-qualifying hedges used to economically hedge fixed-rate long-term debt issued by HSBC Holdings. These movements were driven by the decline in long-term US dollar interest rates relative to sterling and euro rates in 2010, and compared with favourable fair value movements of US$748m on these instruments in 2009.

Within our legacy Credit book, a net release of previous write-downs on ABSs and monoline exposures as asset prices improved was more than offset by the non-recurrence of gains in other parts of the business.

Net income from financial instruments designated at fair value fell by US$808m. The growth in equity markets in 2010 was lower than in 2009, resulting in lower investment gains recognised on the fair value of assets held to meet liabilities under insurance and investment contracts. To the extent that these gains accrued to policyholders holding unit-linked insurance policies and insurance or investment contracts with DPF, there was a corresponding decrease in Net insurance claims incurred and movement in liabilities to policyholders . In addition, adverse foreign exchange movements were reported in the year on foreign currency debt designated at fair value, issued as part of our overall funding strategy with an offset from trading assets held as economic hedges reported in Net trading income .

Gains less losses from financial investments increased by US$455m as improved market conditions led to gains on sale of private equity investments and lower impairment charges on certain available-for-sale investments.

Net earned insurance premiums were in line with 2009. The decision in 2009 to place our UK motor insurance business into run-off resulted in no new premiums being written in 2010. In addition, a decision was taken during 2010 not to renew certain contracts in the Irish business. By contrast, we generated strong sales activity in the UK life and French insurance businesses.

Other operating income decreased by US$193m because the gain on the sale and leaseback of our Paris headquarters building in 2010 was exceeded by the gain on the sale and leaseback of the Group s London headquarters building in 2009.

Net insurance claims incurred and movement in liabilities to policyholders decreased by 11%. This was driven by lower investment gains compared with 2009 and by the non-recurrence of the strengthening of reserves in 2009 on the now-closed UK motor insurance book which reflected the rising incidence and severity of claims at that time. The decision not to renew certain contracts in the Irish business resulted in a further decrease in claims.

Loan impairment charges and other credit risk provisions decreased by 45% to US$3.0bn, reflecting the more stable credit environment and helped by mitigating actions taken by management. In GB&M, the improved credit outlook, loan restructuring activity, a release of previous collective impairments and lower specific impairment charges in 2010 contributed to a decline in loan impairment charges and other credit risk provisions. Credit risk provisions on certain available-for-sale ABSs also reduced due to a slowing in the rate of anticipated losses in the underlying collateral pools.

In CMB, the reduction in loan impairment charges and other credit risk provisions was largely due to an improvement in the UK property, retail and services sectors, with reductions also seen in our Continental European businesses. The improvement in economic conditions across the region and the effect of low interest rates also resulted in lower delinquencies in the RBWM portfolios.

Operating expenses in 2010 included one-off payroll and bonus taxes in the UK and France on certain bonuses paid in respect of 2009 totalling US$324m, primarily in GB&M. Operating expenses in 2009 included an accounting gain of US$480m (US$499m as reported) related to a change in the delivery of certain staff benefits in the main UK pension scheme. Excluding these items, operating expenses were 8% higher than in 2009. This was driven by continued strategic investments in people and infrastructure to support our customers, drive future growth and deliver sustainable long-term reductions in our cost base by re-engineering business processes. In addition, rental expenses increased following the sale and leaseback of our headquarters buildings in London and Paris.

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Profit/(loss) before tax and balance sheet data Europe

	2011						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[64] US$m	Total US$m
Profit before tax							
Net interest income/(expense)	5,653	3,107	2,102	936	(574)	(223)	11,001
Net fee income	2,633	1,640	989	942	32		6,236
Trading income/(expense) excluding net interest income	40	5	602	191	(201)		637
Net interest income on trading activities	11	16	1,205	16	53	223	1,524
Net trading income/(expense)[56]	51	21	1,807	207	(148)	223	2,161
Changes in fair value of long- term debt issued and related derivatives					3,180		3,180
Net income/(expense) from other financial instruments designated at fair value	(672)	(21)	(65)		46		(712)
Net income/(expense) from financial instruments designated at fair value	(672)	(21)	(65)		3,226		2,468
Gains less losses from financial investments	51	(1)	453	1	11		515
Dividend income	1	1	42	4	1		49
Net earned insurance premiums	3,768	381			(13)		4,136
Other operating income	95	58	187	5	760	74	1,179
Total operating income	11,580	5,186	5,515	2,095	3,295	74	27,745
Net insurance claims[65]	(3,212)	(287)					(3,499)
Net operating income[52]	8,368	4,899	5,515	2,095	3,295	74	24,246
Loan impairment (charges)/recoveries and other credit risk provisions	(596)	(960)	(876)	(82)	2		(2,512)
Net operating income	7,772	3,939	4,639	2,013	3,297	74	21,734
Total operating expenses	(6,450)	(2,252)	(4,569)	(1,456)	(2,268)	(74)	(17,069)
Operating profit	1,322	1,687	70	557	1,029		4,665
Share of profit/(loss) in associates and joint ventures			7		(1)		6
Profit before tax	1,322	1,687	77	557	1,028		4,671
	%	%	%	%	%		%
Share of HSBC s profit before tax	6.0	7.7	0.4	2.5	4.7		21.3

Cost efficiency ratio	**77.1**	**46.0**	**82.8**	**69.5**	**68.8**		**70.4**
Balance sheet data[49]							
	US$m	**US$m**	**US$m**	**US$m**	**US$m**		**US$m**
Loans and advances to customers (net)	**150,205**	**98,154**	**156,903**	**28,378**	**696**		**434,336**
Total assets	**210,140**	**124,049**	**1,021,486**	**77,410**	**63,141**	**(214,281)**	**1,281,945**
Customer accounts	**176,134**	**104,530**	**154,208**	**58,265**	**267**		**493,404**

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	2010						
	Retail Banking and Wealth Manage-ment[17] US$m	Commercial Banking US$m	Global Banking and Markets[17] US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[64] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	5,537	2,774	2,935	871	(654)	(213)	11,250
Net fee income	2,559	1,570	1,320	883	39		6,371
Trading income/(expense) excluding net interest income	(6)	3	1,541	185	(262)		1,461
Net interest income/(expense) on trading activities	(1)	19	1,127	21	23	213	1,402
Net trading income/(expense)[56]	(7)	22	2,668	206	(239)	213	2,863
Changes in fair value of long- term debt issued and related derivatives					(365)		(365)
Net income/(expense) from other financial instruments designated at fair value	496	113	(23)		61		647
Net income/(expense) from financial instruments designated at fair value	496	113	(23)		(304)		282
Gains less losses from financial investments	(36)		525	(7)	4		486
Dividend income		1	16	2	1		20
Net earned insurance premiums	3,800	278			(11)		4,067
Other operating income	187	163	817	7	754	189	2,117
Total operating income/(expense)	12,536	4,921	8,258	1,962	(410)	189	27,456
Net insurance claims[65]	(4,364)	(342)					(4,706)
Net operating income/(expense)[52]	8,172	4,579	8,258	1,962	(410)	189	22,750
Loan impairment (charges)/ recoveries and other credit risk provisions	(1,217)	(997)	(783)	(26)	3		(3,020)
Net operating income/(expense)	6,955	3,582	7,475	1,936	(407)	189	19,730
Total operating expenses	(5,647)	(2,378)	(4,784)	(1,296)	(1,151)	(189)	(15,445)
Operating profit/(loss)	1,308	1,204	2,691	640	(1,558)		4,285
Share of profit in associates and joint ventures	4	1	12				17
Profit/(loss) before tax	1,312	1,205	2,703	640	(1,558)		4,302
	%	%	%	%	%		%
Share of HSBC s profit before tax	6.9	6.3	14.2	3.4	(8.2)		22.6
Cost efficiency ratio	69.1	51.9	57.9	66.1	(280.7)		67.9

Balance sheet data[49]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	145,069	91,744	170,369	27,629	988		435,799
Total assets	205,032	111,356	962,861	76,631	65,824	(172,177)	1,249,527
Customer accounts	169,016	96,597	169,836	56,114			491,563

For footnotes, see page 95.

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Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax and balance sheet data   Europe (continued)

	2009						
	Retail Banking and Wealth Manage-ment[17] US$m	Commercial Banking US$m	Global Banking and Markets[17] US$m	Global Private Banking US$m	Other US$m	Inter-segment Elimination[64] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	5,405	2,739	4,375	949	(525)	(675)	12,268
Net fee income	2,449	1,679	1,170	883	86		6,267
Trading income excluding net interest income	37	3	2,264	175	382		2,861
Net interest income/(expense) on trading activities	(1)	17	1,869	23	15	675	2,598
Net trading income[56]	36	20	4,133	198	397	675	5,459
Changes in fair value of long- term debt issued and related derivatives					(2,746)		(2,746)
Net income/(expense) from other financial instruments designated at fair value	1,012	133	375		(199)		1,321
Net income/(expense) from financial instruments designated at fair value	1,012	133	375		(2,945)		(1,425)
Gains less losses from financial investments	(20)	2	65	5	(2)		50
Dividend income	(1)	1	29	3	(3)		29
Net earned insurance premiums	3,975	253	(2)		(3)		4,223
Other operating income	204	373	648	28	914	95	2,262
Total operating income/(expense)	13,060	5,200	10,793	2,066	(2,081)	95	29,133
Net insurance claims[65]	(5,221)	(365)			(3)		(5,589)
Net operating income/(expense)[52]	7,839	4,835	10,793	2,066	(2,084)	95	23,544
Loan impairment charges and other credit risk provisions	(1,992)	(1,267)	(2,277)	(29)	(3)		(5,568)
Net operating income/(expense)	5,847	3,568	8,516	2,037	(2,087)	95	17,976
Total operating expenses	(5,522)	(2,294)	(3,987)	(1,183)	(907)	(95)	(13,988)
Operating profit/(loss)	325	1,274	4,529	854	(2,994)		3,988
Share of profit in associates and joint ventures		18	3				21
Profit/(loss) before tax	325	1,292	4,532	854	(2,994)		4,009

	%	%	%	%	%		%
Share of HSBC s profit before tax	4.6	18.3	64.0	12.1	(42.3)		56.7
Cost efficiency ratio	70.4	47.4	36.9	57.3	(43.5)		59.4

Balance sheet data[49]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	147,768	89,084	176,115	25,541	973		439,481
Total assets	211,566	111,874	978,934	76,871	84,010	(194,655)	1,268,600
Customer accounts	165,176	102,249	169,375	58,213	6		495,019

For footnotes, see page 95.

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Report of the Directors: Operating and Financial Review (continued)

Hong Kong

HSBC s principal banking subsidiaries in Hong Kong are The Hongkong and Shanghai Banking Corporation Limited and Hang Seng Bank Limited. The former is the largest bank incorporated in Hong Kong and is our flagship bank in the Asia-Pacific region. It is one of Hong Kong s three note-issuing banks, accounting for more than 65% by value of banknotes in circulation in 2011.

	2011 **US$m**	2010 US$m	2009 US$m
Net interest income	**4,691**	4,246	4,195
Net fee income	**3,097**	2,962	2,669
Net trading income	**1,189**	1,312	1,225
Other income	**1,705**	1,682	1,378
Net operating income[52]	**10,682**	10,202	9,467
Impairment charges[53]	**(156)**	(114)	(500)
Net operating income	**10,526**	10,088	8,967
Total operating expenses	**(4,758)**	(4,431)	(3,946)
Operating profit	**5,768**	5,657	5,021
Income from associates[54]	**55**	35	8
Profit before tax	**5,823**	5,692	5,029
Cost efficiency ratio	**44.5%**	43.4%	41.7%
RoRWA[55]	**5.3%**	5.0%	4.2%
Year-end staff numbers	**28,984**	29,171	27,614

Increase in profitability driven by increased

customer lending and growth in trade flows

combined with strong cost discipline.

25%

growth in trade revenues

Best offshore renminbi bond house

(IFR Asia Awards 2011)

For footnotes, see page 95.

The commentary on Hong Kong is on an underlying basis unless stated otherwise.

Economic background

Hong Kong registered very strong economic growth entering 2011. This eased during the course of the year due to supply chain disruptions triggered by the earthquake in Japan and some slowing in demand from mainland China following a tightening of policy to counter inflation. Nonetheless, Hong Kong GDP grew by 5% in 2011. Some slowing in the pace of growth was welcomed as it helped reduce inflationary pressures that had been mounting earlier in 2011 in both consumer and property markets. Unemployment rates in Hong Kong improved steadily during 2011, falling from 3.9% at the end of 2010 to 3.2% by the end of the year. Inter-bank interest rates stayed low during 2011, rising slightly to 0.325% by 31 December.

Review of performance

Our operations in Hong Kong reported pre-tax profits of US$5.8bn compared with US$5.7bn in 2010, an increase of 2%. On an underlying basis, excluding gains arising from the reclassification of Bao Viet as an associate and following the sale of HSBC Private Equity (Asia) Ltd, both in 2010, profit before tax rose by 5%.

The increase in profitability was driven by higher revenues from increased customer lending which reflected growth in trade flows, coupled with strong demand for wealth management products, partly offset by a rise in staff and support costs reflecting wage inflation and higher business volumes in 2011.

Following significant loan growth in 2010 and the first half of 2011, we experienced slower growth in our businesses during the second half of 2011.

In RBWM, we retained market leadership across our key products. In residential mortgages we retained the number one market position as we continued to provide competitive products for our customers. Our leading market share in life insurance reflected our strong customer focus and diverse product offerings. We also maintained market leadership in the provision of mandatory provident funds and launched a new product which offers our customers a wider choice and lower fees. We retained our number one position in cards reflecting the success of our various marketing campaigns and customer focus, and saw continued strong sales of wealth management products, though revenues were affected in the latter part of 2011 as stock market turnover reduced and investor sentiment weakened.

Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax by global business

	2011	2010	2009
	US$m	US$m	US$m
Retail Banking and Wealth Management	**3,022**	3,001	2,789
Commercial Banking	**1,608**	1,352	956
Global Banking and Markets	**1,316**	1,347	1,446
Global Private Banking	**188**	227	197
Other	**(311)**	(235)	(359)
	5,823	5,692	5,029

In CMB, we grew trade revenues as we continued to capture cross-border opportunities, particularly with mainland China, which accounted for more than half of our new-to-bank CMB customers. The number of cross-border referrals between Hong Kong and mainland China increased by 9%. We also opened four new business banking centres in Hong Kong and set up the China Corporate team in Hong Kong to service mainland Chinese companies looking to expand internationally.

We continued to strengthen the collaboration between CMB and GB&M, resulting in incremental revenue growth through the provision of foreign exchange and interest rate management products to our corporate clients.

In GB&M, we maintained our number one market position in Hong Kong dollar bond issuance and acted as a joint lead manager on the government s first inflation-linked bond issue, the largest ever retail bond issue in Hong Kong. We also continued to enhance our equity capital markets capabilities, expanded our equity research team, and were bookrunner in six of the ten largest initial public offerings (IPO s) in Hong Kong this year. During 2011 we won several awards including Best Investment Bank and Best Equity House from *FinanceAsia* and Best Flow House and Best Debt Capital Markets House in Asia from *Euromoney*.

We continued to reinforce our position as a leading international renminbi bank and became the market leader in offshore renminbi bond issuance and won awards from both *Finance Asia* and *IFR Asia* for Best Offshore Renminbi Bond House. We arranged the first ever renminbi subordinated bank bond and participated in the largest ever offshore renminbi bond deal by a sovereign issuer, demonstrating the depth and diversity of our involvement in this market.

Net interest income was 11% higher than in 2010, driven by the income from strong lending growth during 2010 and the first half of 2011 which reflected increased trade flows and demand for credit. We saw more moderate loan growth in

GB&M and RBWM in the second half of 2011, which was more than offset by a reduction in certain trade finance loans in CMB. The Hong Kong property market slowed in the second half of 2011 and we continued to lend conservatively, with average loan to value ratios of 49% on new residential mortgage draw-downs and an estimated 37% on the portfolio as a whole.

Spreads narrowed in RBWM due to a shift in the product mix to lower-yielding HIBOR-linked mortgages, and in CMB as growth was concentrated in lower-margin trade financing and HIBOR-linked loans. HIBOR-linked spreads began to improve marginally in the second half of the year due to product repricing.

Average customer deposit balances rose despite a highly competitive environment, supported by the opening of new business centres, growth in the offshore renminbi market, our comprehensive suite of renminbi solutions across Trade and Supply Chain, and Payments and Cash Management.

Net fee income increased by 5% as a result of higher sales of wealth management products, particularly unit trusts reflecting increased product offerings, competitive pricing and ongoing marketing campaigns. This was achieved in the low interest rate environment in which clients sought products which could increase their returns. Card transactions grew, reflecting higher retail spending in 2011 supported by marketing campaigns. Underwriting fees rose due to our participation in many of the largest equity capital market transactions in 2011 supported by the continued enhancement of our equity market capabilities. Remittances and trade-related fees also increased reflecting increased product offerings and higher cross-border trade volumes. This was partly offset by lower broking income, notably towards the end of the year due to increased competition.

Net trading income reduced by 9%. We recorded adverse fair value movements on derivatives relating to certain provident funds as long-term investment returns fell. We also incurred losses on equity options backing an endowment

Report of the Directors: Operating and Financial Review (continued)

product in RBWM due to unfavourable movements in the underlying equity indices which resulted in a corresponding decrease in *Net insurance claims incurred and movement in liabilities to policyholders*.

These losses were partly offset by higher trading income in GB&M due to a rise in net interest income from trading activities from Asian government debt securities and corporate bonds. Trading income fell through lower revenues in credit trading as credit spreads widened in some markets. This was partly offset by higher revenues in foreign exchange following greater market volatility in the region and the collaboration between CMB and GB&M. In addition, revenues in Equities increased in line with improved volumes in the business.

Net expense from financial instruments designated at fair value was US$537m compared with gains in 2010 due to investment losses on assets held by the insurance business as a result of negative movements in the equity market during the second half of 2011. To the extent that these investment losses were attributed to policyholders of unit-linked insurance policies and insurance contracts with DPF, there was a corresponding decrease in Net insurance claims incurred and movement in liabilities to policyholders.

Net earned insurance premiums increased by 18% as a result of successful sales initiatives for deferred annuities, unit-linked products and a universal life insurance product targeted at high net worth individuals. This reflected our strategic focus on wealth management, of which insurance is a key part. The growth in premiums resulted in a

corresponding increase in Net insurance claims incurred and movement in liabilities to policyholders.

Other operating income increased by 10%, largely due to an increase in PVIF and higher revaluation gains on investment properties. PVIF rose as a result of higher life insurance sales, a one-off gain of US$135m recognised upon the refinement of the calculation of the PVIF and a net increase from updates for experience and assumptions during 2011. Partially offsetting this was a higher unwind of cash flows related to the growing in-force book.

Loan impairment charges and other credit risk provisions increased by US$42m from a low base due to a specific impairment charge against one customer, higher collective impairment charges in CMB resulting from lending growth, and an impairment recorded in respect of available-for-sale Greek sovereign debt securities in GPB. These were partly offset by releases in GB&M relating to specific impairment charges raised in 2010.

Operating expenses rose by 7% due to higher staff costs across the business reflecting wage inflation in a competitive labour market and a rise in average staff numbers to support increased business activity. Performance costs increased in GB&M due to higher amortisation charges for previous years performance shares and accelerated expense recognition of current year deferred bonus awards. During 2011 we incurred US$68m of restructuring costs as we took steps to improve efficiency, including the restructuring of our regional head office.

Report of the Directors: Operating and Financial Review (continued)

2010 compared with 2009

Economic background

Relatively low interest rates and rapid growth in demand from mainland China contributed to Hong Kong s economic recovery in 2010. GDP in the year was 6.8% higher than in 2009. A revival in both employment and wage growth helped to boost consumer demand. Inflationary pressures began to emerge in the second half of the year with the annual rate of CPI inflation rising to 3.1% in December. The government initiated a number of measures in November aimed at restricting the pace of price increases in the property market.

Review of performance

Our operations in Hong Kong reported pre-tax profits of US$5.7bn compared with US$5.0bn in 2009, an increase of 13%. On an underlying basis, excluding accounting gains arising from the reclassification of Bao Viet as an associate and following the sale of HSBC Private Equity (Asia) Ltd, profit before tax increased by 11%.

The increase in profitability was driven by strong revenue growth, particularly in investment and insurance product sales and trade-related fees, as we capitalised on the improved economic conditions. Lending balances rose, most notably in CMB and GB&M following a recovery in trade flows and strong economic growth. Customer deposit balances increased, reflecting growth in customer numbers in RBWM and CMB. Loan impairment charges were significantly lower than in 2009 across all global businesses, reflecting an improvement in credit conditions. Revenue growth was in part offset by an increase in staff and IT costs driven by business expansion to maintain our strong market position.

We retained our market leadership in residential mortgages, credit cards, life insurance and deposits. The Premier customer base increased by 31% compared with 31 December 2009 to more than 500,000 customers. The Advance proposition, which was launched in early 2010, had a customer base of over 670,000 by the end of the year. In life insurance, we retained the number one market share position for new business annualised premiums as a result of successful sales activity and customer demand and a strategy targeted towards the high net worth customer segment. CMB s cross-border referrals more than doubled with the increase in trade flows from mainland China. We continued the development of offshore renminbi-related products and maintained our position as a market leader for renminbi products in Hong Kong.

Net interest income was broadly in line with 2009, as strong loan growth was partly offset by lower spreads resulting from competitive pressures and the low interest rate environment. In Balance Sheet Management, net interest income decreased as yield curves flattened, higher yielding positions matured and funds were reinvested at lower rates.

The recovery in trade volumes in 2010 and the pursuit of CMB s leading international bank for business strategy resulted in significant growth in commercial lending, notably in commercial, industrial and trade related lending. To a lesser extent, growth was also noted in commercial real estate, supported by a buoyant property market. Average personal lending balances also rose, driven by strong growth in residential mortgage lending, where we continued to lend conservatively with average loan-to-value ratios of 55% on new mortgage drawdowns and an estimated 38% on the overall portfolio.

Asset spreads narrowed as a result of competitive pressures, particularly in trade-related lending and HIBOR-linked residential mortgages.

The growth in customer numbers in the Premier proposition in RBWM and new-to-bank customers in CMB resulted in increased customer deposits. The benefit of the higher average deposit balances was limited by narrower deposit spreads as interest rates remained at historically low levels.

Net fee income increased by 11%, primarily due to an increase in sales of investment products driven by improved market sentiment and successful sales campaigns, and growth in trade-related fees and income from Payments and Cash Management as volumes improved. Fees from

funds under management also grew as a result of higher net inflows and improved fund performance, while underwriting fees rose due to several significant initial public offerings (IPO s) and loan syndications concluded in 2010.

Net trading income was 7% higher than in 2009. Increased holdings of debt securities led to a rise in net interest income from trading activities. Foreign exchange revenues benefited from increased turnover due to high levels of client demand. This was partly offset by lower revenues from Credit trading, following the strong results achieved in 2009 as credit spreads narrowed, and from Rates trading as market volatility reduced in 2010.

Net income from financial instruments designated at fair value was US$384m compared with US$784m in 2009. The movement was primarily due to lower revaluation gains in 2010 on assets held to support linked insurance liabilities,

Report of the Directors: Operating and Financial Review (continued)

where the value of our liabilities to policyholders is determined in line with the value of supporting assets. To the extent that these lower investment gains were attributed to policyholders, there was a corresponding decrease in *Net insurance claims incurred and movement in liabilities to policyholders*.

Net earned insurance premiums grew by 18% to US$4.3bn as successful sales campaigns drove strong growth, particularly in deferred annuity and unit-linked products. A life insurance product targeted at high net worth individuals also performed well. Growth in the insurance business resulted in a related increase in Net insurance claims incurred and movement in liabilities to policyholders .

Other operating income increased by 21% to US$1.5bn due to an increase in PVIF reflecting higher life insurance sales, partly offset by the non-recurrence of a gain on sale of a property in 2009.

Loan impairment charges and other credit risk provisions decreased by 77% to US$114m, reflecting the recovery in economic conditions. Lower specific impairment charges in CMB and GB&M were incurred as credit conditions improved and loan impairment charges fell in RBWM, mainly on unsecured lending as unemployment and bankruptcy levels fell.

Operating expenses rose by 12% as the business grew and the economy recovered. Staff costs grew as we recruited in a competitive market and from general wage increases, while bonuses rose in line with the strong business performance. Marketing costs rose notably in RBWM due to the launch of several large campaigns, including Advance and credit cards promotions and rising transaction volumes led to higher back office and support costs.

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Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax and balance sheet data Hong Kong

	2011						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[64] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	2,571	1,317	1,051	173	(464)	43	4,691
Net fee income	1,741	706	475	160	15		3,097
Trading income/(expense) excluding net interest income	120	169	652	135	(116)		960
Net interest income on trading activities	9	1	246		16	(43)	229
Net trading income/(expense)[56]	129	170	898	135	(100)	(43)	1,189
Changes in fair value of long- term debt issued and related derivatives							
Net income/(expense) from other financial instruments designated at fair value	(475)	(72)	(5)		15		(537)
Net income/(expense) from financial instruments designated at fair value	(475)	(72)	(5)		15		(537)
Gains less losses from financial investments	3	10	21		(10)		24
Dividend income		1	14		24		39
Net earned insurance premiums	4,317	758	13				5,088
Other operating income	505	175	79	8	1,185	(268)	1,684
Total operating income	8,791	3,065	2,546	476	665	(268)	15,275
Net insurance claims[65]	(3,887)	(697)	(9)				(4,593)
Net operating income[52]	4,904	2,368	2,537	476	665	(268)	10,682
Loan impairment (charges)/recoveries and other credit risk provisions	(77)	(66)	23	(36)			(156)
Net operating income	4,827	2,302	2,560	440	665	(268)	10,526
Total operating expenses	(1,811)	(703)	(1,248)	(252)	(1,012)	268	(4,758)
Operating profit/(loss)	3,016	1,599	1,312	188	(347)		5,768
Share of profit in associates and joint ventures	6	9	4		36		55
Profit/(loss) before tax	3,022	1,608	1,316	188	(311)		5,823
	%	%	%	%	%		%
Share of HSBC s profit before tax	13.8	7.3	6.0	0.9	(1.4)		26.6
Cost efficiency ratio	36.9	29.7	49.2	52.9	152.2		44.5

Balance sheet data[49]							
	US$m	**US$m**	**US$m**	**US$m**	**US$m**		**US$m**
Loans and advances to customers (net)	**56,296**	**54,986**	**39,667**	**5,447**	**1,269**		**157,665**
Total assets	**85,866**	**63,516**	**238,892**	**20,680**	**84,782**	**(20,712)**	**473,024**
Customer accounts	**181,316**	**79,225**	**35,283**	**19,622**	**(101)**		**315,345**

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Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax and balance sheet data Hong Kong (continued)

	2010						
	Retail Banking and Wealth Manage-ment[17] US$m	Commercial Banking US$m	Global Banking and Markets[17] US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[64] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	2,604	1,106	915	173	(463)	(89)	4,246
Net fee income	1,656	634	495	163	14		2,962
Trading income/(expense) excluding net interest income	198	121	680	120	(12)		1,107
Net interest income on trading activities	4		100		12	89	205
Net trading income[56]	202	121	780	120		89	1,312
Changes in fair value of long- term debt issued and related derivatives					(2)		(2)
Net income/(expense) from other financial instruments designated at fair value	328	(10)	61		1		380
Net income/(expense) from financial instruments designated at fair value	328	(10)	61		(1)		378
Gains less losses from financial investments			56	1	41		98
Dividend income		1	12		17		30
Net earned insurance premiums	3,655	665	12				4,332
Other operating income	513	68	156	12	1,140	(283)	1,606
Total operating income	8,958	2,585	2,487	469	748	(283)	14,964
Net insurance claims[65]	(4,193)	(559)	(10)				(4,762)
Net operating income[52]	4,765	2,026	2,477	469	748	(283)	10,202
Loan impairment charges and other credit risk provisions	(76)	(28)	(10)				(114)
Net operating income	4,689	1,998	2,467	469	748	(283)	10,088
Total operating expenses	(1,693)	(653)	(1,124)	(242)	(1,002)	283	(4,431)
Operating profit/(loss)	2,996	1,345	1,343	227	(254)		5,657
	5	7	4		19		35

Share of profit in associates and joint ventures							
Profit/(loss) before tax	3,001	1,352	1,347	227	(235)		5,692
	%	%	%	%	%		%
Share of HSBC s profit before tax	15.7	7.1	7.1	1.2	(1.2)		29.9
Cost efficiency ratio	35.5	32.2	45.4	51.6	134.0		43.4
Balance sheet data[49]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	50,983	48,670	34,491	4,760	1,787		140,691
Total assets[68]	76,871	55,030	223,286	20,598	62,486	(8,706)	429,565
Customer accounts	176,960	71,209	29,388	19,241	686		297,484

For footnotes, see page 95.

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Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax and balance sheet data Hong Kong (continued)

	2009						
	Retail Banking and Wealth Manage-ment[17] US$m	Commercial Banking US$m	Global Banking and Markets[17] US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[64] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	2,577	938	1,150	212	(558)	(124)	4,195
Net fee income	1,519	530	454	125	41		2,669
Trading income/(expense) excluding net interest income	191	92	787	91	(93)		1,068
Net interest income on trading activities	3		16		14	124	157
Net trading income/(expense)[56]	194	92	803	91	(79)	124	1,225
Changes in fair value of long- term debt issued and related derivatives					(3)		(3)
Net income/(expense) from other financial instruments designated at fair value	707	(46)	138		(11)		788
Net income/(expense) from financial instruments designated at fair value	707	(46)	138		(14)		785
Gains less losses from financial investments	78	18	(106)		19		9
Dividend income	1	1	10		16		28
Net earned insurance premiums	3,161	500	13				3,674
Other operating income	354	64	51	10	1,062	(267)	1,274
Total operating income	8,591	2,097	2,513	438	487	(267)	13,859
Net insurance claims[65]	(3,979)	(404)	(9)				(4,392)
Net operating income[52]	4,612	1,693	2,504	438	487	(267)	9,467
Loan impairment (charges)/recoveries and other credit risk provisions	(203)	(168)	(131)	1	1		(500)
Net operating income	4,409	1,525	2,373	439	488	(267)	8,967
Total operating expenses	(1,625)	(570)	(928)	(242)	(848)	267	(3,946)
Operating profit/(loss)	2,784	955	1,445	197	(360)		5,021
Share of profit in associates and joint ventures	5	1	1		1		8
	2,789	956	1,446	197	(359)		5,029

Profit/(loss) before tax

	%	%	%	%	%		%
Share of HSBC s profit before tax	39.4	13.5	20.4	2.8	(5.1)		71.0
Cost efficiency ratio	35.2	33.7	37.1	55.3	174.1		41.7
Balance sheet data[49]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	43,869	28,217	21,991	3,361	1,943		99,381
Total assets[68]	83,604	34,743	217,039	20,353	52,508	(9,004)	399,243
Customer accounts	166,445	62,146	26,650	19,474	726		275,441

For footnotes, see page 95.

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Rest of Asia-Pacific

We offer a full range of banking and financial services in mainland China, mainly through our local subsidiary, HSBC Bank (China) Company Limited. We also participate indirectly in mainland China through our associates.

Outside mainland China, we conduct business in 22 countries and territories in the Rest of Asia-Pacific region, primarily through branches and subsidiaries of The Hongkong and Shanghai Banking Corporation, with particularly strong coverage in Australia, India, Indonesia, Malaysia and Singapore.

	2011	2010	2009
	US$m	US$m	US$m
Net interest income	**5,102**	3,828	3,539
Net fee income	**2,111**	1,932	1,557
Net trading income	**1,658**	1,618	1,606
Other income	**1,842**	1,854	1,301
Net operating income[52]	**10,713**	9,232	8,003
Impairment charges[53]	**(267)**	(439)	(896)
Net operating income	**10,446**	8,793	7,107
Total operating expenses	**(5,806)**	(5,143)	(4,450)
Operating profit	**4,640**	3,650	2,657
Income from associates[54]	**2,831**	2,252	1,543
Profit before tax	**7,471**	5,902	4,200
Cost efficiency ratio	**54.2%**	55.7%	55.6%
RoRWA[55]	**3.1%**	3.1%	2.4%
Year-end staff numbers	**91,051**	91,607	87,141

24%

growth in commercial lending

Profits increased

across all key markets

in the region

Best Foreign Commercial Bank

in China 2011

(Finance Asia Country Awards 2011)

For footnotes, see page 95.

The commentary on Rest of Asia-Pacific is on an underlying basis unless stated otherwise.

Economic background

In **mainland China**, reducing the pace of consumer price inflation was a key priority for policymakers in the first half of 2011. Monetary conditions were tightened by increasing the reserve requirement ratio to 21.5% for large banks and a number of measures were implemented, focused specifically on reducing demand in the property market. As a result, credit growth slowed in the second half of the year which, coupled with the downturn in global trade, helped to slow the pace of growth and reduce inflationary pressures. The annual rate of inflation peaked at 6.5% in July and eased to around 4% by the year end. Meanwhile, the annual pace of GDP growth slowed from 9.7% in the first quarter to 8.9% in the fourth quarter, bringing the full year GDP growth down to 9.2% in 2011 from 10.4% in 2010. In the final months of the year, the outlook for growth in the eurozone became more of a concern and policymakers reverted to easing monetary and fiscal conditions. Towards the end of 2011, the reserve requirement ratio was cut and a number of fiscal stimulus measures were enacted.

Japan s economy began 2011 strongly, but the earthquake and tsunami in March led to a sharp contraction in output. Japan continued to suffer from deflationary pressures, leading the Bank of Japan to expand its quantitative easing programme. It also intervened in foreign exchange markets to stem the upward pressure on the yen.

The Rest of Asia-Pacific region experienced a relatively strong first half, with exports and domestic demand growing robustly, following which growth slowed in the latter months of 2011. The highly trade-dependent economies of **South Korea**, **Taiwan** and **Singapore** experienced the most significant decline in activity. Regional trade was disrupted by the Japanese earthquake in March and floods in the fourth quarter in **Thailand**, which caused a sharp contraction in the production of critical electronic and car components. As a result, trade expanded at a slower pace in 2011 than in 2010. In a number of economies, notably **India** and **South Korea**, domestic demand also slowed markedly in the second half of 2011 after rising inflationary pressures prompted central banks to tighten monetary policy. In **Malaysia**, domestic demand proved more resilient and the level of GDP in Malaysia in the fourth quarter was 5.2% higher than the level seen a year earlier. Across Asia, inflation peaked in the middle of the year providing policymakers in **India**, **Thailand** and **Indonesia** room to start easing monetary policy.

HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax by country within global businesses

	Retail Banking and Wealth Management[17] US$m	Commercial Banking US$m	Global Banking and Markets[17] US$m	Global Private Banking US$m	Other US$m	Total US$m
2011						
Australia	**88**	**106**	**108**		**5**	**307**
India	**(14)**	**122**	**539**	**5**	**161**	**813**
Indonesia	**6**	**89**	**157**		**7**	**259**
Mainland China	**1,112**	**1,340**	**1,116**	**(4)**	**117**	**3,681**
Associates	**1,179**	**1,150**	**529**		**117**	**2,975**
Other mainland China	**(67)**	**190**	**587**	**(4)**		**706**
Malaysia	**173**	**118**	**228**	**1**	**9**	**529**
Singapore	**183**	**133**	**189**	**97**	**(7)**	**595**
Taiwan	**45**	**23**	**130**		**12**	**210**
Vietnam		**51**	**79**		**24**	**154**
Other	**48**	**264**	**543**	**(8)**	**76**	**923**
	1,641	**2,246**	**3,089**	**91**	**404**	**7,471**
2010						
Australia	59	96	95		8	258
India	(83)	71	508	4	179	679
Indonesia	12	94	116		(3)	219
Mainland China	839	833	683	(7)	217	2,565
Associates	973	746	443		188	2,350
Other mainland China	(134)	87	240	(7)	29	215
Malaysia	120	88	194		(1)	401
Singapore	169	87	100	84	84	524
Taiwan	31	36	87		(7)	147
Vietnam	(7)	50	61		7	111
Other	22	201	644		131	998
	1,162	1,556	2,488	81	615	5,902
2009						
Australia	30	32	140		(4)	198
India	(220)	(41)	394	1	240	374
Indonesia	(24)	60	129		(11)	154
Mainland China	494	616	479	(7)	50	1,632
Associates	678	558	285			1,521
Other mainland China	(184)	58	194	(7)	50	111
Malaysia	88	53	140		5	286
Singapore	154	77	222	98	(9)	542
Taiwan	6	65	87		2	160
Vietnam	(8)	40	63		6	101
Other	(9)	162	617	(2)	(15)	753
	511	1,064	2,271	90	264	4,200

For footnote, see page 95.

In **Australia** GDP growth in early 2011 was initially affected by weather-related disruptions, particularly to coal exports. However, activity strengthened and GDP rose by 2.5% in the year to September, predominantly from ongoing investment in the mining sector. Labour market conditions eased during the year, with the unemployment rate rising modestly to 5.2% by the year end. The Reserve Bank of Australia reduced its policy rate in November and December from 4.75% to 4.25%.

Review of performance

Our operations in the Rest of Asia-Pacific region reported pre-tax profits of US$7.5bn compared with US$5.9bn in 2010, an increase of 27%. Reported profits included gains arising from the dilution of HSBC s shareholding in Ping An following its issue of share capital to third parties in 2010 and 2011 of US$188m and US$181m, respectively. On an underlying basis, excluding these gains, pre-tax profit rose by 23%.

Report of the Directors: Operating and Financial Review (continued)

The growth in profitability in the region reflected strong lending and deposit growth during 2010 and 2011, mainly in Singapore and mainland China, coupled with widening deposit spreads due to higher interest rates in certain countries, notably India and mainland China. Loan impairment charges improved as a result of the non-recurrence of a number of individual impairments and the reduction of certain unsecured lending portfolios. Costs increased, though to a lesser extent than revenues, to support business expansion, notably in mainland China, and maintain our competitive position in our six strategic markets. The contribution from our associates in mainland China also grew, benefiting from ongoing loan growth and increased income from fee-based revenue streams.

We continued to invest in building our franchise in mainland China where the operating profit of our operations more than doubled and we remained the leading foreign bank by network size. In CMB, we increased the coverage of our renminbi trade settlement services to 24 cities within the country, representing the widest geographic coverage among all foreign banks, and offered renminbi capabilities in over 50 countries worldwide. Cross-border referrals between mainland China and the rest of the world grew by 9% compared with 2010 as we capitalised on our international network to capture outbound and inbound trade flows. In GB&M, we focused on leveraging our global connectivity and product capabilities to be the leading international bank of choice for multinational corporations doing business with mainland China and large corporates looking to expand internationally.

Profit before tax increased in other key countries across the region as we maintained our strategic focus on these markets, particularly in intermediating cross-border trade flows. Trade revenues grew in most of our sites and we were awarded the Best Trade Finance Bank in Asia Pacific by *FinanceAsia* for the fourteenth consecutive year. Trade-related lending grew strongly in Singapore as we continued to enhance our trade finance capabilities. In Malaysia we expanded our branch network through the launch of new Amanah branches. We also experienced strong commercial lending growth in both Malaysia and Indonesia as a result of various marketing campaigns. In India, we were ranked the number one foreign bank by *Bloomberg* for domestic bonds in 2011 and issued the first and only offshore renminbi bond in the country.

As part of our strategic review process, in December 2011 we announced the sale of our private banking operations in Japan and, in January 2012,

we announced the sale of our RBWM operations in Thailand. We expect to complete these transactions during 2012.

Net interest income increased by 28%. Average lending balances grew most notably in CMB and GB&M, particularly in mainland China, as we captured inbound and outbound trade flows and as demand for credit in the region increased. In RBWM mortgage lending balances rose, notably in Singapore and Australia, driven by competitive product offerings and strong property markets.

This was partly offset by continued pressure on asset spreads, most notably in RBWM (particularly in Singapore and Australia), due to competitive pressures and growth in residential mortgage lending at lower spreads.

Customer deposit balances rose across most of the region, notably in Payments and Cash Management reflecting our investment in infrastructure as part of a targeted strategy to support growth in customer lending. Deposit spreads increased as interest rates rose in a number of countries, particularly in mainland China and India.

Net interest income from Balance Sheet Management was higher than in 2010, reflecting increased interest rates and the widening of onshore US dollar lending spreads in mainland China, and a higher return from short-term lending and growth in the balance sheet in Singapore as we attracted increased customer deposits.

Net fee income increased by 4%, primarily from trade-related fees as we targeted asset growth and trade activity, largely in mainland China, Bangladesh and Singapore, supported by marketing activities, customer acquisition and a rise in transactions from existing customers. Card fees rose, notably in Australia from the increased issuance of our co-branded credit cards, higher retail spending, and more customers converting to a higher card status.

Net trading income of US$1.7bn was broadly unchanged compared with 2010. Net interest income on trading activities was lower as we progressively reduced our positions in government debt securities following increased market volatility in bond markets, and from growth in structured deposits where the related income is recorded under Net interest income . This was offset by higher Foreign Exchange trading income due to increased customer transaction volumes resulting from the collaboration between GB&M and CMB and as more clients sought protection from volatility in the markets.

Net expense from financial instruments designated at fair value was US$18m compared with

Report of the Directors: Operating and Financial Review (continued)

income of US$29m in 2010. This was due to investment losses on assets held by the insurance business, primarily in Singapore, as a result of negative equity market movements during the second half of 2011. To the extent that these investment losses were attributed to policyholders of unit-linked insurance policies and insurance contracts with DPF, there was a corresponding decrease in *Net insurance claims incurred and movement in liabilities to policyholders*.

Losses from financial investments were US$23m compared with gains of US$151m in 2010, due to an impairment loss on an equity investment in 2011 in GB&M, lower gains on the disposal of government debt securities across the region and the non-recurrence of a gain on disposal of an equity investment in a Singaporean property company in 2010.

Net earned insurance premiums increased by 58% to US$759m as a result of successful sales initiatives, most notably resulting in improved sales of a universal life insurance product targeted at high net worth individuals in Singapore. The growth in premiums resulted in a corresponding increase in Net insurance claims incurred and movement in liabilities to policyholders.

Other operating income increased by US$92m, largely due to a rise in the PVIF asset in Singapore as a result of higher life insurance sales and a net increase from experience and assumption updates.

Loan impairment charges and other credit risk provisions decreased by 42% to US$267m as a result of the non-recurrence of a number of individual loan impairment charges in GB&M on a small number of accounts, coupled with the ongoing reduction of unsecured lending portfolios in India. We remain cautious on the outlook for credit quality and sustained our focus on maintaining high levels of underwriting and asset quality.

Operating expenses increased by 8% due to wage inflation which reflected the competitive labour market, along with an increase in average staff numbers, notably in mainland China. Increased business volumes across the region led to higher support costs. Premises and equipment costs also rose in certain countries, reflecting increased rental expenses resulting from lease renewals and new branch openings.

Share of profit from associates and joint ventures increased by 22%. The contribution from BoCom rose, driven by strong loan growth, wider deposit spreads following interest rate increases in mainland China and higher fee income, notably from investment banking, settlements and cards. Income from Industrial Bank also increased as a result of strong growth in customer lending, a rise in fee-based revenue and a fall in loan impairment charges. Higher profits from Ping An resulted from strong growth in sales in the insurance business and increased income from the banking business following the acquisition of Shenzhen Development Bank in July 2011.

Report of the Directors: Operating and Financial Review (continued)

2010 compared with 2009

Economic background

Economic activity accelerated in **mainland China**, building on the recovery which began in 2009. Annual GDP growth peaked at 11.9% in the first quarter of the year, as resilient domestic demand coincided with an acceleration in export growth as world demand recovered. Investment growth remained strong amid large scale government infrastructure projects and construction of public housing. Meanwhile, consumer spending was boosted by robust growth in employment and wages. In the final months of 2010, inflation became more of a concern, with the annual rate of CPI inflation rising to 4.6% in December. The People s Bank of China increased the commercial banking sector s required Statutory Deposit Ratio by 4.5 percentage points to 19.5% (for major banks) and 17.0% (for the rest) and raised the policy rate by 50 basis points over the course of the year. The renminbi exchange rate rose by 3% against the US dollar throughout the course of the year.

Japan s economic conditions improved in 2011, led mainly by a recovery in world trade, though unemployment remained at about 5% throughout the year. The Bank of Japan introduced a new programme of monetary stimulus in October 2010, aimed at curbing yen appreciation and reducing the deflationary pressures evident in the economy.

Elsewhere in the region, economies rebounded strongly, with growth in external demand a common feature. Comparing the third quarter of 2010 with the same period in 2009, GDP in **Taiwan** grew by 9.8%, in **South Korea** by 4.4% and in **India** by 8.9%. In the last, concerns emerged over the rate of wholesale price inflation, which rose to 8.4% in December. In **Singapore**, GDP growth was volatile as activity in the pharmaceutical sector fluctuated, contracting at an annualised rate of nearly 19% in the third quarter but rising 6.9% in the fourth quarter. **Malaysian** GDP, boosted by private consumption and exports, rose by 5.3% year on year in the third quarter, after surging 10.1% in the first quarter and 8.9% in the second quarter. In **Thailand**, the re-emergence of political risks in the second quarter of 2010 appeared not to dent household consumption or foreign direct investment. Foreign direct investment into **Indonesia** underpinned GDP growth of 5.8% in the third quarter. The economies of the **Philippines** and **Vietnam** also grew strongly. In **Australia** growth was more modest, in part because of a rise in the Reserve Bank of Australia s interest rate to 4.75% in the second half of the year. Activity in the mining sector continued to grow rapidly.

Review of performance

Our operations in the Rest of Asia-Pacific region reported pre-tax profits of US$5.9bn compared with US$4.2bn in 2009, an increase of 41%. Reported profits included an accounting gain of US$188m arising from the dilution of HSBC s shareholding in Ping An Insurance following its issue of share capital to a third party in 2010. On an underlying basis, which excludes this dilution gain, pre-tax profit rose by 29% as business volumes increased across many countries and all global businesses as the economic environment in the region improved.

The economic performance of the region was reflected in a recovery in trade volumes, an increase in our customers appetite for investment-related products, strong growth in lending balances and a significant decline in loan impairment charges. All these factors contributed to an increase in our profitability, as did a rise in our share of profit from associates in mainland China. Operating expenses increased to support this business growth.

During 2010 we continued to target growth, particularly in the key regional markets of mainland China, India, Indonesia, Singapore, Malaysia and Australia. We consolidated our position as the leading foreign bank in mainland China with 106 outlets in 27 cities, 16 rural bank outlets and 38 Hang Seng Bank outlets in 13 cities. We maintained our leadership in the development of renminbi products and now have renminbi capabilities in 36 countries across all six continents. In July 2010 we agreed to acquire a substantial part of The Royal Bank of Scotland Group plc s commercial and retail businesses in India. In Malaysia, four additional Amanah branches were opened.

Our focus on higher value segments was reflected in the Premier customer base in the region which grew by 33% while the Advance proposition was launched in nine markets, exceeding 660,000 customers by the year end. In CMB, we continued to build on our international connectivity, with cross-regional referrals nearly doubling as we pursued our objective to be the leading international business bank.

Net interest income was broadly in line with 2009 as strong loan growth was offset by narrower asset spreads in the face of strong competition. Higher average lending balances resulted from business growth in GB&M and CMB across the region, reflecting the recovery in trade activity. Average RBWM lending balances also rose, mainly in the mortgage book, most notably in Australia,

Report of the Directors: Operating and Financial Review (continued)

Singapore and Malaysia, as well as in Taiwan and mainland China, supported by successful marketing campaigns.

The narrower asset spreads were also the consequence of a shift to lower risk customers following the managed reduction of certain unsecured lending portfolios, particularly in India.

Average customer deposit balances grew, primarily in mainland China, Australia and Singapore as a result of a targeted strategy to expand the customer base.

Balance Sheet Management income declined from 2009 as higher yielding trades matured, interest rates generally remained low and yield curves flattened.

Net fee income was 16% higher. An improvement in equity markets and inflows of funds under management drove a significant increase in fee income in GB&M while, in CMB, the recovery in trade activity led to higher trade-related fees and credit facilities. In RBWM, fee income also rose from the increased sales of investment and insurance products.

Net trading income declined by 7%, as reduced market volatility led to lower Rates trading income. In India, trading income further declined as gains achieved in 2009 from narrowing bond yields did not recur while in South Korea, lower trading revenues reflected the non-recurrence of one-off gains recognised in 2009. These were partly offset by higher foreign exchange income in mainland China and wider margins in India as a result of strong client volumes in the growing economies and a rise in interest income from trading activities resulting from increased holdings of debt securities.

Net income from financial instruments designated at fair value fell by US$95m. The movement was due to lower revaluation gains in 2010 than in 2009 on assets held to support insurance contracts. To the extent that these lower investment gains were attributed to policyholders, there was a corresponding decrease in Net insurance claims incurred and movement in liabilities to policyholders .

Gains less losses from financial investments were US$141m compared with losses of US$15m in 2009, as a result of a gain on disposal of an equity investment in a Singaporean property company and gains on sales of other available-for-sale investments. Impairments reported in 2009 did not recur in 2010.

Other operating income increased by 8% to US$1.4bn, largely due to an increase in PVIF, reflecting higher life insurance sales in the region and recoveries against initial fair value on loan portfolios acquired with Bank Ekonomi in Indonesia and from The Chinese Bank Co., Ltd in Taiwan.

Net earned insurance premiums increased by 15% to US$448m, largely due to higher sales in Malaysia, Taiwan and mainland China, primarily from successful product launches and marketing campaigns.

Growth in the insurance business resulted in a related increase in *Net insurance claims incurred and movement in liabilities to policyholders* which was more than offset by the decrease corresponding to the lower investment gains reported above in Net income from financial instruments designated at fair value .

Loan impairment charges and other credit risk provisions decreased by 55% to US$439m. As economic and credit conditions improved across the region, loan impairment charges fell in RBWM, most notably in India as certain unsecured lending portfolios were managed down, and fewer specific impairments were recognised in CMB. Partly offsetting this improvement were specific impairment charges booked in GB&M.

Operating expenses increased by 8% to US$5.1bn in support of business growth and to capitalise on the region s economic recovery. Examples were the continuing expansion of the branch network in mainland China and the opening of the new headquarters building in Shanghai, as well as local incorporation and expansion of the Taiwan operations. Staff numbers rose to support business expansion, particularly in the key regional

markets of mainland China, Australia, Singapore and Indonesia. Business initiatives were supported by marketing campaigns in most markets and higher transaction volumes which led to increased processing costs.

Share of profit from associates and joint ventures in the region increased by 45%, with a higher contribution from Ping An Insurance driven by strong sales growth. The share of profit from Bank of Communications also increased due to growth in lending and higher fee income from cards, wealth management and settlement activity. Growth in lending and an increase in fee income led to a higher contribution from Industrial Bank.

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Profit before tax and balance sheet data Rest of Asia-Pacific

	2011						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[64] US$m	Total US$m
Profit before tax							
Net interest income	1,838	1,254	1,964	116	123	(193)	5,102
Net fee income/(expense)	904	513	621	82	(9)		2,111
Trading income/(expense) excluding net interest income	94	156	1,153	66	(90)		1,379
Net interest income/(expense) on trading activities	(2)	1	76		11	193	279
Net trading income/(expense)[56]	92	157	1,229	66	(79)	193	1,658
Changes in fair value of long- term debt issued and related derivatives					4		4
Net income/(expense) from other financial instruments designated at fair value	(38)	2	1		15		(20)
Net income/(expense) from financial instruments designated at fair value	(38)	2	1		19		(16)
Gains less losses from financial investments		2	(25)	1	(1)		(23)
Dividend income			2				2
Net earned insurance premiums	493	266					759
Other operating income	145	72	75	5	1,592	(178)	1,711
Total operating income	3,434	2,266	3,867	270	1,645	(178)	11,304
Net insurance claims[65]	(351)	(240)					(591)
Net operating income[52]	3,083	2,026	3,867	270	1,645	(178)	10,713
Loan impairment (charges)/ recoveries and other credit risk provisions	(222)	10	(57)	2			(267)
Net operating income	2,861	2,036	3,810	272	1,645	(178)	10,446
Total operating expenses	(2,409)	(945)	(1,268)	(181)	(1,181)	178	(5,806)
Operating profit	452	1,091	2,542	91	464		4,640
Share of profit/(loss) in associates and joint ventures	1,189	1,155	547		(60)		2,831
Profit before tax	1,641	2,246	3,089	91	404		7,471

	%	%	%	%	%		%
Share of HSBC s profit before tax	**7.5**	**10.3**	**14.1**	**0.4**	**1.9**		**34.2**
Cost efficiency ratio	**78.1**	**46.6**	**32.8**	**67.0**	**71.8**		**54.2**
Balance sheet data[49]							
	US$m	**US$m**	**US$m**	**US$m**	**US$m**		**US$m**
Loans and advances to customers (net)	**40,970**	**38,404**	**41,114**	**3,190**	**190**		**123,868**
Total assets	**54,484**	**50,688**	**195,549**	**12,879**	**16,616**	**(12,400)**	**317,816**
Customer accounts	**60,831**	**40,423**	**60,855**	**11,872**	**31**		**174,012**

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Report of the Directors: Operating and Financial Review (continued)

Profit before tax and balance sheet data Rest of Asia-Pacific (continued)

	2010						
	Retail Banking and Wealth Manage-ment[17]	Commercial Banking	Global Banking and Markets[17]	Global Private Banking	Other	Inter-segment elimination[64]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit before tax							
Net interest income	1,581	938	1,435	91	55	(272)	3,828
Net fee income/(expense)	834	442	611	55	(10)		1,932
Trading income/(expense) excluding net interest income	80	129	967	69	(38)		1,207
Net interest income on trading activities			138		1	272	411
Net trading income/(expense)[56]	80	129	1,105	69	(37)	272	1,618
Changes in fair value of long- term debt issued and related derivatives					(2)		(2)
Net income/(expense) from other financial instruments designated at fair value	41	2	(1)		(16)		26
Net income/(expense) from financial instruments designated at fair value	41	2	(1)		(18)		24
Gains less losses from financial investments		3	51		92		146
Dividend income			1				1
Net earned insurance premiums	386	62					448
Other operating income	109	86	55	1	1,499	(152)	1,598
Total operating income	3,031	1,662	3,257	216	1,581	(152)	9,595
Net insurance claims[65]	(324)	(39)					(363)
Net operating income[52]	2,707	1,623	3,257	216	1,581	(152)	9,232
Loan impairment charges and other credit risk provisions	(298)	(19)	(122)				(439)
Net operating income	2,409	1,604	3,135	216	1,581	(152)	8,793
Total operating expenses	(2,233)	(799)	(1,094)	(135)	(1,034)	152	(5,143)
Operating profit	176	805	2,041	81	547		3,650
Share of profit in associates and joint ventures	986	751	447		68		2,252
Profit before tax	1,162	1,556	2,488	81	615		5,902
	%	%	%	%	%		%

Share of HSBC s profit before tax							
	6.1	8.2	13.1	0.4	3.2		31.0
Cost efficiency ratio	82.5	49.2	33.6	62.5	65.4		55.7
Balance sheet data[49]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	37,831	31,423	35,810	3,489	178		108,731
Total assets	49,758	41,588	166,710	12,126	19,450	(11,570)	278,062
Customer accounts	54,741	36,943	53,752	12,620	99		158,155

For footnotes, see page 95.

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Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax and balance sheet data *Rest of Asia-Pacific (continued)*

	2009						
	Retail Banking and Wealth Manage-ment[17]	Commercial Banking	Global Banking and Markets[17]	Global Private Banking	Other	Inter-segment elimination[64]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit before tax							
Net interest income	1,493	807	1,174	115	91	(141)	3,539
Net fee income/(expense)	656	331	534	55	(19)		1,557
Trading income/(expense) excluding net interest income	80	134	1,013	55	(18)		1,264
Net interest income/(expense) on trading activities	(1)		202			141	342
Net trading income/(expense)[56]	79	134	1,215	55	(18)	141	1,606
Changes in fair value of long- term debt issued and related derivatives					(1)		(1)
Net income/(expense) from other financial instruments designated at fair value	110	1	(2)		2		111
Net income/(expense) from financial instruments designated at fair value	110	1	(2)		1		110
Gains less losses from financial investments	5	2	(7)		(19)		(19)
Dividend income			1		1		2
Net earned insurance premiums	337	28					365
Other operating income/(expense)	69	66	39	(2)	1,200	(134)	1,238
Total operating income	2,749	1,369	2,954	223	1,237	(134)	8,398
Net insurance claims[65]	(380)	(15)					(395)
Net operating income[52]	2,369	1,354	2,954	223	1,237	(134)	8,003
Loan impairment charges and other credit risk provisions	(649)	(221)	(23)	(2)	(1)		(896)
Net operating income	1,720	1,133	2,931	221	1,236	(134)	7,107
Total operating expenses	(1,895)	(636)	(950)	(131)	(972)	134	(4,450)
Operating profit/(loss)	(175)	497	1,981	90	264		2,657
Share of profit in associates and joint ventures	686	567	290				1,543
Profit before tax	511	1,064	2,271	90	264		4,200
		%	%	%	%		%

	%						
Share of HSBC s profit before tax	7.2	15.0	32.1	1.3	3.7		59.3
Cost efficiency ratio	80.0	47.0	32.2	58.7	78.6		55.6

Balance sheet data[49]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	30,433	22,595	23,989	2,834	192		80,043
Total assets	40,465	31,221	138,685	11,928	7,160	(7,320)	222,139
Customer accounts	47,573	30,196	43,698	12,496	36		133,999

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Middle East and North Africa

The network of branches of HSBC Bank Middle East Limited, together with HSBC s subsidiaries and associates, gives us the widest reach in the region. Our associate in Saudi Arabia, The Saudi British Bank (40% owned), is the Kingdom s sixth largest bank by total assets.

	2011 US$m	2010 US$m	2009 US$m
Net interest income	**1,432**	1,367	1,485
Net fee income	**627**	677	625
Net trading income	**482**	370	394
Other income	**66**	(4)	90
Net operating income[52]	**2,607**	2,410	2,594
Impairment charges[53]	**(293)**	(627)	(1,334)
Net operating income	**2,314**	1,783	1,260
Total operating expenses	**(1,159)**	(1,078)	(1,001)
Operating profit	**1,155**	705	259
Income from associates[54]	**337**	187	196
Profit before tax	**1,492**	892	455
Cost efficiency ratio	**44.5%**	44.7%	38.6%
RoRWA[55]	**2.6%**	1.6%	0.8%
Year-end staff numbers	**8,373**	8,676	8,281

Pre-tax profit significantly

above 2010 despite regional

political unrest and economic pressures

Loan impairment charges

decline to 2008 levels

Best trade finance bank in the Middle East

and North Africa

(Global Trade Review 2011)

for the fourth consecutive year

For footnotes, see page 95.

The commentary on Middle East and North Africa is on an underlying basis unless stated otherwise.

Economic background

In the Middle East and North Africa region, GDP grew by more than 5% in 2011, though the headline figure masks a wide variance in overall performance and growth drivers. In the oil producing states of the Gulf, high oil prices prompted growth in oil output and encouraged substantial increases in current and capital spending, most notably in **Saudi Arabia**. The export-oriented service sectors of countries including the **UAE** also grew robustly, supported in part by firm Asian demand.

The aggregate fiscal and current account surpluses of the Gulf Co-operation Council members stood at 15% and 25% of GDP, respectively, significantly higher than in 2010. Despite the pick-up in growth, CPI inflation remained generally muted with slow private sector wage growth and broadly unchanged real estate prices.

Regional political uncertainties weighed more heavily on performance elsewhere, however, particularly in countries that were subject to regime change. In **Egypt**, the level of GDP fell by an estimated 6 percentage points year-on-year as unrest held back investment and service sector exports, particularly tourism, contracted. Increased pressure on public finances and external account balances also added to the challenges for the post-revolution economies.

Review of performance

Our operations in the Middle East and North Africa reported a profit before tax of US$1.5bn, an increase of US$600m, or 67%. In 2010, we completed the sale of our investment in the British Arab Commercial Bank on which a loss of US$42m was incurred. In 2011, we recorded a dilution gain of US$27m as a result of the reduction of our holding in HSBC Saudi Arabia Limited following its merger with SABB Securities Limited. On an underlying basis, excluding these items, pre-tax profits increased by 57% as significant loan impairment charges in 2010 did not recur and trading income rose. In addition, profits from our associate, The Saudi British Bank, increased significantly driven by a decline in loan impairment charges as the credit environment in Saudi Arabia improved.

Despite political unrest and economic pressures, profits increased in all countries with the exception of Qatar, which was adversely affected by new regulations on foreign banks which curtailed growth in certain products, and Jordan, where we incurred a

Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax by country within global businesses

	Retail Banking and Wealth Management[17] US$m	Commercial Banking US$m	Global Banking and Markets[17] US$m	Global Private Banking US$m	Other US$m	Total US$m
2011						
Egypt	**43**	**55**	**129**		**(2)**	**225**
Qatar	**(4)**	**35**	**81**			**112**
United Arab Emirates	**134**	**240**	**200**	**(6)**	**7**	**575**
Other	**17**	**109**	**93**			**219**
MENA (excluding Saudi Arabia)	**190**	**439**	**503**	**(6)**	**5**	**1,131**
Saudi Arabia	**57**	**98**	**140**	**4**	**62**	**361**
	247	**537**	**643**	**(2)**	**67**	**1,492**
2010						
Egypt	38	82	77		(2)	195
Qatar	19	52	67			138
United Arab Emirates	17	186	121	1	(1)	324
Other	19	57	(19)			57
MENA (excluding Saudi Arabia)	93	377	246	1	(3)	714
Saudi Arabia	25	107	53	(16)	9	178
	118	484	299	(15)	6	892
2009						
Egypt	18	51	97		58	224
Qatar	10	60	66			136
United Arab Emirates	(177)	(136)	307	(2)	5	(3)
Other	3	(15)	(80)		(3)	(95)
MENA (excluding Saudi Arabia)	(146)	(40)	390	(2)	60	262
Saudi Arabia	42	61	55	8	27	193
	(104)	21	445	6	87	455

For footnote, see page 95.

specific loan impairment charge related to a corporate customer. Customer deposits across the region grew by 10%, reflecting the overall resilience of the oil-based regional economies and the strength of the HSBC brand.

We initiated a number of strategic programmes to optimise and reconfigure our branch network. This resulted in branch closures and consolidations in Jordan, Lebanon, Qatar and Bahrain together with an exit from our retail operations in Kuwait and part of our Principal Investments business. We also reconfigured domestic private banking in the UAE in order to focus solely on international private banking products and services through the conversion of the existing operation into a representative office for GPB.

In RBWM, we continued to focus on wealth management and secured lending, while building long-term relationships through our Premier and Advance customer offerings. During 2011, we implemented new technologies to improve our financial planning capabilities. We also successfully launched mobile banking in the UAE, Oman, Bahrain and Jordan allowing customers to access

HSBC Internet Banking instantly through smart phones.

In CMB, we continued to strengthen our position as a leading international trade and business bank, achieving double-digit trade-related growth year-on-year and increasing market share in key markets. We also launched services to support settlements in renminbi to further facilitate trade between mainland China and the region.

In the UAE, we entered into partnerships with a number of Free Trade Zones to provide improved access to banking services for internationally-oriented SMEs.

In Payments and Cash Management, we launched ClientSphere, a system which will further simplify cash management products and improve the overall customer experience. We also won a number of awards, including Best Overall Bank for Cash Management in the Middle East from *Global Finance Awards* and Best Cash Management Bank in the Middle East from *Euromoney*.

Report of the Directors: Operating and Financial Review (continued)

Greater collaboration between CMB and GB&M benefited both businesses with a significant increase in GB&M-related revenues from 2010.

In GB&M, we continued to focus on our key clients and used our global expertise and reach both to complete a number of cross-border deals for regional clients and provide risk management solutions tailored for customer needs, including Islamic products. We won a number of awards, including Best for Middle Eastern Currencies in the *Euromoney* FX survey and Best Risk Advisor in Middle East from *Euromoney*. We continued to be recognised as a leading provider of Islamic financial services and we were awarded Best Islamic Investment Bank, Middle East and Sukuk House of the Year from *The Asset Magazine* Triple A Islamic Finance Awards.

Net interest income rose by 6%, driven by strong growth in average trade lending balances in the second half of 2010 and throughout 2011 in CMB as we leveraged opportunities to support global and intra-regional trade flows. GB&M also benefited from the restructuring of a large customer facility along with improved spreads on investment portfolios. This was partly offset by a reduction in spreads in CMB as we priced competitively to drive volume growth. In addition, average lending balances declined in RBWM as unsecured lending portfolios continued to be managed down and replaced by higher quality lending resulting in an overall improvement in the credit quality of the portfolio. Central bank regulations limiting interest rates on certain products in Qatar also contributed to lower net interest income.

Net fee income decreased by 7%, despite higher trade volumes in CMB, as lower institutional equity activity in GB&M reflected the challenging political environment. In addition, net fee income in RBWM decreased due to a decline in the number of credit cards in issue as certain portfolios were managed down, along with lower late fees as a result of an improvement in delinquency rates.

Trading income increased by 31%, mainly in Rates in GB&M due to an increase in government bond trading along with a net release of credit valuation adjustments driven by movements in exchange rates and an improvement in counterparty risk. A greater focus on sales of GB&M products to CMB customers, notably foreign exchange, also contributed to the rise in trading income.

Loan impairment charges and other credit risk provisions decreased markedly as the significant loan impairment charges which resulted from restructuring activity for a small number of large GB&M customers in 2010 did not recur. In addition, lower loan impairment charges in RBWM reflected a significant improvement in delinquency rates, which resulted from a repositioning of the loan book towards higher quality lending as we continued to manage down higher risk unsecured lending, together with strengthened collection practices. Our lending portfolios were not significantly adversely affected by political instability in the region, although uncertainties remain in certain of these markets.

Operating expenses increased by 8% due to an increase in staff costs as we enhanced the employee base, and to a lesser extent, in line with inflation. Strategic programmes, including de-layering our management structure, streamlining our business processes and implementing the hub and spoke model to drive future sustainable cost savings, resulted in lower staff numbers than last year. This resulted in restructuring costs of US$31m. Marketing costs also rose as we increased investment in the promotion of the HSBC brand.

Profit from associates and joint ventures increased by 81%, mainly from The Saudi British Bank, driven by a decline in loan impairment charges as the credit environment in Saudi Arabia improved, along with cost control.

Report of the Directors: Operating and Financial Review (continued)

2010 compared with 2009

Economic background

Economic activity in much of the Middle East and North Africa showed signs of stabilising during 2010. A 30% year on year rise in average oil prices led to a marked strengthening of public finances in the Gulf states, allowing governments such as **Saudi Arabia** to boost public current and capital spending. The high and stable average oil prices also improved external account positions in the Gulf, leading to an increase in reserves and overall net foreign asset accumulation following the modest drawdowns in 2009.

As well as receiving support from rising public spending, non-oil goods and service exporters in the region also benefited from rising external demand, particularly from Asia. The **UAE** was a leading beneficiary, most notably in its transport and logistics sectors. Banking sector activity remained relatively subdued, with rates of credit growth flat or negative in real terms across much of the region. This contributed to subdued consumer and asset price inflation. Although there was some evidence in **Saudi Arabia**, **Oman** and **Kuwait** that stronger growth and higher commodity prices were putting pressure on prices in late 2010, the pace of increase remained below that seen in other emerging markets. Inflation was largely absent in the UAE.

Dubai had another challenging year in 2010, as it continued to struggle with high levels of debt, falling real estate prices and a stagnant credit market. Although no figures have been released, officials estimated in October that real GDP was likely to have grown by 2.3% in 2010, mostly from global trade as exports rose 35% in the year to the third quarter. The domestic economy was considerably weaker through most of the year although there were signs of an improvement by the year end.

In **Egypt,** GDP growth returned to 6% by the end of 2010, driven primarily by domestic demand. Egypt s structural economic strengths leave us positive on the medium-term outlook, although recent political turmoil might overshadow its near-term prospects.

Review of performance

Our operations in the Middle East and North Africa reported pre-tax profits of US$892m, an increase of US$437m compared with 2009.

In October 2010, we completed the sale of our investment in the British Arab Commercial Bank, on which a loss of US$42m was recorded. On an

underlying basis and excluding this loss, pre-tax profits increased by US$481m.

Profits increased strongly in the second half of 2010 compared with the first half of the year, reflecting increased stability in the regional economy and growing momentum in several of the key markets.

The improvement in the credit environment and our risk management actions combined to contribute to significantly lower loan impairment charges and other credit risk provisions. The benefit was partly offset by lower revenues from the run-off of higher yielding unsecured loans, mainly in the UAE.

Our Premier and Advance customer base continued to grow in line with our strategy to build a sustainable wealth-driven, premium-based RBWM business, with Premier attracting 35,000 net new customers in the year, of whom 19,000 were new to the Group. During 2010, we launched the Advance proposition across most of the region and the number of customers reached 152,000 at 31 December 2010. The opening of our 100th branch in Egypt is an example of initiatives to expand our regional presence.

In CMB, we continued to build on our competitive advantage in international connectivity. The increased opportunities to support business and trade flows between the region and the rest of the world, particularly mainland China and India, led to strong trade-related revenues and supported our market-leading position in this business. As a result, we gained market share in our key markets and received several awards for trade services including Leading Trade Services Bank in the Middle East and North Africa which was awarded by *Global Trade Review* for the fourth consecutive year.

As part of our continued support to local internationally-focused businesses, we fully allocated the pledged US$100m fund to UAE SME customers engaged in international cross-border business.

In GB&M we continued to invest in the region to support existing and anticipated new business and we now have a fully functional dealing room in Abu Dhabi and a China desk in the UAE to support East-East business. We continued to be recognised as the dominant player in regional bond markets and won several awards, including Best Investment Bank in the Middle East awarded by *Euromoney*.

Net interest income decreased by 8% as average lending balances declined in both RBWM and CMB, the proportion of higher yielding assets fell and the cost of liquidity remained high.

Report of the Directors: Operating and Financial Review (continued)

In RBWM, spreads narrowed as we focused new lending on Premier and Advance customers, while concurrently managing down higher risk unsecured lending balances, mostly in the UAE.

In CMB, asset balances and net interest income rose throughout the second half of 2010 as increasing trade finance balances contributed to growing revenues.

Average customer accounts declined as corporate customers reduced their deposits in response to tighter liquidity in the local markets. This was partly offset by an increase in average liability balances in RBWM, which was driven by successful deposit campaigns launched in 2010 and by the acquisition of Premier and A dvance customers. Our overall liquidity position improved although the market returns on the deployment of liquidity remained low.

Net fee income increased by 8%, primarily driven by higher volumes of credit facilities related to trade, guarantees and remittances in CMB. The benefit was partly offset by lower advisory revenues from equity capital markets in GB&M as a result of limited issuances in the regional equity markets.

Net trading income fell by 6% to US$370m. Subdued trading conditions and the non-recurrence of gains which had resulted from the tightening of credit spreads on certain positions in early 2009 resulted in lower Credit trading income. Foreign exchange income decreased with the easing in market volatility as speculation regarding the unpegging of Gulf currencies from the US dollar receded.

Other operating income declined by US$37m as gains arising in 2009 from the buy-back and extinguishment of own debt did not recur.

Loan impairment charges and other credit risk provisions decreased by 53%. An overall improvement in credit conditions in the region along with enhanced collections processes, improvements in the quality of our customer base and a reduction in unsecured lending resulted in significantly lower net collective impairment provisions, notably in the UAE, and lower requirements for specific corporate provisions.

In RBWM, strengthened collections processes and a repositioning of the loan book contributed to lower delinquency rates. In CMB, loan impairment charges and other credit risk provisions decreased due to significantly lower net collectively assessed impairment charges and fewer specific loan impairment charges, with the majority of the charge in 2010 relating to a small number of large corporate customers.

Loan impairment charges and other credit risk provisions in GB&M rose, mainly from restructuring activity which drove UAE-related loan impairments for a small number of large corporate customers in the first half of 2010. The improvement in economic conditions during the latter part of 2010 resulted in lower loan impairment charges in the second half of the year.

Operating expenses increased by 8%, driven by increased investment in marketing and advertising, including key sponsorship deals and the promotion of the HSBC brand through strategic messaging in the Abu Dhabi and Dubai airports, together with an increase in premises and people costs, mainly from the investment in the branch network expansion in Egypt.

Profit from associates and joint ventures decreased by 5%. The contribution from The Saudi British Bank was lower as revenue fell in challenging operating conditions.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax and balance sheet data Middle East and North Africa

	2011						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[64] US$m	Total US$m
Profit/(loss) before tax							
Net interest income	**589**	**496**	**371**	**2**	**2**	**(28)**	**1,432**
Net fee income/(expense)	**173**	**271**	**173**	**13**	**(3)**		**627**
Trading income/(expense) excluding net interest income	**62**	**95**	**266**	**1**	**(1)**		**423**
Net interest income/(expense) on trading activities			**32**		**(1)**	**28**	**59**
Net trading income/(expense)[56]	**62**	**95**	**298**	**1**	**(2)**	**28**	**482**
Net income from financial instruments designated at fair value					**10**		**10**
Gains less losses from financial investments	**1**	**1**	**(7)**		**(3)**		**(8)**
Dividend income	**1**	**1**	**3**				**5**
Other operating income/(expense)	**22**	**11**	**11**	**(1)**	**124**	**(108)**	**59**
Total operating income	**848**	**875**	**849**	**15**	**128**	**(108)**	**2,607**
Net insurance claims[65]							
Net operating income[52]	**848**	**875**	**849**	**15**	**128**	**(108)**	**2,607**
Loan impairment charges and other credit risk provisions	**(126)**	**(116)**	**(51)**				**(293)**
Net operating income	**722**	**759**	**798**	**15**	**128**	**(108)**	**2,314**
Total operating expenses	**(535)**	**(320)**	**(295)**	**(21)**	**(96)**	**108**	**(1,159)**
Operating profit/(loss)	**187**	**439**	**503**	**(6)**	**32**		**1,155**
Share of profit in associates and joint ventures	**60**	**98**	**140**	**4**	**35**		**337**
Profit/(loss) before tax	**247**	**537**	**643**	**(2)**	**67**		**1,492**
	%	%	%	%	%		%
Share of HSBC s profit before tax	**1.1**	**2.5**	**2.9**		**0.3**		**6.8**
Cost efficiency ratio	**63.1**	**36.6**	**34.7**	**140.0**	**75.0**		**44.5**
Balance sheet data[49]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	**4,921**	**12,446**	**8,479**	**26**	**3**		**25,875**
Total assets	**6,549**	**14,556**	**34,676**	**72**	**4,792**	**(3,181)**	**57,464**
Customer accounts	**18,549**	**10,943**	**6,703**	**114**	**113**		**36,422**

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

	2010						
	Retail Banking and Wealth Management[17] US$m	Commercial Banking US$m	Global Banking and Markets[17] US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[64] US$m	Total US$m
Profit/(loss) before tax							
Net interest income	553	473	334		14	(7)	1,367
Net fee income	200	258	202	17			677
Trading income/(expense) excluding net interest income	59	85	205	1	(7)		343
Net interest income/(expense) on trading activities	1	7	18		(6)	7	27
Net trading income/(expense)[56]	60	92	223	1	(13)	7	370
Net income/(expense) from financial instruments designated at fair value							
Gains less losses from financial investments	1		(3)		(1)		(3)
Dividend income	2	1	4				7
Other operating income/(expense)	27	(8)	(1)	1	40	(67)	(8)
Total operating income	843	816	759	19	40	(67)	2,410
Net insurance claims[65]							
Net operating income[52]	843	816	759	19	40	(67)	2,410
Loan impairment charges and other credit risk provisions	(227)	(145)	(255)				(627)
Net operating income	616	671	504	19	40	(67)	1,783
Total operating expenses	(524)	(297)	(263)	(18)	(43)	67	(1,078)
Operating profit/(loss)	92	374	241	1	(3)		705
Share of profit/(loss) in associates and joint ventures	26	110	58	(16)	9		187
Profit/(loss) before tax	118	484	299	(15)	6		892
	%	%	%	%	%		%
Share of HSBC s profit before tax	0.6	2.6	1.6	(0.1)			4.7
Cost efficiency ratio	62.2	36.4	34.7	94.7	107.5		44.7
Balance sheet data[49]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	5,063	12,293	7,247	21	2		24,626
Total assets	6,286	13,991	31,253	59	4,129	(2,961)	52,757

Customer accounts	17,538	10,319	5,306	290	58	33,511

For footnotes, see page 95.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax and balance sheet data Middle East and North Africa (continued)

	2009						
	Retail Banking and Wealth Manage-ment[17]	Commercial Banking	Global Banking and Markets[17]	Global Private Banking	Other	Inter-segment elimination[64]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit/(loss) before tax							
Net interest income	644	464	330	1	46		1,485
Net fee income	203	219	198	3	2		625
Trading income excluding net interest income	55	75	235	1	3		369
Net interest income on trading activities			20		5		25
Net trading income[56]	55	75	255	1	8		394
Gains less losses from financial investments	12	(2)	1		5		16
Dividend income			3				3
Other operating income/(expense)	35	39	35	(1)	39	(76)	71
Total operating income	949	795	822	4	100	(76)	2,594
Net insurance claims[65]							
Net operating income[52]	949	795	822	4	100	(76)	2,594
Loan impairment charges and other credit risk provisions	(588)	(573)	(173)				(1,334)
Net operating income	361	222	649	4	100	(76)	1,260
Total operating expenses	(508)	(269)	(255)	(6)	(39)	76	(1,001)
Operating profit/(loss)	(147)	(47)	394	(2)	61		259
Share of profit in associates and joint ventures	43	68	51	8	26		196
Profit/(loss) before tax	(104)	21	445	6	87		455
	%	%	%	%	%		%
Share of HSBC s profit before tax	(1.5)	0.3	6.3	0.1	1.2		6.4
Cost efficiency ratio	53.5	33.8	31.0	150.0	39.0		38.6
Balance sheet data[49]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	5,979	10,281	6,554	28	2		22,844
Total assets	6,832	11,861	28,167	96	4,952	(3,801)	48,107
Customer accounts	15,074	10,122	5,752	1,172	409		32,529

For footnotes, see page 95.

Report of the Directors: Operating and Financial Review (continued)

North America

Our North American businesses are located in the US, Canada and Bermuda. Operations in the US are primarily conducted through HSBC Bank USA, N.A., and HSBC Finance, a national consumer finance company. HSBC Markets (USA) Inc. is the intermediate holding company of, inter alia, HSBC Securities (USA) Inc. HSBC Bank Canada and HSBC Bank Bermuda operate in their respective countries.

	2011 US$m	2010 US$m	2009 US$m
Net interest income	**11,480**	12,439	13,670
Net fee income	**3,308**	3,664	4,817
Net trading income/ (expense)	**(362)**	314	331
Other income/(expense)	**1,574**	630	(2,513)
Net operating income[52]	**16,000**	17,047	16,305
Impairment charges[53]	**(7,016)**	(8,295)	(15,664)
Net operating income	**8,984**	8,752	641
Total operating expenses	**(8,919)**	(8,322)	(8,391)
Operating profit/(loss)	**65**	430	(7,750)
Income from associates[54]	**35**	24	12
Profit/(loss) before tax	**100**	454	(7,738)
Cost efficiency ratio	**55.7%**	48.8%	51.5%
RoRWA[55]	**%**	0.1%	(2.1)%
Year-end staff numbers	**30,981**	33,865	35,458

The sale of our Card and Retail Services

business and 195 non-strategic branches

announced

Gross balances in

run-off portfolio down by

US$8.9bn

to US$49.5bn

Reported pre-tax profit of

US$965m

from our Canadian operations

For footnotes, see page 95.

The commentary on North America is on an underlying basis unless stated otherwise.

Economic background

In the **US**, GDP expanded by 3.0% in 2010 and the adoption of stimulative tax policies at the end of that year suggested an even faster rate of growth in 2011. However, this failed to materialise for a number of reasons. The first was the adoption of fiscal austerity by state and local governments. Second, the sharp rise in crude oil prices in the first half of 2011 dampened both business and consumer spending. By the second quarter of 2011, average crude oil prices were 50% higher than the levels a year earlier. The third development concerned the disruption to motor vehicle production caused by parts shortages arising from the Japanese earthquake. Finally, financial market turmoil caused by the eurozone debt crisis and the debt ceiling debate in Washington adversely affected business and consumer confidence. The housing market remained weak, although there were some tentative signs of recovery towards the end of the year, albeit from a very low level. As a result, GDP rose by only 1.7% in 2011.

US headline inflation increased during 2011 with the annual rate of CPI inflation rising to 3.1% compared with 1.7% in 2010, but core inflation remained subdued. The labour market recovery continued to be lacklustre; employment grew roughly 0.6% in 2011 following a decline of the same magnitude in 2010. The unemployment rate fell to 8.5% in December 2011, down from 9.6% in 2010, but much of the decline can be attributed to a fall in labour force participation. The Federal Reserve remained focused on countering deflationary pressures; it committed itself to keeping the Fed funds rate in a range of 0 to 0.25% until at least mid-2013 and, in September, with the intention of exerting downward pressure on longer-term interest rates, it decided to extend the average maturity of its securities portfolio by selling US$400bn of short-term Treasury securities and buying an equivalent amount of longer-term Treasury securities in their place. These moves helped stabilise financial asset prices in the final quarter of the year.

The annual rate of GDP growth in **Canada** slowed in 2011 to 2.4% from 3.2% in 2010. Slower economic growth in the US and other export partners in Europe held back the rate of growth and a slowdown in the pace of job creation dampened the growth of consumer spending as well. Higher energy prices contributed to a rise in inflation, leading to an increase in the annual rate of core CPI inflation to 2.9% from 1.8% the year before. The Bank of Canada held its policy interest rate steady at 1.0% in 2011.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax by country within global businesses

	Retail Banking and Wealth Management[17] US$m	Commercial Banking US$m	Global Banking and Markets[17] US$m	Global Private Banking US$m	Other US$m	Total US$m
2011						
US	**(2,861)**	**431**	**567**	**83**	**782**	**(998)**
Canada	**147**	**545**	**265**		**8**	**965**
Bermuda	**49**	**26**	**43**	**7**	**9**	**134**
Other					**(1)**	**(1)**
	(2,665)	**1,002**	**875**	**90**	**798**	**100**
2010						
US	(2,305)	402	1,284	113	(39)	(545)
Canada	131	505	227		4	867
Bermuda	58	32	38	(3)	7	132
Other				1	(1)	
	(2,116)	939	1,549	111	(29)	454
2009						
US[69]	(5,275)	158	488	(49)	(3,626)	(8,304)
Canada	34	347	142		(100)	423
Bermuda	60	37	36	(2)	10	141
Other		1	1	1	(1)	2
	(5,181)	543	667	(50)	(3,717)	(7,738)

For footnotes, see page 95.

Review of performance

Our operations in North America reported a profit before tax of US$100m in 2011, compared with US$454m in 2010, a decrease of 78%. Reported profits included favourable movements on our own debt designated at fair value of US$970m resulting from changes in credit spreads, compared with favourable movements of US$142m and a gain of US$66m on the sale of our stake in the Wells Fargo HSBC Trade Bank in 2010. On an underlying basis, which excludes the above, we reported a pre-tax loss of US$870m in 2011 compared with a profit before tax of US$285m in 2010.

Our 2011 North America results continued to be affected by the pace of recovery of the US economy, in particular the decline in house prices and high levels of unemployment, as well as the impact of proposed regulatory changes and ongoing compliance initiatives. We expect these factors, as well as the ongoing delays in foreclosure processes, to continue to affect our results going forward.

The reduction in our underlying profit was partly attributable to a decline in GB&M driven by higher costs, mainly from compliance and remediation, lower releases of collective loan impairment allowances and reduced trading income, which in part reflected the non-recurrence of price appreciation on assets in the legacy credit portfolio. In our consumer finance portfolios, revenue

continued to decline following the reduction in lending balances, and adverse fair value movements on non-qualifying hedges increased reflecting lower long-term US interest rates. However, these effects were partly offset by a corresponding decline in loan impairment charges.

Performance in the second half of 2011 deteriorated, driven by an increase in adverse fair value movements on non-qualifying hedges as US long-term interest rates declined reflecting increased concerns regarding the pace of US economic recovery and ongoing eurozone concerns. In addition, there was a marked rise in loan impairment charges in our run-off portfolio, reflecting deterioration in delinquency rates, and higher estimated costs to obtain and realise collateral, both related to the industry-wide delays in foreclosure processing.

Our Canadian business continued to perform strongly during 2011. Profit before tax increased by 4% to US$955m driven by improved credit quality in our CMB business, while in GB&M, higher pre-tax profits were driven by a rise in revenue from Balance Sheet Management.

In 2011, we made significant progress in our strategy for our North American businesses. In the second half of 2011, we announced the sale of our Card and Retail Services business to Capital One Financial Group, which we expect to complete in the

Report of the Directors: Operating and Financial Review (continued)

first half of 2012. We also announced the sale of 195 non-strategic branches, principally in upstate New York, to First Niagara Bank, N.A. We expect this transaction to close in stages, commencing in the second quarter of 2012. These transactions remain subject to regulatory approval. In addition, we announced the disposal of our Canadian investment advisory business and sold our private equity businesses in the US and Canada as well as the cessation of life insurance manufacturing in the US, with effect from January 2012.

The results of our Card and Retail Services business can be seen on page 88. We expect the sale of this business to have a significant impact on both the revenue and profitability of our North America operations going forward.

In 2011, we incurred charges of US$236m (2010: US$13m) associated with restructuring activities in North America which included the impairment of software development costs. In addition we reduced the size of many of our support functions to correspond to the reduced scale of our operations in the region. During 2011 we achieved about US$240m of sustainable savings.

In RBWM, we remained focused on managing down the residual balances in our run-off CML portfolio. We also continued to direct efforts towards the expansion of wealth management and Premier propositions.

In our CMB and GB&M businesses, we continued to proactively target companies that trade and invest internationally. In 2011, we increased the number of CMB relationship managers in areas with strong international connectivity, including the US West Coast, Texas, Florida and central Canada. We grew revenue from the sale of GB&M products to CMB customers and, in GB&M, we continued to interconnect our operations across the Americas to deliver more integrated solutions for our customers.

Net interest income declined by 8% to US$11.5bn, primarily due to lower lending balances in HSBC Finance resulting from the continued run-off of the residual balances in the CML portfolio, as well as the sale of our vehicle finance portfolio in 2010. In Card and Retail Services, lower net interest income reflected a reduction in lending balances despite higher customer spending, as our customers continued to reduce outstanding credit card debt. It was also affected by lower yields due to the effects of the US Credit Card Accountability, Responsibility and Disclosure Act (CARD Act), which included restrictions on the repricing of delinquent accounts. These reductions were partly offset by a fall in our cost of funds.

Net interest income from Balance Sheet Management activities increased compared with 2010, largely driven by an increase in securities holdings in the US investment portfolio, and favourable positioning for interest rate movements in Canada.

Net fee income fell by 10% to US$3.3bn reflecting the closure of our Taxpayer Financial Services business and the sale of our vehicle finance loan portfolio and loan servicing platform in 2010.

In our Card and Retail Services business fee income reduced, driven by lower late and overlimit fees reflecting reduced delinquencies and fewer accounts, as well as the effect of customers actively seeking to reduce credit card debt and the CARD Act. In addition, fee expense rose as revenue-share payments to our credit card partners increased as improved portfolio performance resulted in increased cash flows. The decline in net fee income was partly offset by a reduction in fees written off reflecting lower fees billed to our customers and improved credit quality.

Net trading expense of US$362m compared with net trading income of US$319m in 2010, primarily driven by an increase in adverse fair value movements on non-qualifying hedges used to economically hedge floating rate debt issued by HSBC Finance. This was due to a decrease in long-term US interest rates, reflecting heightened concerns regarding the pace of US economic recovery and the ongoing eurozone crisis. These rates declined to a greater extent than in 2010, resulting in adverse fair value movements of US$1.1bn in 2011 compared with US$353m in 2010.

In GB&M, trading income declined by 29% as revenue in the legacy credit portfolio was adversely affected by the non-recurrence of price appreciation on assets, as well as a 2010 gain from a legal settlement of US$89m relating to certain loans previously purchased for resale from a third party which did not recur, and the exit from the Bank Notes business in 2010. This decline was partly offset by a rise in foreign exchange

and metals revenue, reflecting greater client activity and increased price volatility resulting from global economic uncertainty. Metals revenue also benefited from a rally in precious metal prices. In addition, growth in revenue from Rates was driven by an increase in new deal activity. In RBWM, charges for loan repurchase obligations relating to loans previously sold fell from US$341m to US$92m.

Report of the Directors: Operating and Financial Review (continued)

Gains less losses from financial investments increased by 82% following the sale of available-for-sale debt securities in the Balance Sheet Management portfolio. These transactions were undertaken to manage portfolio risk and duration.

Other operating income increased by 37% to US$226m due to the non-recurrence of losses on the sale of our vehicle finance loan portfolio in 2010. This was partly offset by adverse movements in the PVIF asset within the insurance business reflecting assumption updates, including an increase in expected expense rates and updates to mortality, as well as the non-recurrence of a US$56m gain on the sale of our New York headquarters in 2010.

Loan impairment charges and other credit risk provisions decreased by 16% to US$7.0bn, the lowest reported level since 2006.

Loan impairment charges in the CML portfolio fell reflecting the continued run-off, partly offset by higher costs to obtain collateral and delays in the timing of expected cash flows from our real estate secured portfolio as a result of the delays in processing foreclosures. Loan impairment charges increased in the second half of 2011 following a deterioration in delinquency and the adverse effects of the continued disruption to foreclosures.

We anticipate delinquency and write-off levels in the CML portfolio will remain under pressure in 2012 as the US economic environment continues to affect our business, as well as from foreclosure delays. The magnitude of these trends will largely be dependent on economic recovery, including unemployment rates and improvements in the housing market.

In our Card and Retail Services business, loan impairment charges and other credit risk provisions declined by 26% to US$1.6bn driven by lower lending balances and improved delinquency rates as overall credit quality improved.

Further commentary on delinquency trends in the US RBWM portfolios is provided in Areas of special interest US personal lending on page 124.

In CMB, loan impairment charges and other credit risk provisions declined by 68%, with significant reductions in both Canada and the US.

This was mainly due to lower lending balances and improved credit quality in Canada. In the US the decline was mainly in the commercial real estate and mid-market sectors, while loan impairment charges in Business Banking also declined reflecting improved credit quality and lower delinquency levels. This was partly offset by a specific loan impairment charge associated with the downgrade of a commercial real estate loan exposure.

The reduction in loan impairment charges and other credit risk provisions was partly offset by an increase in GB&M reflecting lower releases of collective loan impairment allowances than in 2010. In addition, 2011 included an individually assessed loan impairment charge associated with a corporate lending relationship.

Operating expenses increased by 7% to US$8.9bn, including an increase in litigation provisions and a new provision of US$257m related to US mortgage foreclosure servicing costs. In addition, we incurred a charge of US$48m associated with costs expected to arise from foreclosure delays involving loans serviced for GSEs. During 2011, restructuring initiatives resulted in charges of US$236m, while in 2010 operating expenses benefited from a pension curtailment gain of US$147m.

Operating expenses also increased in our GB&M business. This largely reflected higher legal and compliance costs, and an increase in staff costs which included higher amortisation charges for previous years performance shares and accelerated expense recognition of current year deferred bonus awards. The drivers of expense growth in North America were in part offset by lower costs following the sale of the vehicle finance servicing operation in 2010 and the closure of Taxpayer Financial Services, as well as lower marketing expenses in our Card and Retail Services business. Our third party collection costs were also lower, reflecting reduced delinquencies and the continued run-off of lending

balances in the CML portfolio.

We expect that costs incurred in ensuring that we satisfy requirements relating to our mortgage foreclosure process will increase our operating expenses in the future.

Report of the Directors: Operating and Financial Review (continued)

2010 compared with 2009

Economic background

The economic recession in the **US** officially ended in the middle of 2009 but, given its depth and duration, the subsequent recovery was disappointing. In 2010, GDP expanded by 2.9%. The initial stage of the recovery was helped by tax reductions and direct subsidies for home purchases, but the growth momentum faded as their impact waned. In addition, fiscal tightening by state and local governments intensified, leading to spending cutbacks and job cuts that adversely affected consumer confidence and the rate of growth of consumer spending. Unemployment fell from 10.0% in the fourth quarter of 2009 to 9.4% by the end of 2010. The annual rate of core inflation (excluding food and energy products) fell steadily during the year to 0.8% in December, the smallest rate of annual increase in the 50 year history of the series.

In the fourth quarter of 2010, the Federal Reserve launched a US$600bn programme of large scale asset purchases to ease monetary conditions. Asset prices rebounded and consumer spending picked up sharply, helping to renew economic activity.

In the year ended November 2010, **Canadian** GDP rose by 3%, compared with a decline of 1.2% in the year to November 2009, driven by housing construction, consumer spending and inventory restocking. Employment growth in the first half of 2010 was strong and the unemployment rate fell to 7.6% in December 2010 from the high of 8.7% in 2009. CPI inflation remained close to the Bank of Canada s 2% target through much of 2010 but the recovery in economic activity prompted the central bank to begin normalising the policy rate from a low of 0.25% to 1% by October.

Review of performance

In North America, a reported profit before tax of US$454m in 2010 compared with a loss of US$7.7bn in 2009. On an underlying basis, the pre-tax profit of US$246m compared with a pre-tax loss of US$4.0bn. The improved performance was largely due to a marked decline in loan impairment charges in our Card and Retail Services business and run-off portfolios, partly offset by lower revenue reflecting a reduction in lending balances, the effects of the CARD Act and adverse fair value movements on non-qualifying hedges.

Our results in 2011 will continue to be affected in general terms by the strength of the US economy and the impact of proposed regulatory changes on our

business and, specifically, by the extent to which unemployment rates improve and the recovery in the housing market is sustained.

In 2010, we continued to reposition our core businesses and we remained focused on managing down our run-off assets. In addition, we made progress with the changes required to conform with new regulatory frameworks and policies.

In our core RBWM business, we continued to grow our Premier proposition, with customer numbers increasing by 37% to over 700,000, and we expanded our branch network, opening five new branches in the states of California, Maryland and Virginia. Our Card and Retail Services business continued to be profitable, despite a decline in lending balances as customers reduced their outstanding credit card debt.

In CMB, we increased pre-tax profits by 51% to US$873m as credit quality improved and we grew our revenue through repricing. In line with our global strategy to be the leading international business bank, CMB actively targeted the growing number of companies with international banking requirements achieving a 28% increase in referral volumes to other HSBC sites, and GB&M drove cross-regional and cross-global business connectivity. GB&M and GPB also continued to appeal to internationally focused customers, attracted by the Group s presence in both emerging and developed markets.

Net interest income fell by 10% to US$12.4bn as customer lending balances declined, mainly in HSBC Finance, due to the run-off of the residual balances in our Mortgage Services, Consumer Lending and vehicle finance portfolios. We took additional steps during 2010 to accelerate this process, selling US$1.0bn in vehicle finance loans in March and the remainder of the portfolio (US$4.3bn) in August to the same purchaser. Lower balances in our Card and Retail Services business reflected a decline in active accounts, actions taken to mitigate risk and an increased focus by our customers on reducing their credit card debt.

Asset spreads in Mortgage Services and Consumer Lending widened, reflecting lower funding costs and higher yields resulting from lower levels of modified loans and delinquent balances. In our Card and Retail Services portfolio asset spreads also widened due to lower funding costs, re-pricing initiatives and contract re-negotiation with certain merchants, partly offset by the effects of the CARD Act.

Average customer deposit balances increased in RBWM and CMB as we continued to grow our customer base. In GB&M, our increased deposit base reflected a rise in repurchase transactions. Deposit spreads improved, despite falling interest rates, mainly due to repricing as competitive pressures eased.

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Lower net interest income from Balance Sheet Management reflected the sales and maturities of higher yielding assets and the reinvestment of the proceeds into lower yielding, lower risk assets.

Net fee income fell by 25% to US$3.7bn. Lower transaction volumes, a reduction in customer spending and customers actively seeking to reduce credit card debt improved delinquency trends, and the effects of changes required by the CARD Act led to lower late and overlimit fees in our Card and Retail Services business.

Net trading income of US$314m was 8% lower than in 2009, primarily because of US$353m adverse fair value movements in non-qualifying hedges due to the decrease in long-term US interest rates. This compared with US$184m in favourable fair value movements on these instruments in 2009. The majority of these instruments were interest rate swaps used to economically hedge floating rate debt issued by HSBC Finance. The debt was issued to offset the increase in the duration of the company s mortgage portfolio resulting from lower prepayment rates and the corresponding rise in interest rate risk.

In 2010, we increased our estimates of exposure on repurchase obligations associated with loans previously sold, primarily to Government-sponsored enterprises (GSE s), which reduced our trading income by US$341m compared with US$65m in 2009. This related mainly to mortgages originated through broker channels. These trading losses were partly offset by a rise in GB&M, despite lower revenue from Rates, as write-backs on legacy positions in Credit trading compared with write-downs in 2009.

Net expense from financial instruments designated at fair value of US$31m compared with net income of US$192m in 2009. This was due to adverse fair value movements from interest rate ineffectiveness in the economic hedging of our long-term debt. In 2009, fair value movements on economic hedges resulted in net income.

Gains less losses from financial investments declined by 52% due to lower gains from asset sales in the available-for-sale portfolio, undertaken to reduce the overall level of balance sheet risk.

Net earned insurance premiums and *Net insurance claims incurred and movement in liabilities to policyholders* both declined. Lower premiums reflected a fall in sales of payment protection products following the discontinuance of mortgage originations in HSBC Finance. Claims and reserves declined as the lending balances and associated in-force insurance contracts reduced.

Other operating income declined by 70% to US$167m as we recognised a loss of US$207m on the sale of our vehicle finance loan portfolio and loan servicing platform. In addition, gains in 2009 from the sale of residential mortgages and the refinement of the income recognition methodology of long-term insurance contracts did not recur. This was partly offset by a gain on the sale of our New York headquarters building in 2010.

Loan impairment charges and other credit risk provisions decreased by 47% to US$8.3bn, the lowest level since 2006. Although most significant in RBWM, the decline was across all businesses as the economy generally improved in 2010.

Loan impairment charges in Card and Retail Services declined by 57%, reflecting lower lending balances and an increased focus by our customers on reducing outstanding credit card debt. There was also an overall improvement in the credit quality of the portfolio, with lower delinquency levels and better delinquency roll rates.

Loan impairment charges in our Mortgage Services and Consumer Lending businesses fell by 29% as balances continued to run-off and delinquent balances reduced. Loss severity also improved reflecting an increase in deed-in-lieu and short sales agreements, both of which result in lower losses than foreclosed loans.

As a result of investigations into the foreclosure practices of certain mortgage service providers, there could be additional delays in the processing of foreclosures.

In GB&M, a net release of loan impairment charges and other credit risk provisions of US$184m compared with a reported net charge of US$621m in 2009. This reflected an improvement in the credit environment and a release of impairments on available-for-sale ABSs. In CMB, loan impairment charges declined as the improved economic conditions resulted in credit upgrades on certain accounts and fewer downgrades across all business lines.

Operating expenses fell by 2% to US$8.3bn, reflecting the non-recurrence of restructuring costs following the closure of the Consumer Lending branch network in 2009 and the reduced scope of our business operations in the US as we ran off the legacy portfolios in HSBC Finance. In addition, we recorded a pension curtailment gain in 2010 and deposit insurance costs declined as a 2009 special assessment did not recur. These reductions were partly offset by a rise in marketing expenses in Card and Retail Services, an increase in litigation provisions and higher regulatory and compliance costs.

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Profit/(loss) before tax and balance sheet data North America

	2011						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[64] US$m	Total US$m
Profit/(loss) before tax							
Net interest income	8,931	1,528	893	187	9	(68)	11,480
Net fee income/(expense)	1,836	551	773	149	(1)		3,308
Trading income/(expense) excluding net interest income	(946)	34	261	17	(26)		(660)
Net interest income/(expense) on trading activities	25	1	205		(1)	68	298
Net trading income/(expense)[56]	(921)	35	466	17	(27)	68	(362)
Changes in fair value of long- term debt issued and related derivatives					967		967
Net income/(expense) from other financial instruments designated at fair value			(5)		2		(3)
Net income/(expense) from financial instruments designated at fair value			(5)		969		964
Gains less losses from financial investments	58	7	195		2		262
Dividend income	15	9	13	3			40
Net earned insurance premiums	236						236
Other operating income	(125)	110	193	11	2,244	(2,207)	226
Total operating income	10,030	2,240	2,528	367	3,196	(2,207)	16,154
Net insurance claims[65]	(154)						(154)
Net operating income[52]	9,876	2,240	2,528	367	3,196	(2,207)	16,000
Loan impairment (charges)/ recoveries and other credit risk provisions	(6,929)	(105)	(11)	30	(1)		(7,016)
Net operating income	2,947	2,135	2,517	397	3,195	(2,207)	8,984
Total operating expenses	(5,615)	(1,166)	(1,642)	(307)	(2,396)	2,207	(8,919)
Operating profit/(loss)	(2,668)	969	875	90	799		65
Share of profit/(loss) in associates and joint ventures	3	33			(1)		35
Profit/(loss) before tax	(2,665)	1,002	875	90	798		100
	%	%	%	%	%		%
Share of HSBC s profit before tax	(12.2)	4.6	4.0	0.4	3.7		0.5
Cost efficiency ratio	56.9	52.1	65.0	83.7	75.0		55.7
Balance sheet data[49]							

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net) reported in:							
loans and advances to customers (net)	**86,490**	**32,215**	**19,289**	**4,753**			**142,747**
assets held for sale (disposal groups)	**31,058**	**520**					**31,578**
Total assets	**144,278**	**43,747**	**320,783**	**7,138**	**10,378**	**(22,022)**	**504,302**
Customer accounts reported in:							
customer accounts	**63,558**	**47,003**	**30,465**	**14,862**	**94**		**155,982**
liabilities of disposal groups held for sale	**10,104**	**5,040**					**15,144**

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	2010						
	Retail Banking and Wealth Management[17] US$m	Commercial Banking US$m	Global Banking and Markets[17] US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[64] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	9,912	1,525	952	190	(71)	(69)	12,439
Net fee income/(expense)	2,142	534	845	149	(6)		3,664
Trading income/(expense) excluding net interest income	(472)	17	563	13	(12)		109
Net interest income on trading activities	24	2	93		17	69	205
Net trading income/(expense)[56]	(448)	19	656	13	5	69	314
Changes in fair value of long- term debt issued and related derivatives					111		111
Net income/(expense) from other financial instruments designated at fair value	6		(2)		(4)		
Net income/(expense) from financial instruments designated at fair value	6		(2)		107		111
Gains less losses from financial investments	5	(6)	141		3		143
Dividend income	18	7	12	3	2		42
Net earned insurance premiums	245						245
Other operating income	(250)	242	71	15	2,351	(2,196)	233
Total operating income	11,630	2,321	2,675	370	2,391	(2,196)	17,191
Net insurance claims[65]	(148)				4		(144)
Net operating income[52]	11,482	2,321	2,675	370	2,395	(2,196)	17,047
Loan impairment (charges)/ recoveries and other credit risk provisions	(8,194)	(323)	184	38			(8,295)
Net operating income	3,288	1,998	2,859	408	2,395	(2,196)	8,752
Total operating expenses	(5,408)	(1,081)	(1,310)	(297)	(2,422)	2,196	(8,322)
Operating profit/(loss)	(2,120)	917	1,549	111	(27)		430
Share of profit/(loss) in associates and joint ventures	4	22			(2)		24
Profit/(loss) before tax	(2,116)	939	1,549	111	(29)		454
	%	%	%	%	%		%
Share of HSBC s profit before tax	(11.1)	5.0	8.1	0.6	(0.2)		2.4
Cost efficiency ratio	47.1	46.6	49.0	80.3	101.1		48.8

Balance sheet data[49]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	131,194	30,277	24,338	4,723			190,532
Total assets	154,204	39,213	306,298	5,824	9,373	(22,425)	492,487
Customer accounts	76,817	46,425	22,324	12,812	108		158,486

For footnotes, see page 95.

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Profit/(loss) before tax and balance sheet data North America (continued)

	2009						
	Retail Banking and Wealth Manage-ment[17]	Commercial Banking	Global Banking and Markets[17]	Global Private Banking	Other	Inter-segment elimination[64]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit/(loss) before tax							
Net interest income/(expense)	11,244	1,391	999	178	(84)	(58)	13,670
Net fee income	3,300	453	919	142	3		4,817
Trading income/(expense) excluding net interest income	257	(10)	(179)	(3)	(30)		35
Net interest income/(expense) on trading activities	60	3	175	(1)	1	58	296
Net trading income/(expense)[56]	317	(7)	(4)	(4)	(29)	58	331
Changes in fair value of long- term debt issued and related derivatives					(3,497)		(3,497)
Net income from other financial instruments designated at fair value					1		1
Net expense from financial instruments designated at fair value					(3,496)		(3,496)
Gains less losses from financial investments	16	3	277				296
Dividend income	21	5	27	2	(2)		53
Net earned insurance premiums	309						309
Other operating income	1	162	325	11	1,828	(1,761)	566
Total operating income/(expense)	15,208	2,007	2,543	329	(1,780)	(1,761)	16,546
Net insurance claims[65]	(241)						(241)
Net operating income/ (expense)[52]	14,967	2,007	2,543	329	(1,780)	(1,761)	16,305
Loan impairment charges and other credit risk provisions	(14,424)	(519)	(621)	(98)	(2)		(15,664)
Net operating income/ (expense)	543	1,488	1,922	231	(1,782)	(1,761)	641
Total operating expenses	(5,724)	(958)	(1,255)	(281)	(1,934)	1,761	(8,391)
Operating profit/(loss)	(5,181)	530	667	(50)	(3,716)		(7,750)
Share of profit/(loss) in associates and joint ventures		13			(1)		12
Profit/(loss) before tax	(5,181)	543	667	(50)	(3,717)		(7,738)
	%	%	%	%	%		%
Share of HSBC s profit before tax	(73.1)	7.7	9.4	(0.7)	(52.6)		(109.3)
Cost efficiency ratio	38.2	47.7	49.4	85.4	(108.7)		51.5

Balance sheet data[49]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	151,671	31,292	18,654	5,236			206,853
Total assets	179,079	38,232	260,649	6,572	2,071	(11,589)	475,014
Customer accounts	74,228	42,900	19,095	12,834	100		149,157

For footnotes, see page 95.

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North America RBWM profit/(loss) before tax and balance sheet data

	2011				2010			
	Card and Retail Services US$m	Run-off portfolios US$m	Rest of RBWM US$m	North America RBWM US$m	Card and Retail Services US$m	Run-off portfolios US$m	Rest of RBWM US$m	North America RBWM US$m
Profit/(loss) before tax								
Net interest income	**4,128**	**2,990**	**1,813**	**8,931**	4,727	3,404	1,781	9,912
Net fee income/(expense)	**1,273**	**(49)**	**612**	**1,836**	1,333	55	754	2,142
Trading income/(expense) excluding net interest income		**(1,145)**	**199**	**(946)**		(377)	(95)	(472)
Net interest income on trading activities			**25**	**25**			24	24
Net trading income/(expense)[56]		**(1,145)**	**224**	**(921)**		(377)	(71)	(448)
Changes in fair value of long- term debt issued and related derivatives								
Net income from other financial instruments designated at fair value							6	6
Net income from financial instruments designated at fair value							6	6
Gains less losses from financial investments		**55**	**3**	**58**		5		5
Dividend income		**5**	**10**	**15**	3	3	12	18
Net earned insurance premiums		**230**	**6**	**236**		236	9	245
Other operating income	**61**	**(185)**	**(1)**	**(125)**	52	(253)	(49)	(250)
Total operating income	**5,462**	**1,901**	**2,667**	**10,030**	6,115	3,073	2,442	11,630
Net insurance claims[65]		**(156)**	**2**	**(154)**		(152)	4	(148)
Net operating income[52]	**5,462**	**1,745**	**2,669**	**9,876**	6,115	2,921	2,446	11,482
Loan impairment charges and other credit risk provisions	**(1,600)**	**(4,982)**	**(347)**	**(6,929)**	(2,174)	(5,811)	(209)	(8,194)
Net operating income/(expense)	**3,862**	**(3,237)**	**2,322**	**2,947**	3,941	(2,890)	2,237	3,288
Total operating expenses	**(1,801)**	**(1,238)**	**(2,576)**	**(5,615)**	(1,962)	(1,190)	(2,256)	(5,408)
Operating profit/(loss)	**2,061**	**(4,475)**	**(254)**	**(2,668)**	1,979	(4,080)	(19)	(2,120)
Share of profit in associates and joint ventures		**3**		**3**		4		4
Profit/(loss) before tax	**2,061**	**(4,472)**	**(254)**	**(2,665)**	1,979	(4,076)	(19)	(2,116)
	%	**%**	**%**	**%**	%	%	%	%
Share of HSBC s profit before tax	**9.4**	**(20.4)**	**(1.2)**	**(12.2)**	10.4	(21.4)	(0.1)	(11.1)
Cost efficiency ratio	**33.0**	**70.9**	**96.5**	**56.9**	32.1	40.7	92.2	47.1
Balance sheet data[49]								
	US$m	**US$m**	**US$m**	**US$m**	US$m	US$m	US$m	US$m
Loans and advances to customers (net) reported in:								
loans and advances to customers		**43,543**	**42,947**	**86,490**	30,710	55,010	45,474	131,194

assets held for sale (disposal groups)	**29,137**		**1,921**	**31,058**				
Total assets	**30,635**	**56,830**	**56,813**	**144,278**	32,044	70,587	51,573	154,204
Customer accounts reported in:								
customer accounts			**63,558**	**63,558**			76,817	76,817
liabilities of disposal groups held for sale			**10,104**	**10,104**				

For footnotes, see page 95.

Latin America

Our operations in Latin America principally comprise HSBC Bank Brasil S.A.-Banco Múltiplo, HSBC México, S.A., HSBC Bank Argentina S.A. and HSBC Bank (Panama) S.A. In addition to banking services, we operate insurance businesses in Brazil, Mexico, Argentina and Panama.

	2011 US$m	2010 US$m	2009 US$m
Net interest income	**6,956**	6,311	5,573
Net fee income	**1,781**	1,749	1,729
Net trading income	**1,378**	733	848
Other income	**1,338**	938	874
Net operating income[52]	**11,453**	9,731	9,024
Impairment charges[53]	**(1,883)**	(1,544)	(2,526)
Net operating income	**9,570**	8,187	6,498
Total operating expenses	**(7,255)**	(6,394)	(5,375)
Operating profit	**2,315**	1,793	1,123
Income from associates[54]		2	1
Profit before tax	**2,315**	1,795	1,124
Cost efficiency ratio	**63.3%**	65.7%	59.6%
RoRWA[55]	**2.3%**	2.0%	1.4%
Year-end staff numbers	**54,035**	56,044	54,288

Underlying pre-tax profit driven by

strong revenue growth

and operating expense discipline

14%

growth in CMB lending balances

Strong increase

in sales of GB&M products

to CMB customers

For footnotes, see page 95.

The commentary on Latin America is on an underlying basis unless stated otherwise.

Economic background

In **Brazil**, economic growth in 2011 slowed more quickly than expected, and is anticipated to have ended the year with the economy growing at an annual rate of 3%. While the fallout from the crisis in the eurozone contributed to the slowdown, it was mostly attributable to an easing in domestic demand following a tightening in monetary conditions in response to rising inflation. By the end of 2011 inflation had fallen to 6.5% after peaking at around 7.5% in June. This allowed the government to reverse much of the policy tightening implemented in early 2011.

Mexico s economy maintained a robust rate of growth in 2011, although export growth moderated at the end of the year on the back of lower external demand. By contrast, domestic demand continued to strengthen, reflecting the greater availability of credit, growth in wages and a steady reduction in unemployment. GDP grew at an annual rate of 3.9% in 2011. The annual rate of CPI inflation rose at the end of 2011 to 3.8% due to a rebound in some agricultural prices and exchange rate depreciation. The Central Bank of Mexico maintained its policy interest rate at 4.5% throughout the year.

In **Argentina**, during the first three quarters of 2011, real GDP increased by 9.4% compared with the same period in 2010, mainly from increases in consumption of 11.3% and in gross fixed investment of 19.9%. The annual rate of CPI inflation remained high and the GDP deflator measure of inflation accelerated to 16.4% in the third quarter of 2011.

Review of performance

In Latin America, our operations reported a profit before tax of US$2.3bn in 2011, an increase of 29% compared with 2010. On an underlying basis, which excludes a gain of US$83m from the sale of HSBC Afore (the Mexican pension administration business), profit before tax increased by 21%. This was driven by strong growth in lending balances in our CMB and RBWM businesses in Brazil, which reflected the favourable economic environment. Improved revenue in GB&M arose from higher income from foreign exchange driven by greater volatility and an increase in client activity, while growth in insurance revenue followed an increase in our sales force. This was partly offset by cost growth driven by restructuring initiatives, inflationary pressures and business growth, while a rise in loan impairment charges and other credit risk provisions reflected the strong rise in lending, particularly in Brazil.

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Profit/(loss) before tax by country within global businesses

	Retail Banking and Wealth Management[17] US$m	Commercial Banking US$m	Global Banking and Markets[17] US$m	Global Private Banking US$m	Other US$m	Total US$m
2011						
Argentina	**91**	**107**	**148**		**(2)**	**344**
Brazil	**241**	**566**	**515**	**13**	**(105)**	**1,230**
Mexico	**403**	**129**	**268**	**4**	**(178)**	**626**
Panama	**23**	**59**	**52**	**3**	**(9)**	**128**
Other	**(55)**	**6**	**66**		**(30)**	**(13)**
	703	**867**	**1,049**	**20**	**(324)**	**2,315**
2010						
Argentina	89	90	105			284
Brazil	151	382	430	6	64	1,033
Mexico	174	24	210	4	(11)	401
Panama	48	57	33	2		140
Other	(100)	1	51	(2)	(13)	(63)
	362	554	829	10	40	1,795
2009						
Argentina	25	86	121			232
Brazil	(202)	211	493	5	3	510
Mexico	(24)	66	223	7		272
Panama	69	55	24			148
Other	(54)	(19)	40	(1)	(4)	(38)
	(186)	399	901	11	(1)	1,124

For footnote, see page 95.

During 2011, we made progress in the execution of our regional strategy while also improving the efficiency of our operations. We recruited additional relationship managers in our CMB businesses in Brazil to support business growth, particularly from Business Banking and mid-market customers and the increasing number of businesses with international requirements. We increased our focus on sales and customer service with the addition of relationship managers in RBWM in Brazil, and opened 14 new branches in Argentina to capture opportunities arising from demographic changes and upward social mobility.

In order to improve the risk profile of our RBWM business we continued to reposition our lending portfolio towards higher credit-quality customers, notably by building long-term relationships with customers. In Brazil, we increased our focus on secured lending and wealth management products.

In GB&M, our pre-tax profits increased to over US$1.0bn in 2011 as we continued to utilise the connectivity of the HSBC network to serve the growing number of global corporate businesses in Latin America. During 2011, our GB&M sales force actively targeted our CMB customer

base and achieved strong growth in revenue compared with

2010, most notably from the sale of GB&M foreign exchange products.

To enhance efficiency, we restructured our regional and country support functions, and in Mexico we consolidated the branch network, reducing it by 43 in the last quarter of 2010 and 77 in 2011. In the second half of 2011 we completed the sale of HSBC Afore and our retail banking operations in Chile. As a consequence, we reduced staff numbers by more than 1,900 in 2011.

In January 2012, we entered into an agreement to sell our operations in Costa Rica, Honduras and El Salvador. We expect to complete this transaction during 2012, subject to regulatory approval.

Net interest income rose by 7% to US$7.0bn, driven by growth in average lending balances in both 2010 and in 2011. This was mainly in CMB and RBWM, reflecting favourable economic conditions and growing consumer demand, partly offset by a rise in internal funding costs on higher balances of reverse repos and government bonds held for trading. In CMB, we grew our average customer lending balances, particularly in Brazil, reflecting the favourable economic conditions, the increase in our customer base and our investment in relationship managers. The rise was mainly in working capital products following marketing campaigns and new

product launches, while higher overdraft balances arose from increased utilisation rates. We also grew our trade-related lending in response to strong customer demand and our focus on sales to customers with international connectivity. In RBWM, increased average lending balances and strong lending growth in 2011 led to higher net interest income, mainly in Brazil and Argentina, reflecting economic growth, lower unemployment and increased household income. This was partly offset by a compression of asset spreads in Mexico and Brazil as an increased proportion of our lending book comprised secured, lower-yielding products.

Net fee income declined marginally, driven by a reduction in Mexico where regulatory changes relating to ATM transactions resulted in a reduction in the fees we were able to charge for use of our network. Credit card fees in Mexico declined as a result of lower balances. This was partly offset by growth in fee income from our CMB business in Brazil, mainly in Payments and Cash Management and Account Services, reflecting increased volumes.

Net trading income was 82% higher than in 2010. The majority of the increase was in Brazil due to a rise in net interest income earned on trading activities resulting from an increase in reverse repos and government bonds held for trading. The cost of internally funding these assets also increased, but the related interest expense is reported within Net interest income . Additionally, trading income in Brazil increased as a result of higher revenue from sales of foreign exchange products reflecting market volatility, while in Mexico higher trading income was due to the completion of a small number of individually large derivative transactions in GB&M.

Net income from financial instruments designated at fair value was 26% higher than in 2010, mainly due to growth in premiums from unit-linked pension products in Brazil which resulted in an increase in the underlying financial assets. Since investment income accruing from these assets was largely attributable to policyholders, there was a corresponding increase in *Net insurance claims incurred and movement in liabilities to policyholders* .

Gains less losses from financial investments rose by 36%, mainly due to a gain on the sale of shares in a Mexican listed company and increased gains from the sale of debt securities in Argentina.

Net insurance premiums increased by 26% to US$2.7bn. This was mainly in Brazil, reflecting strong growth in sales of unit linked pension and life and credit protection products, following an increase in the sales force and targeted sales campaigns. In

Argentina, strong growth in net insurance premiums was mainly attributable to volume growth and the repricing of motor insurance policies in response to inflationary pressures. In Mexico, a rise in net insurance premiums was principally due to higher sales of an endowment product and improved term life lapse rates. The growth in net insurance premiums, as well as the increase in policyholder assets described above, resulted in corresponding increases in Net insurance claims incurred and movement in liabilities to policyholders .

Other operating income of US$244m was 74% higher than in 2010 due to gains of US$61m resulting from the sale and leaseback of branches in Mexico. In addition, there was a net increase in the PVIF in Brazil and Mexico as a result of higher life insurance sales, partly offset by a net decrease from experience and assumption updates in addition to a higher unwind of cash flows from the growing in-force book.

Loan impairment charges and other credit risk provisions rose by 17% to US$1.9bn. The increase was mainly in Brazil driven by strong lending growth in RBWM and CMB, as well as worsening delinquency in the second half of 2011, notably in the credit card and Business Banking portfolios. In addition, higher loan impairment charges included a significant individually assessed loan impairment charge related to a single commercial customer.

Loan impairment charges and other credit risk provisions in Mexico declined by 28% reflecting the continued managed decline of the higher risk sections of the credit card portfolio, as well as improvements to both the collections and credit quality of the portfolio following targeted sales campaigns and enhanced pre-screening.

Operating expenses were 10% higher than in 2010. In 2011, we incurred US$338m of restructuring costs, the majority of which are reported in Other , as we took steps to improve the ongoing efficiency of our operations in the region, including cancelling certain regional projects, restructuring regional and country support functions and consolidating the branch network in Mexico.

In addition, operating expenses were adversely affected by inflationary pressures across the region, as well as union agreed wage increases and a rise in volume-driven transactional taxes in Brazil and Argentina. Sustainable savings of about US$220m resulting from the restructuring and organisational effectiveness programmes enabled investment in strategic initiatives, including the recruitment of additional relationship managers.

Report of the Directors: Operating and Financial Review (continued)

2010 compared with 2009

Economic background

The **Brazilian** economy expanded at its fastest rate in three decades in 2010, with GDP growing 7.5% on an annual basis in the third quarter. Consumer demand played a major role supported by a rapid expansion of credit, which rose by 20.5% in 2010, and robust labour market conditions, as the unemployment rate fell to an all-time low of 5.3% in December. The growth of domestic demand led to a rapid rise in import growth and a widening of Brazil s current account deficit and contributed, along with a rise in food prices during the year, to an increase in CPI inflation to 5.9% in December compared with 4.3% at the end of 2009. The Central Bank tightened monetary policy by 2 percentage points between April and July 2010 and raised commercial banks reserve requirements and capital adequacy ratios on certain consumer loans in December.

Mexico s economy continued to recover in 2010, and GDP rose by 5.5% in the year. Strong external demand was the main driver of the recovery, leading to robust growth in the production of Mexican manufactured goods. By contrast, domestic demand was lacklustre, reflecting high unemployment, restricted credit availability and low levels of consumer confidence. This weak domestic demand and the rise in the peso kept inflation subdued during 2010 and the Central Bank of Mexico maintained its policy rate at 4.5% throughout the year.

In **Argentina**, third quarter GDP was 7.5% higher than for the comparable period in 2009. This improvement was led by a strong rebound in industrial production, which expanded by 12.7% in the year to November 2010. The manufacture of motor vehicles recovered particularly strongly, rising by 35% during the year, with many being exported to Brazil. Inflation remained high, in part due to rapid growth in the price of food and beverages.

Review of performance

Our operations in Latin America reported pre-tax profits of US$1.8bn compared with US$1.1bn in 2009, largely reflecting the strong performance in Brazil, which recorded pre-tax profits in excess of US$1bn for the first time. On an underlying basis, pre-tax profits increased by 49% as loan impairment charges declined, reflecting better economic conditions and actions taken to improve asset quality by managing down riskier portfolios and enhancing risk management processes. Revenue was marginally lower as trading income declined from the strong

performance recorded in 2009 and fee income fell due to reduced transaction volumes, although this was largely offset by increased income from Balance Sheet Management.

In RBWM, spreads tightened in Mexico as lending was refocused from higher-yielding consumer loans to higher quality assets. The managing down of certain portfolios in Brazil and Mexico and the strengthening of underwriting and collections processes resulted in an overall increase in pre-tax profit in RBWM. Across the region we continued to focus on new customer acquisition in the mass affluent market segment through our Premier and Advance propositions. The number of Premier customers increased to over 790,000 at 31 December 2010. Advance was launched in Brazil, Mexico, Argentina, Panama and Chile in 2010 and customer numbers exceeded 425,000 at the end of the year. The insurance business continued to perform strongly, with revenue growing in Brazil, Mexico and Argentina due to the improving economic conditions.

The regional economic recovery and our focus on growing the CMB business drove increased domestic lending in our major markets. GB&M and CMB both benefited from our global connectivity by increasing intra-regional and inter-regional business, with GB&M in particular contributing to other regions and global businesses through increased cross-referrals. Our operations in Brazil and mainland China worked closely together on a number of initiatives, including the completion of the first renminbi-denominated trade settlement in the region. Dedicated sales desks were established in mainland China and Hong Kong to support our Latin America customers and promote trade with Brazil.

Net interest income increased by 4% to US$6.3bn. Increased volumes of financial investments, a decline in the cost of funding trading positions as market interest rates fell and a change in the portfolio mix to higher-yielding longer-term assets drove a rise in revenue from Balance Sheet Management.

Average customer lending balances fell in RBWM, as certain portfolios were managed down, notably in credit cards in Mexico and other higher-risk personal loan balances in Mexico and Brazil. However, year-end balances were higher than in 2009 as we reversed the decline in customer lending by selectively growing certain portfolios. Demand-driven lending increased in CMB and GB&M in Brazil and Argentina while, in Mexico, increased average lending balances in CMB were attributable to the continued strategy of targeting state and municipal customers.

Report of the Directors: Operating and Financial Review (continued)

Our operations in Brazil actively grew customer account balances to fund loan growth and meet higher liquidity requirements following regulatory changes. In Mexico and Argentina, sales and marketing initiatives supported by product and channel enhancements resulted in an increase in current and savings account balances. However, the benefit was partly offset by tighter spreads on customer accounts as a result of decreased market interest rates in Mexico and Argentina.

Fee income fell by 7% to US$1.7bn, driven by lower transaction volumes in credit cards and account services in Mexico and reduced account services income in Brazil. Regulatory restrictions in Brazil and Mexico also reduced the fees that could be charged for certain banking services.

Net trading income of US$733m was 23% lower than in 2009. A decline in market volatility which resulted in fewer trading opportunities meant that the strong performances in Foreign Exchange and Rates in 2009 were not repeated.

Net income on financial instruments designated at fair value declined by 21% to US$425m, primarily due to lower investment returns experienced on assets held in support of the pension-linked portfolio in Brazil and annuity products in Argentina. An offsetting decrease was recorded in Net insurance claims incurred and movement in liabilities to policyholders .

Gains less losses from financial investments declined by US$93m, largely because the gains on the sale of Visa Inc. shares in 2009 did not recur.

Net earned insurance premiums increased marginally to US$2.1bn, driven by improved economic conditions which resulted in higher sales of policies in Brazil and Argentina through the branch network and a rise in premiums in Mexico. This, combined with repricing initiatives in Argentina and higher contributions in the pension-linked product in Brazil from RBWM and CMB customers, resulted in increased premiums.

Net insurance claims incurred and movement in liabilities to policyholders of US$1.8bn declined by 9%, mainly in pension-linked products in Brazil as lower investment gains were allocated to policyholders. This was partly offset by an increase related to higher premiums in Argentina and Mexico.

Loan impairment charges and other credit risk provisions declined by 44% in 2010 to US$1.5bn. In RBWM, the reduction in loan impairment charges reflected a significant decline in the size of the credit card portfolio in Mexico and an improvement in its quality as a result of repositioning the portfolio towards higher quality customers, tighter origination criteria and improved collection practices. Loan impairment charges also declined in Brazil, primarily in consumer finance portfolios including motor vehicle finance and payroll loans, as economic conditions improved and these portfolios were managed down. In CMB, loan impairment charges fell, largely in Brazil, as improved economic conditions and better credit quality resulted in lower specific impairment charges, while in Mexico loan impairment charges remained broadly unchanged.

Operating expenses increased by 10% to US$6.4bn, driven largely by inflationary pressures and investment in infrastructure and technology projects across the region in support of improved operational efficiency and business growth. Staff costs increased in Brazil and Argentina due to union-agreed wage increases, although this was partly offset by a decline in average headcount as costs continued to be managed carefully. Non-staff expenditure also rose, driven mainly by higher marketing and advertising costs in Brazil as we positioned ourselves in this key growth market, and transactional taxes increased as sales grew.

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Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax and balance sheet data Latin America

	2011						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[64] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	4,519	2,229	882	25	(7)	(692)	6,956
Net fee income	939	610	196	36			1,781
Trading income/(expense) excluding net interest income	68	106	372	5	(7)		544
Net interest income on trading activities			134		8	692	834
Net trading income[56]	68	106	506	5	1	692	1,378
Net income from financial instruments designated at fair value	424	124	2				550
Gains less losses from financial investments	11	1	124	1			137
Dividend income	10	3	1				14
Net earned insurance premiums	2,068	551	34				2,653
Other operating income	265	57	32	2	222	(250)	328
Total operating income	8,304	3,681	1,777	69	216	(250)	13,797
Net insurance claims[65]	(1,850)	(478)	(16)				(2,344)
Net operating income[52]	6,454	3,203	1,761	69	216	(250)	11,453
Loan impairment charges and other credit risk provisions	(1,369)	(501)	(12)		(1)		(1,883)
Net operating income	5,085	2,702	1,749	69	215	(250)	9,570
Total operating expenses	(4,382)	(1,835)	(700)	(49)	(539)	250	(7,255)
Operating profit/(loss)	703	867	1,049	20	(324)		2,315
Share of profit in associates and joint ventures							
Profit/(loss) before tax	703	867	1,049	20	(324)		2,315
	%	%	%	%	%		%
Share of HSBC s profit before tax	3.2	4.0	4.8	0.1	(1.5)		10.6
Cost efficiency ratio	67.9	57.3	39.8	71.0	249.5		63.3
Balance sheet data[49]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	19,025	25,834	11,011	62	6		55,938
Total assets	39,231	38,410	66,241	1,660	417	(1,070)	144,889
Customer accounts	28,629	24,050	18,940	7,079	62		78,760

Report of the Directors: Operating and Financial Review (continued)

	2010						
	Retail Banking and Wealth Manage-ment[17]	Commercial Banking	Global Banking and Markets[17]	Global Private Banking	Other	Inter-segment elimination[64]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit before tax							
Net interest income	3,979	1,671	772	20	121	(252)	6,311
Net fee income/(expense)	1,006	526	191	32	(6)		1,749
Trading income/(expense) excluding net interest income	35	72	370	3	(27)		453
Net interest income on trading activities			28			252	280
Net trading income/(expense)[56]	35	72	398	3	(27)	252	733
Net income from financial instruments designated at fair value	339	85	1				425
Gains less losses from financial investments	6	2	93		(3)		98
Dividend income	7	2	3				12
Net earned insurance premiums	1,651	374	29				2,054
Other operating income	98	34	15	2	221	(229)	141
Total operating income	7,121	2,766	1,502	57	306	(229)	11,523
Net insurance claims[65]	(1,479)	(297)	(16)				(1,792)
Net operating income[52]	5,642	2,469	1,486	57	306	(229)	9,731
Loan impairment charges and other credit risk provisions	(1,247)	(293)	(4)				(1,544)
Net operating income	4,395	2,176	1,482	57	306	(229)	8,187
Total operating expenses	(4,034)	(1,623)	(653)	(47)	(266)	229	(6,394)
Operating profit	361	553	829	10	40		1,793
Share of profit in associates and joint ventures	1	1					2
Profit before tax	362	554	829	10	40		1,795
	%	%	%	%	%		%
Share of HSBC s profit before tax	1.9	2.9	4.3	0.1	0.2		9.4
Cost efficiency ratio	71.5	65.7	43.9	82.5	86.9		65.7
Balance sheet data[49]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	20,823	24,879	12,242	43			57,987
Total assets	38,819	35,619	64,635	1,608	196	(939)	139,938
Customer accounts	30,149	24,514	27,810	6,053			88,526

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Report of the Directors: Operating and Financial Review (continued)

Profit/(loss) before tax and balance sheet data Latin America (continued)

	2009						
	Retail Banking and Wealth Manage- ment[17]	Commercial Banking	Global Banking and Markets[17]	Global Private Banking	Other	Inter- segment elimination[64]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit/(loss) before tax							
Net interest income/(expense)	3,736	1,544	590	19	(5)	(311)	5,573
Net fee income	1,011	490	188	28	12		1,729
Trading income excluding net interest income	25	38	573	3			639
Net interest income/(expense) on trading activities	4	2	(108)			311	209
Net trading income[56]	29	40	465	3		311	848
Changes in fair value of long- term debt issued and related derivatives							
Net income/(expense) from other financial instruments designated at fair value	510	12	(38)		11		495
Net income/(expense) from financial instruments designated at fair value	510	12	(38)		11		495
Gains less losses from financial investments	90		78				168
Dividend income	8	1	2				11
Net earned insurance premiums	1,752	105	43				1,900
Other operating income/(expense)	175	35	19	2	(1)	(97)	133
Total operating income	7,311	2,227	1,347	52	17	(97)	10,857
Net insurance claims[65]	(1,750)	(58)	(25)				(1,833)
Net operating income[52]	5,561	2,169	1,322	52	17	(97)	9,024
Loan impairment (charges)/recoveries and other credit risk provisions	(2,046)	(534)	57		(3)		(2,526)
Net operating income	3,515	1,635	1,379	52	14	(97)	6,498
Total operating expenses	(3,702)	(1,236)	(478)	(41)	(15)	97	(5,375)
Operating profit/(loss)	(187)	399	901	11	(1)		1,123
Share of profit in associates and joint ventures	1						1

Profit/(loss) before tax	(186)	399	901	11	(1)		1,124
	%	%	%	%	%		%
Share of HSBC s profit before tax	(2.6)	5.6	12.7	0.2			15.9
Cost efficiency ratio	66.6	57.0	36.2	78.8	88.2		59.6

Balance sheet data[49]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	19,748	18,205	9,645	31			47,629
Total assets	35,281	23,212	57,446	328	281	(581)	115,967
Customer accounts	30,628	19,775	20,142	2,344			72,889

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Reconciliation of reported and underlying profit/(loss) before tax

Europe

2011 compared with 2010[17]

	2010 as reported US$m	2010 adjust-ments[10] US$m	Currency translation[11] US$m	2010 at 2011 exchange rates[12] US$m	2011 as reported US$m	2011 adjust-ments[10] US$m	2011 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	11,250	48	365	11,663	11,001		11,001	(2)	(6)
Net fee income	6,371	(55)	176	6,492	6,236		6,236	(2)	(4)
Changes in fair value[14]	(198)	198			2,947	(2,947)		1588	
Other income[15]	5,327	(499)	188	5,016	4,062		4,062	(24)	(19)
Net operating income[16]	22,750	(308)	729	23,171	24,246	(2,947)	21,299	7	(8)
Loan impairment charges and other credit risk provisions	(3,020)		(112)	(3,132)	(2,512)		(2,512)	17	20
Net operating income	19,730	(308)	617	20,039	21,734	(2,947)	18,787	10	(6)
Operating expenses	(15,445)	220	(436)	(15,661)	(17,069)		(17,069)	(11)	(9)
Operating profit	4,285	(88)	181	4,378	4,665	(2,947)	1,718	9	(61)
Income from associates	17		(14)	3	6		6	(65)	100
Profit before tax	4,302	(88)	167	4,381	4,671	(2,947)	1,724	9	(61)

2010 compared with 2009[17]

	2009 as reported US$m	2009 adjust-ments[10] US$m	Currency translation[11] US$m	2009 at 2010 exchange rates[18] US$m	2010 as reported US$m	2010 adjust-ments[10] US$m	2010 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	12,268	(1)	(189)	12,078	11,250		11,250	(8)	(7)
Net fee income	6,267	(210)	(125)	5,932	6,371		6,371	2	7
Changes in fair value[14]	(2,841)	2,841			(198)	198		93	
Other income[15]	7,850	(283)	(104)	7,463	5,327	(362)	4,965	(32)	(33)

Net operating income[16]	23,544	2,347	(418)	25,473	22,750	(164)	22,586	(3)	(11)
Loan impairment charges and other credit risk provisions	(5,568)		48	(5,520)	(3,020)		(3,020)	46	45
Net operating income	17,976	2,347	(370)	19,953	19,730	(164)	19,566	10	(2)
Operating expenses	(13,988)	200	220	(13,568)	(15,445)		(15,445)	(10)	(14)
Operating profit	3,988	2,547	(150)	6,385	4,285	(164)	4,121	7	(35)
Income from associates	21	(1)	(2)	18	17		17	(19)	(6)
Profit before tax	4,009	2,546	(152)	6,403	4,302	(164)	4,138	7	(35)

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Hong Kong

2011 compared with 2010[17]

	2010 as reported US$m	2010 adjust-ments[10] US$m	Currency translation[11] US$m	2010 at 2011 exchange rates[12] US$m	2011 as reported US$m	2011 adjust-ments[10] US$m	2011 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	4,246		(1)	4,245	4,691		4,691	10	11
Net fee income	2,962		(3)	2,959	3,097		3,097	5	5
Changes in fair value[14]	(6)	6						100	
Other income[15]	3,000	(136)	(7)	2,857	2,894		2,894	(4)	1
Net operating income[16]	10,202	(130)	(11)	10,061	10,682		10,682	5	6
Loan impairment charges and other credit risk provisions	(114)			(114)	(156)		(156)	(37)	(37)
Net operating income	10,088	(130)	(11)	9,947	10,526		10,526	4	6
Operating expenses	(4,431)		2	(4,429)	(4,758)		(4,758)	(7)	(7)
Operating profit	5,657	(130)	(9)	5,518	5,768		5,768	2	5
Income from associates	35		(1)	34	55		55	57	62
Profit before tax	5,692	(130)	(10)	5,552	5,823		5,823	2	5

2010 compared with 2009[17]

	2009 as reported US$m	2009 adjust-ments[10] US$m	Currency translation[11] US$m	2009 at 2010 exchange rates[18] US$m	2010 as reported US$m	2010 adjust-ments[10] US$m	2010 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	4,195		(7)	4,188	4,246		4,246	1	1
Net fee income	2,669		(4)	2,665	2,962		2,962	11	11
Changes in fair value[14]	(1)	1			(6)	6		(500)	
Other income[15]	2,604		(6)	2,598	3,000	(136)	2,864	15	10
Net operating income[16]	9,467	1	(17)	9,451	10,202	(130)	10,072	8	7
Loan impairment charges and other credit risk provisions	(500)		1	(499)	(114)		(114)	77	77
Net operating income	8,967	1	(16)	8,952	10,088	(130)	9,958	13	11
Operating expenses	(3,946)		6	(3,940)	(4,431)		(4,431)	(12)	(12)

Operating profit	5,021	1	(10)	5,012	5,657	(130)	5,527	13	10
Income from associates	8			8	35		35	338	338
Profit before tax	5,029	1	(10)	5,020	5,692	(130)	5,562	13	11

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Rest of Asia-Pacific

2011 compared with 2010[17]

	2010 as reported US$m	2010 adjust-ments[10] US$m	Currency translation[11] US$m	2010 at 2011 exchange rates[12] US$m	2011 as reported US$m	2011 adjust-ments[10] US$m	2011 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	3,828		165	3,993	5,102		5,102	33	28
Net fee income	1,932		99	2,031	2,111		2,111	9	4
Changes in fair value[14]	(1)	1			2	(2)			
Other income[15]	3,473	(188)	92	3,377	3,498	(181)	3,317	1	(2)
Net operating income[16]	9,232	(187)	356	9,401	10,713	(183)	10,530	16	12
Loan impairment charges and other credit risk provisions	(439)		(24)	(463)	(267)		(267)	39	42
Net operating income	8,793	(187)	332	8,938	10,446	(183)	10,263	19	15
Operating expenses	(5,143)		(213)	(5,356)	(5,806)		(5,806)	(13)	(8)
Operating profit	3,650	(187)	119	3,582	4,640	(183)	4,457	27	24
Income from associates	2,252		108	2,360	2,831	48	2,879	26	22
Profit before tax	5,902	(187)	227	5,942	7,471	(135)	7,336	27	23

2010 compared with 2009[17]

	2009 as reported US$m	2009 adjust-ments[10] US$m	Currency translation[11] US$m	2009 at 2010 exchange rates[18] US$m	2010 as reported US$m	2010 adjust-ments[10] US$m	2010 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	3,539		240	3,779	3,828	(31)	3,797	8	
Net fee income	1,557		109	1,666	1,932	(3)	1,929	24	16
Changes in fair value[14]	(3)	3			(1)	1		67	
Other income[15]	2,910		208	3,118	3,473	(197)	3,276	19	5
Net operating income[16]	8,003	3	557	8,563	9,232	(230)	9,002	15	5
Loan impairment charges and other credit risk provisions	(896)		(74)	(970)	(439)		(439)	51	55
Net operating income	7,107	3	483	7,593	8,793	(230)	8,563	24	13
Operating expenses	(4,450)		(291)	(4,741)	(5,143)	19	(5,124)	(16)	(8)

Operating profit	2,657	3	192	2,852	3,650	(211)	3,439	37	21
Income from associates	1,543		13	1,556	2,252		2,252	46	45
Profit before tax	4,200	3	205	4,408	5,902	(211)	5,691	41	29

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Middle East and North Africa

2011 compared with 2010[17]

	2010 as reported US$m	2010 adjust-ments[10] US$m	Currency translation[11] US$m	2010 at 2011 exchange rates[12] US$m	2011 as reported US$m	2011 adjust-ments[10] US$m	2011 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	**1,367**		**(12)**	**1,355**	**1,432**		**1,432**	**5**	**6**
Net fee income	**677**		**(4)**	**673**	**627**		**627**	**(7)**	**(7)**
Changes in fair value[14]					**14**	**(14)**			
Other income[15]	**366**	**42**	**(3)**	**405**	**534**	**(27)**	**507**	**46**	**25**
Net operating income[16]	**2,410**	**42**	**(19)**	**2,433**	**2,607**	**(41)**	**2,566**	**8**	**5**
Loan impairment charges and other credit risk provisions	**(627)**		**2**	**(625)**	**(293)**		**(293)**	**53**	**53**
Net operating income	**1,783**	**42**	**(17)**	**1,808**	**2,314**	**(41)**	**2,273**	**30**	**26**
Operating expenses	**(1,078)**		**8**	**(1,070)**	**(1,159)**		**(1,159)**	**(8)**	**(8)**
Operating profit	**705**	**42**	**(9)**	**738**	**1,155**	**(41)**	**1,114**	**64**	**51**
Income from associates	**187**		**(1)**	**186**	**337**		**337**	**80**	**81**
Profit before tax	**892**	**42**	**(10)**	**924**	**1,492**	**(41)**	**1,451**	**67**	**57**

2010 compared with 2009[17]

	2009 as reported US$m	2009 adjust-ments[10] US$m	Currency translation[11] US$m	2009 at 2010 exchange rates[18] US$m	2010 as reported US$m	2010 adjust-ments[10] US$m	2010 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	1,485		(4)	1,481	1,367		1,367	(8)	(8)
Net fee income	625		(1)	624	677		677	8	8
Changes in fair value[14]									
Other income[15]	484		(1)	483	366	42	408	(24)	(16)
Net operating income[16]	2,594		(6)	2,588	2,410	42	2,452	(7)	(5)
Loan impairment charges and other credit risk provisions	(1,334)		1	(1,333)	(627)		(627)	53	53
Net operating income	1,260		(5)	1,255	1,783	42	1,825	42	45
Operating expenses	(1,001)		3	(998)	(1,078)		(1,078)	(8)	(8)

Operating profit	259	(2)	257	705	42	747	172	191
Income from associates	196		196	187		187	(5)	(5)
Profit before tax	455	(2)	453	892	42	934	96	106

For footnotes, see page 95.

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North America

2011 compared with 2010[17]

	2010 as reported US$m	2010 adjust-ments[10] US$m	Currency translation[11] US$m	2010 at 2011 exchange rates[12] US$m	2011 as reported US$m	2011 adjust-ments[10] US$m	2011 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	**12,439**		**64**	**12,503**	**11,480**		**11,480**	**(8)**	**(8)**
Net fee income	**3,664**		**27**	**3,691**	**3,308**		**3,308**	**(10)**	**(10)**
Changes in fair value[14]	**142**	**(142)**			**970**	**(970)**			
Other income[15]	**802**	**(66)**	**4**	**740**	**242**		**242**	**(70)**	**(67)**
Net operating income[16]	**17,047**	**(208)**	**95**	**16,934**	**16,000**	**(970)**	**15,030**	**(6)**	**(11)**
Loan impairment charges and other credit risk provisions	**(8,295)**		**(11)**	**(8,306)**	**(7,016)**		**(7,016)**	**15**	**16**
Net operating income	**8,752**	**(208)**	**84**	**8,628**	**8,984**	**(970)**	**8,014**	**3**	**(7)**
Operating expenses	**(8,322)**		**(46)**	**(8,368)**	**(8,919)**		**(8,919)**	**(7)**	**(7)**
Operating profit/(loss)	**430**	**(208)**	**38**	**260**	**65**	**(970)**	**(905)**		
Income from associates	**24**		**1**	**25**	**35**		**35**	**46**	**40**
Profit/(loss) before tax	**454**	**(208)**	**39**	**285**	**100**	**(970)**	**(870)**		

2010 compared with 2009[17]

	2009 as reported US$m	2009 adjust-ments[10] US$m	Currency translation[11] US$m	2009 at 2010 exchange rates[18] US$m	2010 as reported US$m	2010 adjust-ments[10] US$m	2010 under-lying US$m	Re-ported change[13] %	Under-lying change[13] %
Net interest income	13,670		134	13,804	12,439		12,439	(9)	(10)
Net fee income	4,817		56	4,873	3,664		3,664	(24)	(25)
Changes in fair value[14]	(3,688)	3,688			142	(142)			
Other income[15]	1,506		12	1,518	802	(66)	736	(47)	(52)
Net operating income[16]	16,305	3,688	202	20,195	17,047	(208)	16,839	5	(17)
Loan impairment charges and other credit risk provisions	(15,664)		(53)	(15,717)	(8,295)		(8,295)	47	47
Net operating income	641	3,688	149	4,478	8,752	(208)	8,544	1,265	91

Operating expenses	(8,391)		(103)	(8,494)	(8,322)		(8,322)	1	2
Operating profit/(loss)	(7,750)	3,688	46	(4,016)	430	(208)	222		
Income from associates	12			12	24		24	100	100
Profit/(loss) before tax	(7,738)	3,688	46	(4,004)	454	(208)	246		

For footnotes, see page 95.

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Latin America

2011 compared with 2010[17]

	2010 as reported US$m	2010 adjustments[10] US$m	Currency translation[11] US$m	2010 at 2011 exchange rates[12] US$m	2011 as reported US$m	2011 adjustments[10] US$m	2011 underlying US$m	Reported change[13] %	Underlying change[13] %
Net interest income	**6,311**		**200**	**6,511**	**6,956**		**6,956**	**10**	**7**
Net fee income	**1,749**		**54**	**1,803**	**1,781**		**1,781**	**2**	**(1)**
Other income[15]	**1,671**		**40**	**1,711**	**2,716**	**(83)**	**2,633**	**63**	**54**
Net operating income[16]	**9,731**		**294**	**10,025**	**11,453**	**(83)**	**11,370**	**18**	**13**
Loan impairment charges and other credit risk provisions	**(1,544)**		**(61)**	**(1,605)**	**(1,883)**		**(1,883)**	**(22)**	**(17)**
Net operating income	**8,187**		**233**	**8,420**	**9,570**	**(83)**	**9,487**	**17**	**13**
Operating expenses	**(6,394)**		**(187)**	**(6,581)**	**(7,255)**		**(7,255)**	**(13)**	**(10)**
Operating profit	**1,793**		**46**	**1,839**	**2,315**	**(83)**	**2,232**	**29**	**21**
Income from associates	**2**			**2**				**(100)**	**(100)**
Profit before tax	**1,795**		**46**	**1,841**	**2,315**	**(83)**	**2,232**	**29**	**21**

2010 compared with 2009[17]

	2009 as reported US$m	2009 adjustments[10] US$m	Currency translation[11] US$m	2009 at 2010 exchange rates[18] US$m	2010 as reported US$m	2010 adjustments[10] US$m	2010 underlying US$m	Reported change[13] %	Underlying change[13] %
Net interest income	5,573		468	6,041	6,311		6,311	13	4
Net fee income	1,729		147	1,876	1,749		1,749	1	(7)
Other income[15]	1,722		169	1,891	1,671		1,671	(3)	(12)
Net operating income[16]	9,024		784	9,808	9,731		9,731	8	(1)
Loan impairment charges and other credit risk provisions	(2,526)		(253)	(2,779)	(1,544)		(1,544)	39	44
Net operating income	6,498		531	7,029	8,187		8,187	26	16
Operating expenses	(5,375)		(453)	(5,828)	(6,394)		(6,394)	(19)	(10)
Operating profit	1,123		78	1,201	1,793		1,793	60	49
Income from associates	1			1	2		2	100	100

Profit before tax	1,124		78	1,202	1,795		1,795	60	49

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Report of the Directors: Operating and Financial Review (continued)

Disclosure controls

The Group Chief Executive and Group Finance Director, with the assistance of other members of management, carried out an evaluation of the effectiveness of the design and operation of HSBC Holdings disclosure controls and procedures as at 31 December 2011. Based upon that evaluation, the Group Chief Executive and Group Finance Director concluded that our disclosure controls and procedures as at 31 December 2011 were effective to provide reasonable assurance that information required to be disclosed in the reports which the company files and submits under the US Securities Exchange Act of 1934, as amended, is recorded, processed, summarised and reported as and when required. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives.

There has been no change in HSBC Holdings internal controls over financial reporting during the year ended 31 December 2011 that has materially affected, or is reasonably likely to materially affect, HSBC Holdings internal controls over financial reporting.

Management s assessment of internal controls over financial reporting

Management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and has completed an assessment of the effectiveness of the Group s internal controls over financial reporting as of 31 December 2011. In making the assessment, management used the framework for Director s internal control evaluation contained within the UK Corporate Governance Code (The Revised Turnbull Guidance), as well as the criteria established by the Committee of Sponsoring Organisations of the Treadway Commission (COSO) in Internal Control-Integrated Framework .

Based on the assessment performed, management concluded that as at 31 December 2011, the Group s internal controls over financial reporting were effective.

KPMG Audit Plc, which has audited the consolidated financial statements of the Group for the year ended 31 December 2011, has also audited the effectiveness of the Group s internal control over financial reporting under Auditing Standard No. 5 of the Public Company Accounting Oversight Board (United States) as stated in their report on pages 276 and 277.

Report of the Directors: Operating and Financial Review (continued)

Other information

Funds under management and assets held in custody

Funds under management

	2011 US$bn	2010 US$bn
Funds under management		
At 1 January	**925**	857
Net new money	**2**	42
Value change	**(40)**	33
Exchange and other	**(40)**	(7)
At 31 December	**847**	925

	At 31 December	
	2011 US$bn	2010 US$bn
Funds under management by business		
Global Asset Management	**396**	439
Global Private Banking	**259**	277
Affiliates	**3**	3
Other	**189**	206
	847	925

Funds under management (FuM) at 31 December 2011 amounted to US$847bn, a decrease of 8% when compared with 2010. Both Global Asset Management and GPB fund holdings decreased, reflecting adverse equity market and foreign exchange movements.

Global Asset Management funds, including emerging market funds, decreased by 10% to US$396bn as a result of client withdrawals from lower yielding liquidity funds mainly in Europe and North America and adverse global equity markets performance and foreign exchange movements, partly offset by inflows in long-term funds, particularly in Europe.

GPB funds decreased by 7% compared with 31 December 2010 to US$259bn as net new money inflows which benefited from cross-business referrals and the focus on faster-growing market business were more than offset by adverse movements in financial markets and foreign exchange. Client assets, which include FuM and cash deposits and provide an indicator of overall GPB volumes, decreased by US$12bn to US$377bn due to the reduction in FuM.

Other FuM, decreased by 8% to US$189bn primarily due to the disposal of the real estate and infrastructure fund management activity during the year.

Assets held in custody and under administration

Custody is the safekeeping and servicing of securities and other financial assets on behalf of clients. At 31 December 2011, we held assets as custodian of US$5.2 trillion, 7% lower than the US$5.7 trillion held at 31 December 2010. This was mainly driven by a decrease in the market value of assets and adverse foreign exchange movements.

Our assets under administration business, which includes the provision of various support function activities including the valuation of portfolios of securities and other financial assets on behalf of clients, complements the custody business. At 31 December 2011, the value of assets held under administration by the Group amounted to US$2.6 trillion, compared with US$2.7 trillion in 2010.

Property

At 31 December 2011, we operated from some 9,500 operational properties worldwide, of which approximately 2,270 were located in Europe, 2,940 in Hong Kong and Rest of Asia-Pacific, 840 in North America, 3,210 in Latin America and 250 in the Middle East and North Africa. These properties had an area of approximately 65.7m square feet (2010: 71.3m square feet).

Our freehold and long leasehold properties, together with all our leasehold land in Hong Kong, were valued in 2011. The value of these properties was US$8.9bn (2010: US$7.1bn) in excess of their carrying amount in the consolidated balance sheet. In addition, properties with a net book value of US$1.3bn were held for investment purposes.

Our operational properties are stated at cost, being historical cost or fair value at the date of transition to IFRSs (their deemed cost) less any impairment losses, and are depreciated on a basis calculated to write off the assets over their estimated useful lives. Properties owned as a consequence of an acquisition are recognised initially at fair value.

Further details are included in Note 25 on the Financial Statements.

Legal proceedings and regulatory matters

Details are included in Note 44 on the Financial Statements.

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Report of the Directors: Operating and Financial Review (continued)

Accounting for deferred bonus arrangements

Recent regulatory and best practice guidance has clarified the required structure and terms of deferred bonus arrangements awarded to employees, who now have a better understanding of the likely nature of awards to be granted in respect of a particular

financial year. As a result, the vesting period in respect of deferred awards expected to be granted in March 2012 is therefore determined to have started on 1 January 2011. An additional expense of US$163m in respect of these deferred awards was recognised in Operating expenses during 2011.

Footnotes to pages 2 to 93

Financial highlights

1 *Dividends recorded in the financial statements are dividends per ordinary share declared in a year and are not dividends in respect of, or for, that year. The third interim dividend for 2010 of US$0.08 was paid on 12 January 2011. The fourth interim dividend for 2010 of US$0.12 was paid on 5 May 2011. First, second and third interim dividends for 2011, each of US$0.09 per ordinary share, were paid on 6 July 2011, 6 October 2011 and 18 January 2012, respectively. Note 11 on the Financial Statements provides more information on the dividends declared in 2011. On 27 February 2012 the Directors declared a fourth interim dividend for 2011 of US$0.14 per ordinary share in lieu of a final dividend, which will be payable to ordinary shareholders on 2 May 2012 in cash in US dollars, or in pounds sterling or Hong Kong dollars at exchange rates to be determined on 23 April 2012, with a scrip dividend alternative. The reserves available for distribution at 31 December 2011 were US$34,621m.*
Quarterly dividends of US$15.50 per 6.2% non-cumulative Series A US dollar preference share, equivalent to a dividend of US$0.3875 per Series A ADS, each of which represents one-fortieth of a Series A US dollar preference share, were paid on 15 March 2011, 15 June 2011, 15 September 2011 and 15 December 2011.
Quarterly coupons of US$0.508 per security were paid with respect to 8.125% capital securities on 18 January 2011, 15 April 2011, 15 July 2011 and 15 October 2011.
Quarterly coupons of US$0.50 per security were paid with respect to 8% capital securities on 15 March, 15 June, 15 September and 15 December 2011.

2 *Return on average invested capital is based on the profit attributable to ordinary shareholders. Average invested capital is measured as average total shareholders equity after adding back goodwill previously amortised or written-off directly to reserves, deducting average equity preference shares issued by HSBC Holdings and deducting/(adding) average reserves for unrealised gains/(losses) on effective cash flow hedges and available-for-sale securities and property revaluation reserves. This measure reflects capital initially invested and subsequent profit.*

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

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

5 *Each American Depositary Share represents five ordinary shares.*

6 *Total shareholder return is defined as the growth in share value and declared dividend income during the relevant period.*

7 *The Financial Times Stock Exchange 100 Index, the Morgan Stanley Capital International World Index and the Morgan Stanley Capital International World Bank Index.*

8 *The core tier 1 capital ratio in 2011 includes the effect of the Basel 2.5 rules.*

9 *HBEU is HSBC Bank plc; HBAP is The Hongkong and Shanghai Banking Corporation; and HBUS is HSBC Bank USA. Figures provided for HSBC Bank plc and The Hongkong and Shanghai Banking Corporation incorporate the major overseas branches of these entities. Subsidiaries of these entities are not included unless there is unrestricted transferability of liquidity between the subsidiaries and the parent. Other entities comprise our other main banking subsidiaries and, as such, includes businesses spread across a range of locations, in many of which we may require a higher ratio of net liquid assets to customer liabilities to reflect local market conditions.*

Reconciliations of reported and underlying profit/(loss) before tax

10 *These columns comprise the net increments or decrements in profits in the current year compared with the previous year which are attributable to acquisitions or disposals gains on the dilution of interests in associates and/or movements in fair value of own debt attributable to credit spread. The inclusion of acquisitions and disposals is determined in the light of events each year.*
11 *Currency translation is the effect of translating the results of subsidiaries and associates for the previous year at the average rates of exchange applicable in the current year.*
12 *Excluding adjustments in 2010.*
13 *Positive numbers are favourable: negative numbers are unfavourable.*
14 *Changes in fair value due to movements in own credit spread on long-term debt issued. This does not include the fair value changes due to own credit spread on structured notes issued and other hybrid instruments included within trading liabilities.*
15 *Other income in this context comprises net trading income, net income/(expense) from other financial instruments designated at fair value, gains less losses from financial investments, dividend income, net earned insurance premiums and other operating income less net insurance claims incurred and movement in liabilities to policyholders.*
16 *Net operating income before loan impairment charges and other credit risk provisions.*
17 *With effect from 1 March 2011, our Global Asset Management business was moved from GB&M to RBWM. Comparative data have been adjusted accordingly.*
18 *Excluding adjustments in 2009.*

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Report of the Directors: Operating and Financial Review (continued)

Financial summary

19 *This footnote is intentionally left blank.*
20 *The effect of the bonus element of the rights issue in 2009 has been included within the basic and diluted earnings per share.*
21 *Dividends per ordinary share expressed as a percentage of basic earnings per share.*
22 *Net interest income includes the cost of funding trading assets, while the related external revenues are reported in Trading income . In our global business results, the cost of funding trading assets is included with GB&M s net trading income as interest expense.*
23 *Gross interest yield is the average annualised interest rate earned on average interest-earning assets (AIEA).*
24 *Net interest spread is the difference between the average annualised interest rate earned on AIEA, net of amortised premiums and loan fees, and the average annualised interest rate paid on average interest-bearing funds.*
25 *Net interest margin is net interest income expressed as an annualised percentage of AIEA.*
26 *In 2011, other interest-earning assets includes the average assets of disposal groups held for sale. In prior years other interest-earning assets included intercompany eliminations. In 2011, intercompany eliminations have been included in the relevant line item.*
27 *Interest income on trading assets is reported as Net trading income in the consolidated income statement.*
28 *Interest income on financial assets designated at fair value is reported as Net income from financial instruments designated at fair value in the consolidated income statement.*
29 *This includes interest-bearing bank deposits only.*
30 *Interest expense on financial liabilities designated at fair value is reported as Net income on financial instruments designated at fair value in the consolidated income statement, other than interest on own debt which is reported in Interest expense .*
31 *This includes interest-bearing customer accounts only.*
32 *The cost of internal funding of trading assets was US$1,161m (2010: US$902m; 2009: US$1,309m) and is excluded from the reported Net trading income line and included in Net interest income . However, this cost is reinstated in Net trading income in our global business reporting.*
33 *Net trading income includes income of US$458m (2010: income of US$23m; 2009: expense of US$444m), associated with changes in the fair value of issued structured notes and other hybrid instrument liabilities derived from movements in HSBC issuance spreads.*
34 *Other changes in fair value include gains and losses arising from changes in the fair value of derivatives that are managed in conjunction with HSBC s long-term debt issued.*
35 *Discretionary participation features.*
36 *Net insurance claims incurred and movement in liabilities to policyholders arise from both life and non-life insurance business. For non-life business, amounts reported represent the cost of claims paid during the year and the estimated cost of notified claims. For life business, the main element of claims is the liability to policyholders created on the initial underwriting of the policy and any subsequent movement in the liability that arises, primarily from the attribution of investment performance to savings-related policies. Consequently, claims rise in line with increases in sales of savings-related business and with investment market growth.*

Consolidated balance sheet

37 *Net of impairment allowances.*
38 *The calculation of capital resources, capital ratios and risk-weighted assets for 2008 to 2010 is on a Basel II basis. 2011 includes the effect of rule changes under Basel 2.5.*
39 *2007 comparatives are on a Basel I basis.*
40 *Capital resources are total regulatory capital, the calculation of which is set out on page 214.*
41 *Includes perpetual preferred securities, details of which can be found in Note 34 on the Financial Statements.*
42 *The definition of net asset value per share is total shareholders equity, less non-cumulative preference shares and capital securities, divided by the number of ordinary shares in issue.*
43 *Currency translation is the effect of translating the assets and liabilities of subsidiaries and associates for the previous year-end at the rates of exchange applicable at the current year-end*
44 *France primarily comprises the domestic operations of HSBC France, HSBC Assurances Vie and the Paris branch of HSBC Bank plc.*

Economic profit

45 *Expressed as a percentage of average invested capital.*

46 *Average invested capital is measured as average total shareholders equity after:*

adding back the average balance of goodwill amortised pre-transition to IFRSs or subsequently written-off, directly to reserves (less goodwill previously amortised in respect of the French regional banks sold in 2008);

deducting the average balance of HSBC s revaluation surplus relating to property held for own use. This reserve was generated when determining the deemed carrying cost of such properties on transition to IFRSs and will run down over time as the properties are sold;

deducting average preference shares and other equity instruments issued by HSBC Holdings; and

deducting average reserves for unrealised gains/(losses) on effective cash flow hedges and available-for-sale securities.

47 *Return on invested capital is profit attributable to ordinary shareholders of the parent company, which can be found in Note 12 on the Financial Statements on page 335.*

Global businesses and geographical regions

48 *The main items reported under Other are certain property activities, unallocated investment activities, centrally held investment companies, gains arising from the dilution of interests in associates and joint ventures, movements in the fair value of own debt designated at fair value (the remainder of the Group s gain on own debt is included in GB&M) and HSBC s holding company and financing operations. The results also include net interest earned on free capital held centrally, operating costs incurred by the head office operations in providing stewardship and central management services to HSBC, and costs incurred by the Group Service Centres and Shared Service Organisations and associated recoveries. At 31 December 2011, there was a US$208m gain arising from the dilution of interests in associates and joint ventures (2010: US$188m gain; 2009: nil) and favourable fair value movements on HSBC s own debt designated at fair value were US$3.9bn (2010: US$0.1bn adverse; 2009: US$6.5bn adverse).*

Report of the Directors: Operating and Financial Review (continued)

49 *Assets by geographical region and global businesses include intra-HSBC items. These items are eliminated, where appropriate, under the heading Intra-HSBC items or inter-segment elimination , as appropriate.*

50 *RWAs from associates have been reallocated in order to properly align with the classification of income. RWAs from Global Asset Management have been reallocated to RBWM, principally from GB&M. Both items represent a reclassification from the basis used in HSBC s 2010 Pillar 3 disclosures. Comparative data have been adjusted accordingly.*

51 *The movement includes the impact of the rule changes under Basel 2.5.*

52 *Net operating income before loan impairment charges and other credit risk provisions.*

53 *Loan impairment charges and other credit risk provisions.*

54 *Share of profit in associates and joint ventures.*

55 *Pre-tax return on average risk-weighted assets. The 2009 RoRWA is based on the 2009 period end risk-weighted assets.*

56 *In the analysis of global businesses, net trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities classified as held for trading, together with related external and internal interest income and interest expense, and dividends received; in the statutory presentation internal interest income and expense are eliminated.*

57 *In 2011, Global Markets included a favourable fair value movement of US$458m on the widening of credit spreads on structured liabilities (2010: favourable fair value movement of US$23m; 2009: adverse fair value movement of US$444m).*

58 *Total income earned on payments and cash management products in the Group amounted to US$5.6bn (2010: US$4.4bn; 2009: US$4.1bn), of which US$4.0bn was in CMB (2010: US$3.3bn; 2009: US$3.1bn) and US$1.5bn was in GB&M (2010: US$1.1bn; 2009: US$1.1bn).*

59 *Total income earned on other transaction services in the Group amounted to US$3.2bn (2010: US$2.7bn; 2009: US$2.2bn), of which US$2.6bn was in CMB relating to trade and receivables finance (2010: US$2.1bn; 2009: US$1.7bn) and US$634m was in GB&M of which US$601m related to trade and receivables finance (2010: US$523m; 2009: US$382m) and US$33m related to banknotes and other (2010: US$113m; 2009: US$125m).*

60 *In each Group entity, Balance Sheet Management is responsible for managing liquidity and funding under the supervision of the local Asset and Liability Management Committee (ALCO). Balance Sheet Management also manages the structural interest rate position of the entity within a Global Markets limit structure.*

61 *Other in GB&M includes net interest earned on free capital held in the global business not assigned to products.*

62 *The foreign exchange effect is not eliminated on an underlying basis as the reporting currency of the principal business within GPB is US dollars.*

63 *Client assets are translated at the rates of exchange applicable for their respective period-ends, with the effects of currency translation reported separately. The main components of client assets are funds under management, which are not reported on the group s balance sheet, and customer deposits, which are reported on the group s balance sheet.*

64 *Inter-segment elimination comprises (i) the costs of shared services and Group Service Centres included within Other which are recovered from global businesses, and (ii) the intra-segment funding costs of trading activities undertaken within GB&M. HSBC s Balance Sheet Management business, reported within GB&M, provides funding to the trading businesses. To report GB&M s Net trading income on a fully funded basis, Net interest income and Net interest income/(expense) on trading activities are grossed up to reflect internal funding transactions prior to their elimination in the inter-segment column.*

65 *Net insurance claims incurred and movement in liabilities to policyholders.*

66 *Employee expenses comprises costs directly incurred by each global business. The reallocation and recharging of employee and other expenses directly incurred in the Other category is shown in Other operating expenses .*

67 *RWAs are non-additive across geographical regions due to market risk diversification effects within the Group.*

68 *Hong Kong Government certificates of indebtedness were reclassified from RBWM to Other at 1 January 2010.*

69 *US includes the impairment of goodwill in respect of RBWM North America.*

Report of the Directors: Operating and Financial Review (continued)

Average balance sheet

70 *Interest income on trading assets is reported as Net trading income in the consolidated income statement.*
71 *Interest income on financial assets designated at fair value is reported as Net income from financial instruments designated at fair value in the consolidated income statement.*
72 *Brazilian operations comprise HSBC Bank Brasil S.A.-Banco Múltiplo and subsidiaries, plus HSBC Serviços e Participações Limitada.*
73 *This includes interest-bearing bank deposits only. See page 36(d) for an analysis of all bank deposits.*
74 *Interest expense on financial liabilities designated at fair value is reported as Net income on financial instruments designated at fair value in the consolidated income statement, other than interest on own debt which is reported in Interest Expense .*
75 *This includes interest-bearing customer accounts only. See page 36(e) for an analysis of all customer accounts.*
76 *Net interest margin is calculated as net interest income divided by average interest earning assets.*
77 *For the purpose of calculating the ratios, earnings consist of income from continuing operations before taxation and non-controlling interests, plus fixed charges, and after deduction of the unremitted pre-tax income of associated undertakings. Fixed charges consist of total interest expense, including or excluding interest on deposits, as appropriate, dividends on preference shares and other equity instruments, as applicable, and the proportion of rental expense deemed representative of the interest factor.*
78 *Trading assets and financial investments held by GB&M in North America include financial assets which may be repledged or resold by counterparties.*
79 *Derivative assets and derivative liabilities of GB&M include derivative transactions between different regions of GB&M.*

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Legal proceedings and regulatory matters

HSBC is party to legal proceedings, investigations and regulatory matters in a number of jurisdictions arising out of its normal business operations. Apart from the matters described below, HSBC considers that none of these matters is material, either individually or in the aggregate. HSBC recognises a provision for a liability in relation to these matters when it is probable that an outflow of economic benefits will be required to settle an obligation which has arisen as a result of past events, and for which a reliable estimate can be made of the amount of the obligation. While the outcome of these matters is inherently uncertain, management believes that, based on the information available to it, appropriate provisions have been made in respect of legal proceedings and regulatory matters as at 31 December 2011 (see Note 33).

Securities litigation

As a result of an August 2002 restatement of previously reported consolidated financial statements and other corporate events, including the 2002 settlement with 46 State Attorneys General relating to real estate lending practices, Household International (now HSBC Finance) and certain former officers were named as defendants in a class action law suit, Jaffe v Household International Inc, et al No 2. C 5893 (N.D.Ill, filed 19 August 2002). The complaint asserted claims under the US Securities Exchange Act of 1934, on behalf of all persons who acquired and disposed of Household International common stock between 30 July 1999 and 11 October 2002. The claims alleged that the defendants knowingly or recklessly made false and misleading statements of material fact relating to Household s Consumer Lending operations, including collections, sales and lending practices, some of which ultimately led to the 2002 State settlement agreement, and facts relating to accounting practices evidenced by the restatement. Following a jury trial concluded in April 2009, which was decided partly in favour of the plaintiffs, the Court issued a ruling on 22 November 2010 within the second phase of the case to determine actual damages, that claim forms should be mailed to class members, and also set out a method for calculating damages for class members who filed claims. As previously reported, lead plaintiffs, in court filings in March 2010, estimated that damages could range somewhere between US$2.4bn to US$3.2bn to class members , before pre-judgement interest.

On 22 December 2011, plaintiffs submitted the report of the Court-appointed claims administrator to the Court. That report stated that the total number of claims that generated an allowed loss was 45,921, and that the aggregate amount of these claims was approximately US$2.23bn. Now that the claims administration process is complete, plaintiffs are expected to ask the Court to assess pre-judgement interest to be included as part of the Court s final judgement. On 27 January 2012, the Court held a status conference at which it set a schedule for us to provide plaintiffs with objections to the claims and for plaintiffs to respond to such objections. The Court also indicated at that conference that it expects to schedule a further conference in April 2012. We expect the Court s final judgement to be entered at some point after this conference.

Despite the jury verdict and the 22 November 2010 ruling, HSBC continues to believe that it has meritorious grounds for appeal of one or more of the rulings in the case, and intends to appeal the Court s final judgement, which could involve a substantial amount once it is entered. Upon appeal, HSBC Finance will be required to provide security for the judgement in order to suspend its execution while the appeal is ongoing by either depositing cash in an interest-bearing escrow account or posting an appeal bond in the amount of the judgement (including any pre-judgement interest awarded).

Given the complexity and uncertainties associated with the actual determination of damages, including the outcome of any appeals, there is a wide range of possible damages. HSBC believes it has meritorious grounds for appeal on matters of both liability and damages and will argue on appeal that damages should be nil or a relatively insignificant amount. If the Appeals Court rejects or only partially accepts HSBC s arguments, the amount of damages, including pre judgement interest, could be higher, and may lie in a range from a relatively insignificant amount to somewhere in the region of US$3.5bn.

Bernard L. Madoff Investment Securities LLC

In December 2008, Bernard L. Madoff (Madoff) was arrested for running a Ponzi scheme and a trustee was appointed for the liquidation of his firm, Bernard L. Madoff Investment Securities LLC (Madoff Securities), an SEC-registered broker-dealer and investment adviser. Since his appointment, the trustee has been recovering assets and processing claims of Madoff Securities customers. Madoff subsequently pleaded guilty to various charges and is serving a 150 year prison sentence. He has acknowledged, in essence, that while purporting to invest his customers money in

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securities and, upon request, return their profits and principal, he in fact never invested in securities and used other customers money to fulfil requests for the return of profits and principal. The relevant US authorities are continuing their investigations into his fraud, and have brought charges against others, including certain former employees and the former auditor of Madoff Securities.

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

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

In July 2010, the US District Court Judge overseeing a putative class action in the Southern District of Florida dismissed all claims against the HSBC defendants for lack of personal jurisdiction and on forum non conveniens grounds. In August 2011, the US Court of Appeals for the Eleventh Circuit affirmed the dismissal.

In November 2011, the US District Court Judge overseeing three related putative class actions in the Southern District of New York dismissed all claims against the HSBC defendants on forum non conveniens grounds, but temporarily stayed this ruling as to one of the actions against the HSBC defendants the claims of investors in Thema International Fund plc in light of a proposed amended settlement agreement pursuant to which, subject to various conditions, the HSBC defendants had agreed to pay from US$52.5m up to a maximum of US$62.5m. In December 2011, the court lifted this temporary stay and dismissed all remaining claims against the HSBC defendants, and declined to consider preliminary approval of the settlement. In

light of the court s decisions, HSBC has terminated the settlement agreement. The Thema plaintiff contests HSBC s right to terminate. Plaintiffs in all three actions have filed notices of appeal to the US Court of Appeals for the Second Circuit.

In December 2010, the Madoff Securities trustee commenced suits against various HSBC companies in the US Bankruptcy Court and in the English High Court. The US action (which also names certain funds, investment managers, and other entities and individuals) sought US$9bn in damages and additional recoveries from HSBC and the various co-defendants. It sought damages against HSBC for allegedly aiding and abetting Madoff s fraud and breach of fiduciary duty. In July 2011, after withdrawing the case from the Bankruptcy Court in order to decide certain threshold issues, the US District Court Judge dismissed the trustee s various common law claims on the grounds that the trustee lacks standing to assert them. In December 2011, the District Court issued an order that allowed the trustee to immediately appeal that ruling and the trustee has filed a notice of appeal.

The District Court returned the remaining claims to the US Bankruptcy Court for further proceedings. Those claims seek, pursuant to US bankruptcy law, recovery of unspecified amounts received by HSBC from funds invested with Madoff, including amounts that HSBC received when it redeemed units HSBC held in the various funds. HSBC acquired those fund units in connection with financing transactions HSBC had entered into with various clients. The trustee s US bankruptcy law claims also seek recovery of fees earned by HSBC for providing custodial, administration and similar services to the funds. In September 2011, certain non-HSBC defendants moved again to withdraw the case from the Bankruptcy Court. Those withdrawal motions are currently pending before the District Court.

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

Between October 2009 and July 2011, Fairfield Sentry Limited and Fairfield Sigma Limited (Fairfield), funds whose assets were directly or indirectly invested with Madoff Securities, commenced multiple suits in the British Virgin Islands (BVI) and the US against numerous fund shareholders, including various HSBC companies that acted as nominees for clients of HSBC s private banking business and other clients who invested in

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the Fairfield funds. The Fairfield actions seek restitution of amounts paid to the defendants in connection with share redemptions, on the ground that such payments were made by mistake, based on inflated values resulting from Madoff s fraud, and some actions also seek recovery of the share redemptions under BVI insolvency law. The actions in the US are currently stayed in the Bankruptcy Court while plaintiffs pursue an appeal of a decision that reversed the Bankruptcy Court s denial of defendants motions to remand or abstain and pending developments in related appellate litigation in the BVI.

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

US mortgage-related investigations

In April 2011, HSBC Bank USA entered into a consent cease and desist order with the Office of the Comptroller of the Currency and HSBC Finance and HNAH entered into a similar consent order with the Federal Reserve Board following completion of a broad horizontal review of industry residential mortgage foreclosure practices. These consent orders require prescribed actions to address the deficiencies noted in the joint examination and described in the consent orders. HSBC Bank USA, HSBC Finance and HNAH continue to work with the Office of the Comptroller of the Currency and the Federal Reserve Board to align their processes with the requirements of the consent orders and are implementing operational changes as required.

These consent orders require an independent review of foreclosures pending or completed between January 2009 and December 2010 (the Foreclosure Review Period) to determine if any customer was financially injured as a result of an error in the foreclosure process. Customer outreach efforts are required, including mailings to customers and industry media advertising, to notify borrowers with foreclosures pending or completed during the Foreclosure Review Period of the foreclosure complaint review process and their ability to request

a review of their foreclosure proceeding. The costs associated with the foreclosure review include the costs of conducting the customer outreach plan and complaint process, and the cost of any resulting remediation.

These consent orders do not preclude additional enforcement actions against HSBC Bank USA, HSBC Finance or HNAH by bank regulatory, governmental or law enforcement agencies, such as the US Department of Justice (DoJ) or 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 consent orders. The Federal Reserve Board has indicated in a press release relating to the financial services industry in general that it believes monetary penalties are appropriate for the enforcement actions and that it plans to announce such penalties. An increase in private litigation concerning these practices is also possible.

It has been announced that the five largest US mortgage servicers (not including HSBC) have reached a settlement with the DoJ, the US Department of Housing and Urban Development and State Attorneys General of 49 states with respect to foreclosure and other mortgage servicing practices. HNAH, HSBC Bank USA and HSBC Finance have had preliminary discussions with 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, HSBC recognised provisions of US$257m in the fourth quarter of 2011 to reflect the estimated liability associated with a proposed settlement of this matter. Any such settlement, however, may not completely preclude other enforcement actions by state or federal agencies, regulators or law enforcement bodies related to foreclosure and other mortgage servicing practices, including, but not limited to matters relating to the securitisation 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.

Participants in the US mortgage securitisation 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 US mortgage market, such as servicers,

originators, underwriters, trustees or sponsors of securitisations, and at particular participants within these groups. As the industry s residential mortgage foreclosure issues continue, HSBC Bank USA has taken title to an

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increasing number of foreclosed homes as trustee on behalf of various securitisation 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 HSBC believes and continues to maintain that the obligations at issue and the related liability are properly those of the servicer of each trust, HSBC continues 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 HSBC Securities (USA) Inc. 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 securitisation trusts contained material misstatements and omissions, including statements regarding the underwriting standards governing the underlying mortgage loans. These include an action filed in September 2011 by the Federal Housing Finance Agency. This action is one of a series of similar actions filed against 17 financial institutions alleging violations of federal securities laws and state statutory and common law in connection with the sale of private-label RMBS purchased by Fannie Mae and Freddie Mac, primarily from 2005 to 2008.

HSBC Bank USA has received subpoenas from the Securities and Exchange Commission (SEC) seeking production of documents and information relating to its involvement and the involvement of its affiliates in specified private-label RMBS transactions as an issuer, sponsor, underwriter, depositor, trustee, custodian or servicer. HSBC Bank USA has also had preliminary contacts with other government authorities exploring the role of trustees in private label RMBS transactions. HSBC Bank USA also received a subpoena from the US Attorney s Office, Southern District of New York seeking production of documents and information relating to loss mitigation efforts with respect to residential mortgages in the State of New York and a Civil Investigative Demand from 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.

HSBC expects this level of focus will continue and, potentially, intensify, so long as the US real estate markets continue to be distressed. As a result, HSBC Group companies may be subject to additional litigation and governmental and

regulatory scrutiny related to its participation in the US mortgage securitisation market, either individually or as a member of a group. HSBC is unable to estimate reliably 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.

Other US regulatory and law enforcement investigations

In October 2010, HSBC Bank USA entered into a consent cease and desist order with the Office of the Comptroller of the Currency and the indirect parent of that company, HNAH, entered into a consent cease and desist order with the Federal Reserve Board. These actions require improvements for an effective compliance risk management programme across the Group s US businesses, including US Bank Secrecy Act (BSA) and Anti Money Laundering (AML) compliance. Steps continue to be taken to address the requirements of these Orders to ensure compliance, and that effective policies and procedures are maintained.

The AML/BSA consent cease and desist orders do not preclude additional enforcement actions against HSBC Bank USA or HNAH by 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 cease and desist orders. HSBC continues to cooperate in ongoing investigations by the DoJ, the Federal Reserve and the Office of the Comptroller of the Currency in connection with AML/BSA compliance including cross-border transactions involving its remittance and its former bulk cash businesses.

HSBC continues to cooperate in ongoing investigations by the DoJ, the New York County District Attorney s Office, the Office of Foreign Asset Control (OFAC), the Federal Reserve and the Office of the Comptroller of the Currency regarding historical transactions involving Iranian parties and other parties subject to OFAC economic sanctions.

In April 2011, HSBC Bank USA received a summons from the US Internal Revenue Service directing HSBC Bank USA to produce records with respect to US-based clients of an HSBC Group company in India. While the summons was withdrawn voluntarily, HSBC Bank USA has cooperated fully by providing responsive documents in its possession in the US to the US Internal Revenue Service, and engaging in efforts to resolve these matters.

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HSBC continues to cooperate in ongoing investigations by the DoJ and the US Internal Revenue Service regarding whether certain Group companies acted appropriately in relation to certain customers who had US tax reporting requirements.

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

HSBC continues to cooperate with an investigation by the US Senate Permanent Subcommittee on Investigations related to AML/BSA compliance, OFAC sanctions and compliance with US tax and securities laws.

In each of these US regulatory and law enforcement matters, HSBC Group companies have received Grand Jury subpoenas or other requests for information from US Government or other agencies, and HSBC is cooperating fully and engaging in efforts to resolve matters. It is likely that there will be some form of formal enforcement action which may be criminal or civil in nature in respect of some or all of the ongoing investigations. Investigations of several other financial institutions in recent years for breaches of BSA, AML and OFAC requirements have resulted in settlements. Some of those settlements involved the filing of criminal charges, in some cases including agreements to defer prosecution of these charges, and the imposition

of fines and penalties. Some of those fines and penalties have been significant depending on the individual circumstances of each action. The investigations are ongoing. Based on the facts currently known, it is not practicable at this time for HSBC to determine the terms on which the ongoing investigations will be resolved or the timing of such resolution or for HSBC 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.

Investigations into the setting of London interbank offered rates and European interbank offered rates

Various regulators and competition and enforcement authorities around the world including in the UK, the US and the EU, are conducting investigations related to certain past submissions made by panel banks in connection with the setting of London interbank offered rates (LIBOR) and European interbank offered rates. As certain HSBC entities are members of such panels, HSBC and/or its subsidiaries have been the subject of regulatory demands for information and are cooperating with their investigations. In addition, HSBC and other panel banks have been named in putative class action lawsuits filed by private parties in the US with respect to the setting of US dollar LIBOR. Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of these regulatory investigations or putative class action lawsuits, including the timing and potential impact, if any, on HSBC.

Regulation and supervision

(Unaudited)

With listings of its ordinary shares in London, Hong Kong, New York, Paris and Bermuda, HSBC Holdings complies with the relevant requirements for listing and trading on each of these exchanges. In the UK, these are the Listing Rules of the Financial Services Authority (FSA); in Hong Kong, The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (HKSE); in the US, where the shares are traded in the form of ADSs, HSBC Holdings shares are registered with the US Securities and Exchange Commission (SEC). As a consequence of its US listing, HSBC Holdings is also subject to the reporting and other requirements of the US Securities Act of 1933, as amended, the Securities Exchange Act of 1934, as amended, and the New York Stock Exchange s (NYSE) Listed Company Manual, in each case as applied to foreign private issuers. In France and Bermuda, HSBC Holdings is subject to the listing rules of Euronext, Paris and the Bermuda Stock Exchange respectively, applicable to companies with secondary listings.

A statement of our compliance with the provisions of the UK Corporate Governance Code issued by the Financial Reporting Council and with the Code on Corporate Governance Practices in Appendix 14 to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited is set out in the Report of the Directors: Governance on page 218.

Our operations throughout the world are regulated and supervised by approximately 500 different central banks and regulatory authorities in those jurisdictions in which we have offices, branches or subsidiaries. These authorities impose a variety of requirements and controls designed to improve financial stability and the transparency of financial markets and their contribution to economic growth. These regulations and controls cover, *inter alia*, capital adequacy, depositor protection, market liquidity, governance standards, customer protection (for example, fair lending practices, product design, and marketing and documentation standards), and social responsibility obligations (for example, anti-money laundering, anti-bribery and corruption, and anti-terrorist financing measures). In addition, a number of countries in which we operate impose rules that affect, or place limitations on, foreign or foreign-owned or controlled banks and financial institutions. The rules include restrictions on the opening of local offices, branches or subsidiaries and the types of banking and non-banking activities that may be conducted by those local offices, branches or

subsidiaries; restrictions on the acquisition of local banks or regulations requiring a specified percentage of local ownership; and restrictions on investment and other financial flows entering or leaving the country. The supervisory and regulatory regimes of the countries where we operate will determine to some degree our ability to expand into new markets, the services and products that we will be able to offer in those markets and how we structure specific operations. As a result of government interventions in response to global economic conditions, there has been (and it is widely anticipated that there will continue to be) a substantial increase in government regulation and supervision of the financial services industry, including the imposition of higher capital and liquidity requirements, heightened disclosure standards and restrictions on certain types of transaction structures.

The FSA supervises us on a consolidated basis. In addition, each operating bank, finance company or insurance operation within HSBC is regulated by local supervisors. The primary regulatory authorities are those in the UK, Hong Kong and the US, our principal jurisdictions of operation. However, and in addition, the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority, as new European Supervisory Authorities since 2011 are also likely to have greater influence on regulatory approaches across the EU. This could lead to changes in how we are regulated and supervised on a day-to-day basis as each of these authorities develops its powers having regard to some of the regulatory initiatives highlighted in this report.

UK regulation and supervision

UK banking and financial services institutions are subject to multiple regulations. The primary UK statute is the Financial Services and Markets Act 2000 (FSMA). Other UK financial services legislation includes that derived from EU directives relating to banking, securities, insurance, investments and sales of personal financial services.

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

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FSA rules establish the minimum criteria for authorisation for banks and financial services businesses in the UK and the FSA has the right to object, on prudential grounds, to persons who hold, or intend to hold, 10 per cent or more of the voting power or shares of a financial institution that it regulates, or of its parent undertaking. They also set out reporting (and, as applicable, consent) requirements with regard to large individual exposures and large exposures to related borrowers. In its capacity as our supervisor on a consolidated basis, the FSA receives information on the capital adequacy of, and sets requirements for, the Group as a whole. Individual banking subsidiaries are directly regulated by their local banking supervisors, who set and monitor, *inter alia*, their capital adequacy requirements.

We calculate capital at a Group level using the Basel II framework of the Basel Committee on Banking Supervision. However, local regulators are at different stages of implementation and local reporting may differ. In most jurisdictions, non-banking financial subsidiaries are also subject to the supervision and capital requirements of local regulatory authorities.

Basel II is structured around three pillars : minimum capital requirements, supervisory review process and market discipline. The Capital Requirements Directive (CRD) implemented Basel II in the EU and the FSA then gave effect to the CRD by including the latter s requirements in its own rulebooks. Further information on developments relevant to our prudential regulatory framework is set out in Future developments on page 213.

The FSA monitors authorised institutions through ongoing supervision and the review of routine and *ad hoc* reports relating to financial, prudential and conduct of business matters. The FSA may periodically obtain independent reports from a skilled person, as to the adequacy of internal control procedures and systems as well as procedures and systems governing records and accounting. The FSA meets regularly with our senior executives to discuss our adherence to the FSA s prudential guidelines. They also regularly discuss fundamental matters relating to our business in the UK and internationally, including areas such as strategic and operating plans, risk control, loan portfolio composition and organisational changes, including succession planning and recovery and resolution arrangements. During the year, we conducted a number of Group-wide stress tests and scenario analyses in accordance with the requirements of the FSA, the EBA and the International Monetary Fund

involving analysis of capital levels and requirements in various stress scenarios. We satisfied the required thresholds in each of these tests. In light of current conditions, we continue to experience an increased level of ongoing interaction with the FSA.

The UK financial services regulatory structure is currently in the process of substantial reform, with the UK Government s proposals to abolish the FSA and establish three new regulatory bodies by the end of 2012 now well advanced. These three bodies will comprise the Financial Policy Committee (FPC), the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The FPC will not directly supervise firms, being responsible for macro-prudential regulation and considering macro issues affecting economic and financial stability. The PRA and the FCA will inherit the majority of the FSA s existing functions and HSBC will be a dual regulated firm, subject to prudential regulation by the PRA and to conduct regulation by the FCA.

FSMA will be substantially revised during the course of 2012 to reflect this regulatory reform.

There are a substantial number of other ongoing regulatory initiatives affecting the Group and driven by or from the UK. These include the UK bank levy, ongoing rule making regarding remuneration and recovery and resolution plans (RRP) and the implementation of the recommendations of the Independent Commission on Banking (ICB). Whilst not strictly a legislative or regulatory matter, certain banks in the UK, including HSBC, have established an accord with the UK Government, referred to as Project Merlin.

Legislation in respect of the UK bank levy was substantively enacted on 5 July 2011, in the form of the Finance Act 2011. The levy applied from 1 January 2011. HSBC is a UK banking group for these purposes and the levy is chargeable on the global consolidated balance sheet at the year end. A charge of US$570m for the UK bank levy has been recognised in 2011. The UK levy is based on the consolidated balance sheet at the year end. Bank levies have also been introduced in France, Germany and South Korea. The overall cost of such levies in 2011 was US$587m.

The Financial Services Act 2010, amongst other things, empowered the FSA to make rules about remuneration requiring all authorised firms to operate a remuneration policy which is consistent with the effective management of risks and the Financial Stability Board s (FSB) Implementation Standards for Principles for Sound Compensation Practices and requiring authorised firms to prepare and keep up-to-date RRP. The FSA has continued,

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during 2011, to consult on the rules made under these powers and the Group continues to discuss RRP with the FSA. We expect the FSA s rules on RRP to be finalised and effective during 2012. In 2011, the FSA also implemented the requirements of CRD III, which requires certain financial institutions, including banks and investment firms, to have in place remuneration policies that are consistent with effective risk management. In addition to the rules required by the FSA for the Group, individual legal entities may also be subject to their own local requirements.

The ICB published its Final Report on 12 September 2011. The UK Government is now considering how it will implement the recommendations in the report. If the ICB s reform proposals were to be adopted as legislation in substantially the form presented, they would have wide ranging implications for the structure and costs of large UK-headquartered banks, and the UK banking industry.

The Chancellor of the Exchequer expressed broad approval of the ICB s Final Report and indicated that the UK Government endorses in principle the proposals to establish a ring-fenced bank and greater primary loss absorbing capacity. The Government is not, however, bound to adopt the Commission s recommendations and are proposing to undertake extensive consultation in two stages during 2012.

The ICB proposed that large UK-headquartered banks (which would include HSBC) should have primary loss-absorbing capacity (PLAC) equal to at least 17% of risk-weighted assets (RWA s) calculated under Basel III. This capacity should be satisfied by issuance of additional equity and/or debt that is loss-absorbing at the point of non-viability. The UK supervisor would retain the power to increase this minimum loss-absorbing capacity to 20% of RWAs if it had concerns about the ability of the bank to restructure or liquidate at the point of failure.

The Government has indicated that, where the activities outside the ring-fence of a large UK-headquartered bank were demonstrably resolvable without adverse impact on UK financial stability, the higher PLAC ratio need not apply Group-wide.

In addition, in respect of UK universal banks, including HSBC s major UK banking subsidiary, HSBC Bank plc, the ICB has proposed a separation of the UK retail and wholesale banking operations through the creation of a ring-fenced retail bank. The ICB recommends that a large ring-fenced bank should be required to maintain an equity ring-fence

buffer of at least 3% of RWAs above the Basel III base requirement of 7% of RWAs.

Following on from this, the ICB also recommended that the minimum leverage ratio of equity-to-total assets should be adjusted from 3% (as it is in the Basel III proposals) up to 4.06%, increasing in the same proportion as the ring-fence buffer.

If the proposals described above are adopted substantially in the form prescribed, major changes to our corporate structure and business activities conducted in the UK through HSBC Bank plc might be required. The changes may include separating the ring-fenced bank from the existing UK incorporated universal bank. The proposals, if adopted, would take an extended period of time to implement and would significantly increase our costs both to implement and to run the ongoing operations as restructured.

In February 2011, certain banks in the UK including HSBC exchanged letters with the UK s Chancellor of the Exchequer to establish an accord (referred to as Project Merlin) setting out the intentions of the banks on matters including lending, taxation, pay and other economic contributions. The intentions were, in large part, provided collectively and are not binding or enforceable on any member of the HSBC Group. In the accord, the banks:

- renewed their intention to implement the recommendations from the UK Business Finance Taskforce, established by the banks, which reported in October 2010, on improving customer relationships, ensuring better access to finance, providing better information and promoting understanding;

agreed to provide the capacity for additional gross new lending to UK corporates, with HSBC providing at least £38.8bn (US$61.9bn), with capacity to increase this to £44.1bn (US$70.4bn), including a goal for UK small and medium-sized enterprises (SMEs) of £11.7bn (US$18.7bn) for the full year, with capacity for additional facilities of at least £1.2bn (US$1.9bn) if required, all subject to, inter alia, suitable demand and normal lending criteria;

agreed to abide by the UK Code of Practice on Taxation for Banks and indicated that they expected to contribute some £8bn (US$12.8bn) to the total direct and indirect tax take in 2010 and some £10bn (US$15.9bn) in 2011 in the ordinary course of business;

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- confirmed that collectively bonus payments in respect of 2010 would be less than in 2009 and agreed that, for each bank, the remuneration packages of the five highest paid senior executive officers who are not directors should be disclosed with more discussion of remuneration policy with shareholders;
- confirmed their intention to maintain their existing charitable contributions, in cash and in kind;
- agreed to make an additional contribution of up to £1bn (US$1.6bn) (up to £250m (US$399m) for HSBC) to the Business Growth Fund plc (as established under the UK Business Finance Taskforce) for equity investment in SMEs subject to demand over the life of the business and an agreed risk-weighting for the investment; and
- agreed to contribute capital of £200m (US$319m) (£50m (US$80m) for HSBC) over two years to the Big Society Bank (now renamed Big Society Capital Limited) on commercial terms.

Additionally, the FSA continues to pursue a full agenda of regulatory development in relation to the conduct of business in the UK, with currently ongoing initiatives such as the Retail Distribution Review and the Mortgage Market Review which will affect those businesses (including HSBC) that provide investment and the provision of home finance in the UK.

Hong Kong regulation and supervision

Banking in Hong Kong is subject to the provisions of the Banking Ordinance and to the powers, functions and duties ascribed by the Banking Ordinance to the Hong Kong Monetary Authority (the HKMA). The principal function of the HKMA is to promote the general stability and effective working of the banking system in Hong Kong. The HKMA is responsible for supervising compliance with the provisions of the Banking Ordinance. The Banking Ordinance gives power to the Chief Executive of Hong Kong to give directions to the HKMA and the Financial Secretary with respect to the exercise of their respective functions under the Banking Ordinance.

The HKMA has responsibility for authorising banks, and has discretion to attach conditions to its authorisation. The HKMA requires that banks or their holding companies file regular prudential returns, and holds regular discussions with the management of the banks to review their operations.

The HKMA may also conduct on-site examinations of banks and, in the case of banks incorporated in Hong Kong, of any local and overseas branches and subsidiaries. The HKMA requires all authorised institutions to have adequate systems of internal control and requires the institutions external auditors, upon request, to report on those systems and other matters such as the accuracy of information provided to the HKMA. In addition, the HKMA may from time to time conduct tripartite discussions with banks and their external auditors.

The HKMA has the power to serve a notice of objection on persons if they are no longer deemed to be fit and proper to be controllers of the bank, if they may otherwise threaten the interests of depositors or potential depositors, or if they have contravened any conditions specified by the HKMA. The HKMA may revoke authorisation in the event of an institution s non-compliance with the provisions of the Banking Ordinance. These provisions require, among other things, the furnishing of accurate reports. The HKMA has implemented Basel II for all Authorised Institutions incorporated in Hong Kong.

The marketing of, dealing in and provision of advice and asset management services in relation to securities in Hong Kong are subject to the provisions of the Securities and Futures Ordinance of Hong Kong (Securities and Futures Ordinance). Entities engaging in activities regulated by the Securities and Futures Ordinance are required to be licensed. The HKMA is the primary regulator for banks involved in the securities business, while the Securities and Futures Commission is the regulator for non-banking entities.

US regulation and supervision

We are subject to extensive federal and state supervision and regulation in the US. Banking laws and regulations of the Board of Governors of the Federal Reserve System (the Federal Reserve Board), the Office of the Comptroller of the Currency (the OCC) and the Federal Deposit Insurance Corporation (the FDIC) govern many aspects of our US business.

On 21 July 2010, the United States enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which provides a broad framework for significant regulatory changes that will extend to almost every area of US financial regulation. Implementation of Dodd-Frank will require further detailed rulemaking over several years by different US regulators, including the Department of the Treasury, the Federal Reserve Board, the FDIC, the SEC, the Commodity Futures

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Trading Commission (CFTC) and the newly created Financial Stability Oversight Council (the FSOC) and Consumer Financial Protection Bureau (the Consumer Bureau), and uncertainty remains about many of the final details, timing and impact of the rules.

The FSOC may take certain actions, including precluding mergers, restricting financial products offered, restricting or terminating activities or imposing conditions on activities or requiring the sale or transfer of assets, against any bank holding company with assets greater than US$50bn that is found to pose a grave threat to financial stability. The FSOC will be supported by the Office of Financial Research (OFR) which will impose data reporting requirements on financial institutions. The cost of operating both the FSOC and OFR will be paid for through an assessment on large bank holding companies, which is currently proposed to begin in July 2012.

Over a transition period from 2013 to 2015, the Federal Reserve Board will apply more stringent capital and risk management requirements on bank holding companies such as HSBC North America Holdings Inc. (HNAH), which will require a minimum leverage ratio of five percent and a minimum total risk-based capital ratio of ten percent. Also, failure to maintain a ratio of tier 1 common to risk-weighted assets of five percent under stress conditions will restrict HNAH from engaging in capital distributions such as dividends or share repurchases. In addition, large bank holding companies, such as HNAH (or their parent companies), are now required to file resolution plans identifying material subsidiaries and core business lines domiciled in the US, describing what strategy would be followed in the event of significant financial distress, and including identifying how insured bank subsidiaries are adequately protected from risk created by other affiliates. The failure to cure deficiencies in a resolution plan would enable the US regulators to impose more stringent capital, leverage and liquidity requirements, restrict the growth, activities or operations of the company or, if such failure persists, require the company to divest assets or operations. The Federal Reserve Board has also proposed a series of increased supervisory standards to be followed by large bank holding companies, including required remediation in the event of failure to meet capital requirements, stress testing requirements and risk management standards. US regulators will also be able to restrict the size and growth of systemically significant non-bank financial companies and large interconnected bank holding companies and will be required to impose

bright-line debt-to-equity ratio limits on financial companies that the FSOC determines pose a grave threat to financial stability.

HSBC and our US operations are subject to supervision, regulation and examination by the Federal Reserve Board because HSBC is a bank holding company under the US Bank Holding Company Act of 1956 (BHCA), as a result of our control of HSBC Bank USA, N.A., McLean, Virginia (HBUS); and HSBC Trust Company (Delaware), N.A., Wilmington, Delaware (HTCD). HNAH, is also a bank holding company . Both HSBC and HNAH are registered as financial holding companies (FHC s) under the BHCA, and, accordingly, may affiliate with securities firms and insurance companies and engage in other activities that are financial in nature or incidental or complementary to activities that are financial in nature. The ability of HSBC and HNAH to engage in expanded financial activities as FHCs depends upon HSBC and HNAH continuing to meet certain criteria set forth in the BHCA, including requirements that they and any US depository institution subsidiaries be well capitalised and well managed , and that any depository institutions have achieved at least a satisfactory record in meeting community credit needs during their most recent examinations pursuant to the Community Reinvestment Act.

In general, under the BHCA, an FHC would be required, upon notice by the Federal Reserve Board, to enter into an agreement with the Federal Reserve Board to correct any failure to comply with the requirements to maintain FHC status. Until such deficiencies are corrected, the Federal Reserve Board may impose limitations on the US activities of an FHC and depository institutions under its control. If such deficiencies are not corrected, the Federal Reserve Board may require an FHC to divest its control of any subsidiary depository institution or to desist from certain financial activities in the US.

The two US banks, HBUS and HTCD, are subject to regulation and examination primarily by the OCC, secondly by the FDIC, and by the Federal Reserve Board. Banking laws and regulations restrict many aspects of their operations and administration, including the establishment and maintenance of branch offices, capital and reserve requirements, deposits and borrowings, investment and lending activities, payment of dividends and numerous other matters. In addition, the FDIC requires FDIC-insured banks with US$50bn or more in total assets (such as HSBC Bank USA) to submit resolution plans that should enable the FDIC to resolve the bank in a manner that ensures that depositors receive access to their insured deposits

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within one business day of the institution s failure (two business days if the failure occurs on a day other than Friday), maximizes the value from the sale or disposition of its assets and minimizes the amount of any loss to be realised by the institution s creditors.

Large bank holding companies, including HNAH, became subject to the US rules adopted in 2008 that provided for the implementation of Basel II in the United States. The US Basel II implementation timetable originally consisted of a parallel calculation period under the current regulatory capital regime (Basel I), followed by a three-year transitional floor period, during which Basel II risk-based capital requirements could not fall below certain floors based on Basel I regulations.

In June 2011, the US banking agencies adopted final regulations to implement the capital floor provision of the so-called Collins Amendment of Dodd-Frank. These regulations eliminated the three-year transitional floor period in favor of a permanent floor based on the generally applicable risk-based capital rules (currently Basel I). Pursuant to these regulations, a banking organisation 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. Prior to adoption of Basel II, HNAH is required to successfully complete a parallel run by measuring regulatory capital under both the new regulatory capital rules and the existing general risk-based rules for a period of at least four quarters. Successful completion of the parallel run period requires the approval of US regulators. We began the parallel run period, which encompasses enhancements to a number of risk policies, processes and systems to align HBUS with the Basel II final rule requirements, in January 2010. The timing of receipt of US regulatory approval is uncertain.

In response to the financial crisis, in December 2010, the Basel Committee issued final rules to strengthen existing capital requirements (Basel III). The US banking agencies are required to finalise, by December 2012, the rules to be applied by US banking organisations commencing on 1 January 2013. While expected to be substantially the same as those of the Basel Committee, the US banking agencies have yet to issue the proposed US version of the Basel III rules. A more detailed description of Basel III can be found in Future developments on page 213.

Apart from the Basel II and Basel III rules regarding credit and operational risks, in June 2010, the Basel Committee agreed on certain revisions to the market risk capital framework (Basel II.5) that would also result in additional capital requirements. In January 2011, the US banking agencies issued a proposal to amend the market risk capital rules to implement certain revisions approved by the Basel Committee. However, the US banking agencies proposal excluded the methodologies adopted by the Basel Committee for calculating capital requirements on certain debt and securitisation positions covered by the market risk rule because such methodologies rely on external credit ratings, which is prohibited by Dodd-Frank.

In December 2011, the US banking agencies proposed to further amend and supplement the market risk capital rules beyond the January 2011 proposed modifications. The December 2011 proposals are intended to implement the provisions of Dodd-Frank requiring that all federal agencies remove references to and reliance on credit ratings in their regulations, and replace such references with appropriate alternative standards for evaluating creditworthiness. Under the December 2011 proposal, the US banking agencies set forth alternative methodologies to external credit ratings which are to be used to assess capital requirements on certain debt as well as securitisation positions subject to the market risk capital rules. The US banking agencies have also indicated they intend to propose similar revisions to the Basel I and Basel II rules to eliminate the use of external credit ratings to determine the risk weights applicable to securitisation and certain corporate exposures under these regulations.

HBUS and HTCD are subject to risk-based assessments from the FDIC, which insures deposits generally to a maximum of US$250,000 per depositor for domestic deposits. Dodd-Frank provides for unlimited deposit insurance for certain non-interest-bearing transaction accounts for the period to 31 December 2012. Due to projected shortfalls in the FDIC fund as a result of continuing bank failures, the FDIC required all insured banks, including HBUS and HTCD, to prepay their insurance premium for the years 2010, 2011 and 2012.

Dodd-Frank changes the FDIC s risk-based deposit insurance assessment framework primarily by basing assessments on an FDIC-insured institution s total assets less tangible equity rather than US domestic deposits, which is expected to shift a greater portion of the aggregate assessments to large FDIC-insured institutions. The new large bank pricing system will result in higher assessment rates for banks with high-risk

asset concentrations, less stable balance sheet liquidity, or potentially higher loss severity in the event of failure.

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Effective by July 2012, Dodd-Frank will require that the lending limits applicable to HBUS and HTCD take into account credit exposure from derivative transactions, securities borrowing and lending transactions, and repurchase and reverse repurchase agreements.

Our US consumer finance operations are subject to extensive state-by-state regulation in the US, and to laws relating to consumer protection (both in general, and in respect of sub-prime lending operations, which have been subject to enhanced regulatory scrutiny); discrimination in extending credit; use of credit reports; privacy matters; disclosure of credit terms; and correction of billing errors. They also are subject to regulations and legislation that limit operations in certain jurisdictions.

One part of Dodd-Frank, commonly referred to as the Volcker Rule , will limit the ability of companies related to a US bank (including HSBC group companies outside the US) to sponsor or invest in private equity or hedge funds or to engage in certain types of proprietary trading in the US unrelated to serving clients. While we do not have segregated proprietary trading desks, the Volcker Rule could affect HSBC both in North America and across the Group. The proposed rule was published for comment on 11 October 2011 and a number of foreign governments and other bodies have made submissions to the US authorities on, inter alia, the overall scope and extra-territorial effects of the proposed rule.

Dodd-Frank also provides regulators with tools to provide greater capital, leverage and liquidity requirements and other prudential standards, particularly for financial institutions that pose significant systemic risk. However, in imposing heightened capital, leverage, liquidity and other prudential standards on non-US banks, the Federal Reserve Board is directed to take into account the principle of national treatment and equality of competitive opportunity, and the extent to which the foreign bank is subject to comparable home country standards.

Furthermore, Dodd-Frank provides for an extensive framework for the regulation of over-the-counter (OTC) derivatives, including mandatory clearing, exchange trading and transaction reporting of certain OTC derivatives, as well as rules regarding the registration of swap dealers and major

swap participants, and related capital, margin, business conduct, record keeping and other requirements applicable to such entities. In December 2011, the CFTC finalised rules under Dodd-Frank requiring regulatory and public reporting for a wide range of OTC derivatives beginning in July 2012. In addition, in January 2012, the CFTC began to finalise rules under Dodd-Frank relating to the regulation of swap dealers and major swap participants. We are assessing how compliance with these new rules will affect our business.

Dodd-Frank also grants the SEC discretionary rule-making authority to impose a new fiduciary standard on brokers, dealers and investment advisers, and expands the extraterritorial jurisdiction of US courts over actions brought by the SEC or the United States with respect to violations of the anti-fraud provisions in the Securities Act, the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940. In addition, regulations which the FSOC, the Consumer Bureau or other regulators may adopt could affect the nature of the activities which our FDIC-insured depository institution subsidiaries may conduct, and may impose restrictions and limitations on the conduct of such activities.

Implementation of Dodd-Frank and related final regulations could result in additional costs or limit or restrict the way we conduct our business, both in relation to our US operations and our non-US operations, although uncertainty remains about many of the details, impact and timing of these reforms and the ultimate effect they will have on HSBC.

Global and regional prudential and other regulatory developments

As outlined earlier, the Group is subject to regulation and supervision by a large number of regulatory and other agencies. In addition to changes being pursued at a local level, changes are also being pursued globally through the actions of bodies such as the G-20, FSB and Basel Committee on Banking Supervision, as well as regionally through the EU and similar. Key areas include the work of the FSB on global systemically important financial institutions (G-SIFI), the Basel Committee s Basel III capital requirements, the EU s measures to implement Basel III (referred to as CRD IV), and the EU s proposed Crisis Management Directive.

The FSB has been designated by the G-20 as the body responsible for co-ordinating the delivery of a global reform programme following the financial crisis, a key element of which is that no firm should be too big or too complicated to fail, and that taxpayers should not bear the cost of resolution.

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HSBC has been classified by FSB as a G-SIFI and therefore will be subject to what the FSB refers to as a multi-pronged and integrated set of policies . These include proposals that would place an additional capital buffer on the Group and require enhanced reporting.

In December 2010, the Basel Committee issued two documents: *A global regulatory framework for more resilient banks and banking systems* and *International framework for liquidity risk measurement, standards and monitoring*, which together are commonly referred to as Basel III . These will be given effect across the EU via a recasting of CRD. The proposals have been issued for a new Regulation and Directive, which collectively are known as CRD IV. Finalised CRD IV rules are not expected until mid-2012 but draft proposals include:

- *Quality of capital:* CRD IV requires a further strengthening and harmonisation of the criteria for eligibility of capital instruments with an emphasis on common equity as the principal component of tier 1 capital;

- *Capital buffers:* proposals comprise a capital conservation buffer of 2.5% of risk-weighted assets to be built up during periods of economic growth, aimed at ensuring the capacity to absorb losses in stressed periods that may span a number of years; and a countercyclical capital buffer of up to an additional 2.5% to be built up in periods in which credit growth exceeds GDP growth;

- *Derivatives and central counterparty clearing:* higher capital requirements to be imposed for bilateral (uncleared) transactions, to incentivise the use of central clearing;

- *Counterparty credit risk:* requirements for managing and capitalising counterparty credit risk are to be strengthened. In particular, an additional capital charge for potential losses associated with the deterioration in the creditworthiness of individual counterparties (Credit Valuation Adjustment or CVA) will be introduced; and

- *Liquidity and funding:* a new minimum standard, the Liquidity Coverage Ratio, designed to improve the short-term resilience of a bank s liquidity risk profile, will be introduced after an observation and review period in 2015.

A description of the estimated impact of adopting Basel III can be found in Impact of Basel III on page 213.

In addition, the EU continues to work on a Crisis Management Directive. This is intended to provide a harmonised framework for the resolution of credit institutions across the EU. It appears that the Directive has been delayed and recent communications from the EU suggest that publication will not now take place until later in 2012. The potential impact of this Directive cannot therefore presently be estimated. However, as with most of the initiatives already highlighted, there is some risk of inconsistency or duplication with other measures already in hand at the national level, both within and outside the EU. The EU also continues to work on its review of existing directives such as the Market Abuse Directive and the Markets in Financial Instruments Directive, the revisions to which may affect at least some of the investment markets in which the Group operates and the instruments in which it trades.

Anti-money laundering and related regulation

The HSBC Group takes its obligations to prevent money laundering and terrorist financing very seriously. We have policies, procedures and training intended to ensure that our employees know and understand our criteria for when a client relationship or business should be evaluated as higher risk. As part of our continuing evaluation of risk, we monitor our activities relating to the countries subject to US economic sanctions

programmes administered by the Office of Foreign Assets Control (OFAC) as well as those subject to UN, UK and EU sanctions. HSBC Group policy requires that relevant Group offices should adhere to the letter and spirit of all applicable laws and regulations. Our business activities include banking services for nationals of, and clients domiciled in, some of the countries. We had a small representative office in Tehran, Iran which was closed in December 2010.

HSBC Bank USA entered into a Consent Cease and Desist Order with the OCC, and HNAH entered into a Consent Cease and Desist Order with the Federal Reserve Board in the first week of October 2010. These Orders require improvement of our Compliance Risk Management Programme including anti-money laundering controls across the Group s US businesses. Steps continue to be taken to address the requirements of these Orders and to ensure that compliance and effective policies and procedures are maintained.

The US State Department has designated certain countries (Cuba, Iran, Sudan and Syria) as state sponsors of terrorism, and US law generally prohibits US persons from doing business with

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such countries. We are aware of initiatives by governmental entities and institutions in the US to adopt rules, regulations or policies prohibiting transactions with or investments in entities doing business with such countries. HSBC Group Policy requires all Group companies to comply to the extent applicable with US law and regulation, including the country and individual sanctions promulgated by OFAC sanctions. This means that not only must US subsidiaries and US nationals comply with

OFAC regulations, but that HSBC subsidiaries outside the US which are not US persons must not participate in US dollar business that would, if conducted by a US person, contravene the OFAC sanctions. We do not consider that our business activities with counterparties in, or directly relating to, these countries are material to our business, and such activities represented a very small part of total assets at 31 December 2011 and total revenues for the year ended 31 December 2011.

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1 *Unaudited.* 2 *Audited.* 3 *Audited where indicated.*

Risk profile

(Unaudited)

Managing our risk profile

A strong balance sheet is core to our philosophy.

We ensured that our portfolios remain aligned to our risk appetite and strategy.

We actively managed our risks, supported by strong forward looking risk identification.

Maintaining capital strength and strong liquidity position

Our core tier 1 capital ratio remains strong at 10.1%.

We have sustained our strong liquidity position throughout 2011.

The ratio of customer advances to deposits remains below 90%.

Strong governance

Robust risk governance and accountability is embedded across the Group.

The Board, advised by the Group Risk Committee, approves our risk appetite.

A new global operating model has been implemented across the global Risk function.

Our top and emerging risks

Macro-economic and geopolitical risk.

Macro-prudential, regulatory and legal risks to our business model.

Risks related to our business operations, governance and internal control systems.

For details of HSBC s policies and practices regarding risk management and governance see the Appendix to Risk on page 188.

Managing risk

(Unaudited)

The continued growth in our business in 2011 was achieved while ensuring risks were assumed in a measured manner and in line with our appetite for such risks. This approach is encapsulated within our risk appetite framework.

Report of the Group Risk Committee

Further commentary on risk appetite, risk governance and stress testing can be found within the Report of the Group Risk Committee, on page 233 of the Corporate Governance section.

The diversification of our lending portfolio across the regions, together with our broad range of global businesses and products, ensured that we were not overly dependent on a few countries or markets to generate income and growth in 2011. Our geographical diversification also supported our strategies for growth in faster-growing markets and those with international connectivity.

During 2011 financial markets were dominated by concerns over sovereign debt default risk within the peripheral eurozone countries and the potential for contagion across core European countries. Middle East turmoil and the perception that the world economic recovery remained fragile continued to cause concerns. Within the challenging economic and financial environment, we maintained our conservative risk profile by reducing exposure to the most likely areas of stress. Our top and emerging risk framework supports our approach to forward-looking risk identification and assists in providing focus on appropriate stress tests required to evaluate the potential impact of emerging scenarios. Where applicable and necessary, we have adjusted our risk appetite.

We continued to selectively manage our exposure to sovereign debt, with the overall quality of the portfolio remaining strong. We regularly updated our assessment of higher risk countries and adjusted our risk appetite and exposures to reflect the updates.

During 2011, credit quality improved in general terms and loan impairment charges and other credit risk provisions declined, most notably in the US reflecting lower lending balances in our consumer finance portfolios, partly offset by increases in new collectively assessed loan impairment allowances in both Latin America and Hong Kong on the back of strong lending growth. On a constant currency basis, our loan impairment charges and other credit risk provisions in 2011 were US$12.1bn, 15% lower than in 2010.

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Capital and liquidity

Preserving our strong capital position has long been, and will remain, a key priority for HSBC. We are well equipped to respond to the capital requirements imposed by Basel III, which are discussed further on page 212, and to sustain future growth. We utilise an enterprise-wide approach to testing the sensitivities of our capital plans against a number of scenarios; our approach to scenario stress testing analysis is discussed on page 188.

We continue to maintain a very strong liquidity position and are well positioned for the emerging new regulatory landscape.

Top and emerging risks

(Unaudited)

Details of the top and emerging risks identified through our risk management processes are set out below:

Macro-economic and geopolitical risk

- Eurozone risk of sovereign default
- Eurozone member departing from the currency union
- Increased geopolitical risk in certain regions

Eurozone risk of sovereign and counterparty defaults

Exposures to the eurozone have received increasing focus given the continued instability in the area and the potential for contagion from the peripheral to core eurozone countries.

There is an increasing risk of sovereign defaults by the peripheral eurozone countries which would place further pressure on banks within the core European countries that are exposed to these sovereigns. Although our exposure to the peripheral eurozone countries is relatively limited, we are exposed to counterparties in the core European countries which could be affected by any sovereign crisis. Our eurozone exposures are described in more detail on pages 113 to 118.

Potential impact on HSBC

- Our exposures to European banks may come under stress, heightening the potential for credit and market risk losses, if the sovereign debt crisis in the region increases the need to recapitalise parts of the sector.
- Trade and capital flows may contract as a result of banks deleveraging, protectionist measures being introduced in certain markets or the emergence of geopolitical risks, which in turn might curtail profitability.
- A prolonged period of low interest rates due to policy actions taken to address the eurozone crisis will constrain, through spread compression and low returns on assets, the interest income we earn from investing our excess deposits.
- In the event of contagion from stress in the peripheral eurozone sovereign and financial sectors, our ability to borrow from other financial institutions or to engage in funding transactions may be adversely affected by market dislocation and tightening liquidity.
- We have actively managed the risk of sovereign defaults during 2011 by reducing exposures and other measures.

Eurozone member departing from the currency union

The risk of a eurozone member departing from the currency union is a plausible scenario. Should it materialise it would have a significant impact on the entire financial sector and the wider economy. It would crystallise sovereign risks and those to the bank and corporate sectors, and the disruption caused would affect consumer activity.

Potential impact on HSBC

- We could incur significant losses stemming from the exit of one or more countries from the eurozone and the return to their local currencies.
- In addition, should such an event happen in a disorderly manner, it could trigger banking defaults in companies with which we do business and have a knock-on effect on the global banking system.
- In seeking to manage and mitigate this risk, we have prepared and tested detailed operational contingency plans to deal with such a scenario. We are keeping these plans under close review as events develop.

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Increased geopolitical risk in certain regions

We are subject to geopolitical risks in the countries in which we operate. During 2011, these were particularly heightened in the Middle East and in certain parts of Asia.

In the Middle East, the Arab Spring has spread across the region, leading to political instability in a number of countries. In Asia, tensions persist in certain areas following leadership and regime changes which pose a threat of instability and potential conflict.

Potential impact on HSBC

Our results are subject to the risk of loss from unfavourable political developments, currency fluctuations, social instability and changes in government policies on matters such as expropriation, authorisations, international ownership, interest-rate caps, foreign exchange transferability and tax in the jurisdictions in which we operate. Actual conflict could bring about loss of life amongst our staff and physical damage to our assets.

We have increased our monitoring of the geopolitical and macro-economic outlook, in particular in countries where we have material exposures and a physical presence. Our internal credit risk rating of sovereign counterparties takes these factors into account and drives our appetite for conducting business in those countries. Where necessary, we adjust our country limits and exposures to reflect our appetite and mitigate these risks as appropriate.

Macro-prudential, regulatory and legal risks to our business model

Regulatory developments affecting our business model and Group profitability

Regulatory investigations and requirements relating to conduct of business and financial crime negatively affecting our results and brand

Dispute risk

Financial service providers face increasingly stringent and costly regulatory and supervisory requirements, particularly in the areas of capital and liquidity management, conduct of business, operational structures and the integrity of financial services delivery. Increased government intervention and control over financial institutions, together with measures to reduce systemic risk, may significantly alter the competitive landscape. These measures may

be introduced as formal requirements in a supra-equivalent manner and to differing timetables across regulatory regimes.

Regulatory developments affecting our business model and Group profitability

There are several key regulatory changes which are likely to have an effect on our activities. These are set out below:

Basel III/CRD IV

Derivatives and central counterparty clearing: measures have been introduced to give effect to the G20 commitments designed to reduce systemic risk and volatility relating to derivatives trading. The G20 agreed that all standardised over-the-counter (OTC) derivatives were to be exchange traded where appropriate, reported to trade repositories and centrally cleared by the end of 2012. Higher capital requirements under Basel III will be imposed for bilateral (uncleared) transactions to incentivise the use of clearing.

Quality of capital: The Capital Requirement Directive (CRD IV) requires a further strengthening and harmonisation of the criteria for eligibility of capital instruments with an emphasis on common equity as the principal component of tier 1 capital.

Capital buffers: CRD IV proposals comprise a capital conservation buffer of 2.5% of RWAs to be built up during periods of economic growth, aimed at ensuring the capacity to absorb losses in stressed periods that may span a number of years, and a countercyclical capital buffer of up to an additional 2.5% to be built up in periods in which credit growth exceeds GDP growth.

Counterparty credit risk: requirements for managing and capitalising counterparty credit risk are to be strengthened. In particular, an additional capital charge for potential losses associated with the deterioration in the creditworthiness of individual counterparties, the capital valuation adjustment, will be introduced.

Liquidity and funding: a new minimum standard, the liquidity coverage ratio, designed to improve the short-term resilience of a bank s liquidity risk profile, will be introduced after an observation and review period in 2015. To promote resilience by creating incentives for banks to fund their activities with more stable sources of funding, the European Commission will consider proposing a net stable funding ratio after an observation and review period in 2018.

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In addition, the Basel Committee on Banking Supervision will monitor a leverage ratio based on a minimum 3% tier 1 capital ratio over the period beginning in 2013.

UK Independent Commission on Banking: the forthcoming legislation in relation to the report of the Independent Commission on Banking (ICB) is likely to require us to make major changes to our corporate structure and the business activities we conduct in the UK through our major banking subsidiary, HSBC Bank, arising from:

- the likelihood that the retail banking activities currently carried out within that entity may have to be spun-off into a ring-fenced retail bank. These changes would take an extended period to implement with a significant effect on costs to both implement the changes and run the ongoing operations as restructured;
- the call for banks to hold a specified level of primary loss-absorbing capital (PLAC) up to 20% of their respective risk-weighted loans and investment assets. Many of the areas which could affect our business are precisely those areas where changes to the proposals appear likely or where consultation is being undertaken by the UK government. The government has indicated that it may modify the recommendations in the report and is proposing to undertake extensive consultation in two stages during 2012;
- introduction of a non-risk based leverage ratio, not as a binding prudential requirement but as an instrument for supervisory review (pillar 2).

Bank levy: legislation in respect of the UK bank levy was enacted on 19 July 2011. A charge of US$570m for the UK bank levy has been recognised in operating expenses in 2011. The UK levy is based on the consolidated balance sheet at the year-end. Bank levies have also been introduced, most notably in France, Germany and South Korea. The overall cost in 2011 was US$587m.

The Volcker Rule : while we do not have segregated proprietary trading desks, the so called Volcker Rule proposed under the Dodd-Frank Wall Street Reform & Consumer Protection Act (the Dodd-Frank Act) could affect HSBC in North America and across the Group. On 11 October 2011, a proposed rule was published which generated extensive public comment. A number of foreign governments and other bodies have made public

submissions to the US authorities on, inter alia, the overall scope and extra-territorial effects of the proposed rule. However, rulemaking to implement the provisions of the Volcker Rule has not been completed.

G-SIBs: the capital impact of being designated a Global systemically important bank (G-SIB) is discussed on page 213.

Potential impact on HSBC

- The proposals relating to capital and liquidity will affect the capital adequacy and liquidity frameworks under which financial institutions operate and result in increased capital and liquidity requirements, although the nature, timing and effect of many of the changes remain unclear. Increases in capital and liquidity requirements could have a material effect on our future financial condition or the results of our operations. There is also the risk of second and third order impacts of regulation which could constrain the flow of credit within the economy.

The proposed leverage ratio could cause HSBC, as an institution with a relatively low-risk portfolio overall, to constrain business activity in areas which are well collateralised or possess sufficient risk mitigants.

For a further description of the possible effects of the new Basel III/CRD IV rules on HSBC see page 213. If either the quality or amount of the Group s capital were to fall outside the proposed regulations, we could be required to raise more capital or reduce our level of RWAs to meet the requirements. Such actions and any resulting transactions may not be within our operating plans and may not be conducted on the most favourable terms. This could lead to lower returns on equity and cause some business activities and products to be less profitable and, in some instances, to fail to cover their cost of equity.

The proposed changes relating to remuneration, bank levies and other taxes could increase the Group s cost of doing business in the regulatory regimes in which these changes are implemented, reducing future profitability. Proposed changes in regulations such as the rules relating to derivatives and central counterparties regulation, the UK ICB ring-fencing proposals, recovery and resolution plans and the Volcker Rule may affect the manner in which we conduct our activities and structure ourselves, with the potential to both increase the costs of doing business and curtail the types of business we can carry out, with the risk of decreased profitability as a result. Due to the stage of development and implementation of these various regulations, it is not possible to estimate the effect, if any, on our operations.

Report of the Directors: Operating and Financial Review (continued)

We are closely engaged with the governments and regulators in the countries in which we operate to help ensure that the new requirements are properly thought through and understood so that they can be implemented in an effective manner. We are also ensuring that our capital and liquidity plans take into account the potential effects of the changes. Capital allocation and liquidity management disciplines have been expanded to incorporate future increased capital and liquidity requirements and drive appropriate risk management and mitigating actions.

Regulatory investigations and requirements relating to conduct of business and financial crime negatively affecting our results and brand

Financial service providers are at risk of regulatory sanctions or fines related to conduct of business and financial crime. The incidence of regulatory proceedings and other adversarial proceedings against financial service firms is increasing.

Potential impact on HSBC

We are subject to a number of regulatory actions and investigations. See Note 44 on the Financial Statements. It is inherently difficult to predict the outcome of the regulatory proceedings involving our businesses. An unfavourable outcome could have a material adverse effect on our results and brand.

In response to this risk, we are progressing a number of initiatives which seek to address the issues identified and enhance our governance and oversight.

Dispute risk

The current economic environment has increased our exposure to actual and potential litigation against the Group. Further details are discussed in Note 44 on the Financial Statements.

Potential impact on HSBC

Dispute risk gives rise to potential financial loss and significant reputational damage which could adversely affect customer and investor confidence.

Risks related to our business operations,

governance and internal control systems

Challenges to achieving our strategy in a downturn

Internet crime and fraud

- Social media risk

- Level of change creating operational complexity and heightened operational risk

- Information security risk

Challenges to achieving our strategy in a downturn

The external environment remains challenging and the structural changes which the financial sector is going through are creating obstacles to the achievement of strategic objectives. This, combined with the prolonged global macroeconomic slowdown, could affect the achievement of our strategic targets for the Group as a whole and our global businesses.

Potential impact on HSBC

- The downturn may put pressure on our ability to earn returns on equity in excess of our cost of equity while operating within the overall parameters of our risk appetite.

- Through our strategic initiatives, which have heightened the focus on capital allocation and cost efficiency, we are actively seeking to manage and mitigate this risk.

Internet crime and fraud

We are exposed to potentially fraudulent and criminal activities, in particular from a growing threat from internet crime which could result in the loss of customer data and sensitive information. The threat of external fraud may increase during adverse economic conditions, especially in retail and commercial banking.

We also face breakdowns in processes or procedures and systems failure or unavailability and are subject to the risk of disruption to our business arising from events that are wholly or partially beyond our control, such as internet crime and acts of terrorism.

Report of the Directors: Operating and Financial Review (continued)

Potential impact on HSBC

Internet crime and fraud may give rise to losses in service to customers and/or economic loss to HSBC. These risks equally apply when we rely on external suppliers or vendors to provide services to us and our customers.

We have increased our monitoring and have implemented additional controls such as two-factor authentication to mitigate the possibility of losses from these risks.

Social media risk

The scale and profile of social media networks (SMN s) have grown both in terms of customer demographic and geographical reach to represent a significant potential reputational risk to our organisation, given that these networks can be used as powerful broadcasting tools with the capability to reach large numbers of people in a very short time frame.

Potential impact on HSBC

SMNs can be used to exacerbate the effect of customer complaints and service failures, and provide a means for employees to publicise confidential information. SMNs present significant risks to our reputation and brand.

In order to reduce our exposure to these risks, an HSBC presence has been created in several of the larger SMNs in order to provide an official point of contact for our customers and stakeholders. Monitoring has also been implemented in some entities to protect our brand and identity and to understand general sentiment towards us and, in some cases, our specific products and initiatives.

Level of change creating operational complexity and heightened operational risk

There are many drivers of change across HSBC and the banking industry including change driven by new banking regulation, the increased globalisation of the economy and business needs, new products and delivery channels, and organisational change.

Operational complexity has the potential to heighten all types of operational risk across our activities. This includes the risk of process errors,

systems failures and fraud. It can also increase operational costs.

The implementation of our strategy, based on the application of our five filters methodology (see page 11), may involve the withdrawal from certain markets, which presents disposal risks which must be carefully managed.

Potential impact on HSBC

Critical systems failure and a prolonged loss of service availability could cause serious damage to our ability to serve our clients, breach regulations under which we operate and cause long-term damage to our business, reputation and brand. We seek to ensure that our critical systems infrastructure is constantly monitored and properly resourced to mitigate against systems failures.

The potential effects of disposal risks include regulatory breaches, industrial action, loss of key personnel and interruption to systems and processes during business transformation, and they can have both financial and reputational implications. Management actions to manage these risks proactively include a close dialogue with regulators and customers and the involvement of HR, legal, compliance and other functional experts.

Information security risk

The reliability and security of our information and technology infrastructure and customer databases and their ability to combat internet fraud are crucial to maintaining our banking applications and processes and to protecting the HSBC brand.

Potential impact on HSBC

These risks give rise to potential financial loss and reputational damage which could adversely affect customer and investor confidence. Loss of customer data would also result in regulatory breaches which would result in fines and penalties being incurred.

We have invested significantly in addressing this risk through increased training to raise staff awareness of the requirements, enhanced controls around data access and heightened monitoring of information flows.

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Credit risk

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Credit risk is the risk of financial loss if a customer or counterparty fails to meet a payment obligation under a contract. It arises principally from direct lending, trade finance and leasing business, but also from off-balance sheet products such as guarantees and derivatives, and from the Group s holdings of debt and other securities. Credit risk generates the largest regulatory capital requirement of the risks we incur.

Total gross loans and advances decreased by 2% to US$1,139bn reflecting the reclassification of assets to held for sale.

Balance sheet exposure to the sovereign and agency debt of Greece, Ireland, Italy, Portugal and Spain was US$4.7bn at 31 December 2011.

We have amended our presentation of impaired loans as described on page 133. Other than that, there were no material changes to our policies and practices for the management of credit risk in 2011.

A summary of our current policies and practices regarding credit risk is provided in the Appendix to Risk on page 188.

Credit risk in 2011

(Unaudited)

Exposure, impairment allowances and charges

(Audited)

	2011 US$bn	2010 US$bn
At 31 December		
Total gross loans and advances (A)	**1,139.1**	1,186.9
Impairment allowances	**17.6**	20.2
as a percentage of A	**1.55%**	1.70%
Year ended 31 December		
Impairment charges[1]	**11.5**	13.5

For footnote, see page 185.

Loan impairment charges and other credit risk provisions

(Audited)

	2011 US$m	2010 US$m
At 31 December	**12,127**	14,039
	%	%
Personal	**77**	80
Corporate and commercial	**17**	16
Financial	**1**	1
Impairment of available-for-sale debt securities	**5**	3
of which: Greek Government	**2**	
	100	100

In 2011, loans and advances to customers continued to represent the Group s most significant exposure to credit risk. At 31 December 2011, total gross loans and advances were US$1,139bn, a decrease of 2% on a constant currency basis compared with 31 December 2010. The decline reflected the reclassification to assets held for sale of balances relating to the pending sale of our US Card and Retail Services business and 195 branches in upstate New York. For further detail on assets held for sale see page 105.

During 2011, we reduced our exposure to sovereigns and banks in the peripheral European countries. We also reduced our exposure to risk from sovereign and financial institution counterparty positions across the broader eurozone and from specific financial institutions in other countries. At 31 December 2011, our on-balance sheet exposure to the sovereign and agency debt of Greece, Ireland, Italy, Portugal and Spain was US$4.7bn. In 2011, we recognised an impairment charge of US$212m in respect of Greek sovereign and agency exposures classified as available for sale. Our sovereign exposures to Ireland, Italy, Portugal, and Spain are not considered to be impaired at 31 December 2011.

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On a constant currency basis, our personal lending book was US$394bn, 6% lower than at 31 December 2010 following the reclassification referred to above. Excluding the reclassification, total personal lending grew, primarily in the UK due to growth in mortgage balances, driven by successful marketing campaigns, and also in Hong Kong, as we continued to provide competitive mortgage products for our customers, partly offset by the continued run-off of the CML portfolio in the US.

At US$279bn, residential mortgage lending continued to comprise the Group s largest concentration in a single exposure type at 31 December 2011. The Group s most significant exposure to mortgage lending was in the UK, the US and Hong Kong. Our UK mortgage portfolio remained of high quality with an average loan to value (LTV) ratio for new business of 53%, while in Hong Kong the average LTV ratio on new mortgage originations was 49%. The average LTV ratio of our mortgage books in the UK and Hong Kong remained low at 52% and 37%, respectively.

The Group s exposure to personal lending in the US remained significant. At 31 December 2011, total personal lending balances were US$67bn, a decline of 39% compared with 31 December 2010, largely due to the reclassification of certain lending balances to held for sale. In 2011, we continued to make progress in running off the CML portfolio as balances declined by 15% to US$49.5bn. The rate at which balances declined during 2011 was slowed by the industry-wide examination of foreclosure practices.

In dollar terms, lending balances that were two months or more delinquent in the CML portfolio decreased modestly in 2011 reflecting the continued run-off, partly offset by the temporary suspension of foreclosure activities. In our held-for-sale Card and Retail Services portfolio, two months or more delinquency rates improved as the credit quality of the overall portfolio improved.

In 2011, we conducted a review of loan portfolios with significant levels of forbearance. The review resulted in no significant change in our loan impairment allowances, though we amended our presentation of impaired loans to provide more relevant information on the effects of forbearance on the credit risk of loans and advances (see page 133). Our balance of impaired loans increased significantly under the revised presentation, reducing the ratio of total impairment allowances to impaired loans. On a restated basis, this ratio was 42.3% (2010: 43% instead of 71.6% under the previous presentation).

Reclassification to assets held for sale

During 2011, the decline in gross loans and advances was partly due to a reclassification of certain lending balances to assets held for sale. Disclosures relating to assets held for sale are provided in certain credit risk management tables, primarily where the disclosure is relevant to the measurement of these financial assets, as follows:

- Maximum exposure to credit risk (page 107);
- Distribution of financial instruments by credit quality (page 127); and
- Ageing analysis of days past due but not impaired gross financial instruments (page 129).

Although gross loans and advances and related impairment allowances are reclassified from Loans and advances to customers and Loans and advances to banks in the balance sheet, there is no equivalent income statement reclassification. As a result, charges for loan impairment losses shown in the credit risk disclosures include loan impairment charges relating to financial assets classified as assets held for sale.

The table below presents Loans and advances to customers and Loans and advances to banks as reported, and those classified as held for sale:

Reported and held-for-sale loans

	At 31 December 2011	
	Total gross loans and advances US$m	Impairment allowances on loans and advances US$m
As reported	1,139,052	17,636
Assets held for sale	37,273	1,614
Total reported and held for sale	1,176,325	19,250

2010 comparative data have not been separately presented for the credit risk management disclosures as the amounts are insignificant.

Credit exposure

Maximum exposure to credit risk

(Audited)

Our credit exposure is spread across a broad range of asset classes, including derivatives, trading assets, loans and advances to customers, loans and advances to banks and financial investments.

In 2011, our exposure to credit risk remained well diversified across asset classes. During the year, we reduced our exposure to the peripheral eurozone countries and to countries across the broader European economic area, in particular by

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transferring our excess liquidity away from sovereign and bank-issued debt securities and from money market placements with banks to placements with central banks in the most highly-rated countries. Despite this, we increased our overall exposure to credit risk in 2011.

Maximum exposure to credit risk table (page 107)

The table presents our maximum exposure to credit risk from balance sheet and off-balance sheet financial instruments before taking account of any collateral held or other credit enhancements (unless such enhancements meet accounting offsetting requirements). For financial assets recognised on the balance sheet, the maximum exposure to credit risk equals their carrying amount; for financial guarantees and similar contracts granted, it is the maximum amount that we would have to pay if the guarantees were called upon. For loan commitments and other credit-related commitments that are irrevocable over the life of the respective facilities, it is generally the full amount of the committed facilities.

Loans and advances to customers represent our largest exposure to credit risk; however, this balance reduced at the end of 2011, compared with the end of 2010 as certain lending balances were reclassified as Assets held for sale . We were able to successfully grow our residential mortgage portfolios in many other markets, notably in Hong Kong and the UK where credit quality remained high and LTV ratios were low.

Our exposure to loans and advances to banks decreased in 2011, mainly in Europe as funds from maturing term loans and reverse repo balances were redeployed to Cash and balances at central banks . This was offset in part by higher central bank lending in Rest of Asia-Pacific, reflecting strong deposit growth in the region. Our net exposure to loans and advances to banks also decreased.

The loans and advances offset adjustment primarily relates to customer loans and deposits and balances arising from repo and reverse repo transactions. The offset relates to balances where there is a legally enforceable right of offset in the event of counterparty default and where, as a result, there is a net exposure for credit risk management purposes. However, as there is no intention to settle these balances on a net basis under normal circumstances, they do not qualify for net presentation for accounting purposes.

We increased our exposure to cash and balances at central banks in 2011, as discussed above,

reflecting the placement of excess liquidity with central banks in Europe and North America.

Our exposure to derivatives increased in 2011, mainly in Europe reflecting an increase in the fair value of interest rate contracts. This was compounded by an increase in the notional value of outstanding contracts, partly offset by higher netting which rose in line with the increase in fair values. Despite the increase in maximum exposure, our net exposure to derivatives in 2011 decreased due to a rise in the derivative offset.

The derivative offset amount in the table on page 107 relates to exposures where the counterparty has an offsetting derivative exposure with HSBC, a master netting arrangement is in place and the credit risk exposure is managed on a net basis or the position is specifically collateralised, normally in the form of cash. At 31 December 2011, the total amount of such offsets was US$306bn (2010: US$198bn), of which US$272bn (2010: US$178bn) were offsets under a master netting arrangement, US$33.0bn (2010: US$19.1bn) were collateral received in cash and US$0.7bn (2010: US$0.2bn) were other collateral. These amounts do not qualify for net presentation for accounting purposes as settlement may not actually be made on a net basis.

During 2011, we decreased our exposure to trading assets. This reflected a reduction in our holdings of government and highly-rated corporate debt securities and equity positions, notably in Europe. In addition, our reverse repo exposure declined in North America as we did not replace maturities.

In 2011, our loss experience continued to be dominated by the personal lending portfolios, with some 77% of our loan impairment charges related to this lending category of which 56% was related to US personal lending. This compared with 80% in 2010, of which 57% was related to US personal lending.

While not considered as offset in the table below, other arrangements including short positions in securities and financial assets held as part of linked insurance/investment contracts where the risk is predominately borne by the policyholder, reduce our maximum exposure to credit risk. In addition, we hold collateral in respect of individual loans and advances (see page 144).

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Maximum exposure to credit risk

(Audited)

	At 31 December 2011			At 31 December 2010		
	Maximum exposure	Offset	Exposure to credit risk (net)	Maximum exposure	Offset	Exposure to credit risk (net)
	US$m	US$m	US$m	US$m	US$m	US$m
Cash and balances at central banks	**129,902**		**129,902**	57,383		57,383
Items in the course of collection from other banks	**8,208**		**8,208**	6,072		6,072
Hong Kong Government certificates of indebtedness	**20,922**		**20,922**	19,057		19,057
Trading assets	**309,449**	**(4,656)**	**304,793**	343,966	(4,189)	339,777
Treasury and other eligible bills	**34,309**		**34,309**	25,620		25,620
Debt securities	**130,487**		**130,487**	168,268		168,268
Loans and advances to banks	**75,525**		**75,525**	70,456		70,456
Loans and advances to customers	**69,128**	**(4,656)**	**64,472**	79,622	(4,189)	75,433
Financial assets designated at fair value	**12,926**		**12,926**	19,593		19,593
Treasury and other eligible bills	**123**		**123**	159		159
Debt securities	**11,834**		**11,834**	18,248		18,248
Loans and advances to banks	**119**		**119**	315		315
Loans and advances to customers	**850**		**850**	871		871
Derivatives	**346,379**	**(305,616)**	**40,763**	260,757	(197,501)	63,256
Loans and advances held at amortised cost	**1,121,416**	**(87,978)**	**1,033,438**	1,166,637	(91,966)	1,074,671
to banks	**180,987**	**(3,066)**	**177,921**	208,271	(3,099)	205,172
to customers	**940,429**	**(84,912)**	**855,517**	958,366	(88,867)	869,499
Financial investments	**392,834**		**392,834**	392,772		392,772
Treasury and other similar bills	**65,223**		**65,223**	57,129		57,129
Debt securities	**327,611**		**327,611**	335,643		335,643
Assets held for sale[2]	**37,808**	**(204)**	**37,604**			
disposal groups	**37,746**	**(204)**	**37,542**			
non-current assets held for sale	**62**		**62**			
Other assets	**32,992**		**32,992**	30,371	(29)	30,342
Endorsements and acceptances	**11,010**		**11,010**	10,116	(29)	10,087
Other	**21,982**		**21,982**	20,255		20,255
Financial guarantees and similar contracts	**39,324**		**39,324**	49,436		49,436
Loan and other credit-related commitments[3]	**654,904**		**654,904**	602,513		602,513
	3,107,064	**(398,454)**	**2,708,610**	2,948,557	(293,685)	2,654,872

For footnotes, see page 185.

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Report of the Directors: Operating and Financial Review (continued)

Concentration of exposure

Concentrations of credit risk are described in the Appendix to Risk on page 188.

Securities held for trading

(Unaudited)

Total securities held for trading within trading assets were US$186bn at 31 December 2011 (2010: US$235bn). The largest concentration of these assets was to government and government agency debt securities. A detailed analysis of securities held for trading is provided in Note 15 on the Financial Statements and an analysis of credit quality on page 127.

Debt securities, treasury and other eligible bills

(Unaudited)

Our holdings of corporate debt, ABSs and other securities were spread across a wide range of issuers and geographical regions, with 17% invested in securities issued by banks and other financial institutions. A detailed analysis of financial investments is provided in Note 21 on the Financial Statements and an analysis by credit quality on page 127.

At 31 December 2011, our insurance businesses held diversified portfolios of debt and equity securities designated at fair value of US$28.9bn (2010: US$28.3bn) and debt securities classified as financial investments of US$40.1bn (2010: US$38.5bn). For an analysis of securities held by the insurance businesses, see page 178.

Derivatives

(Unaudited)

Derivative assets were US$346bn at 31 December 2011 (2010: US$261bn), of which the largest concentrations were interest rate and foreign exchange derivatives. For an analysis of derivatives, see Note 20 on the Financial Statements.

Loans and advances

(Unaudited)

On a reported basis, gross loans and advances to customers (excluding the financial sector) at 31 December 2011 were US$872bn, a decrease of US$5.0bn or 1% from 31 December 2010.

Summary of gross loans and advances to customers

(Unaudited)

The following commentary is on a constant currency basis:

Personal lending balances of US$394bn in 2011 were 6% lower than at 31 December 2010 following the reclassification of balances to held for sale, and the continued run-off of the CML portfolio, partly offset by growth in residential mortgage lending in the UK and Hong Kong. For more information on Personal lending, see Areas of special interest personal lending on page 119.

Corporate and commercial lending was 49% of gross lending to customers at 31 December 2011, representing our largest lending category. International trade and services was the biggest portion of this category, increasing by 6% compared with 31 December 2010 following economic growth, particularly in Asia. Commercial real estate lending, which represented 8% of total gross lending to customers, increased by 4% in 2011, as the demand for funds in property investment and development remained strong in Hong Kong and certain countries in the Rest of Asia-Pacific region.

In the financial category, our largest exposure was to non-bank financial institutions which decreased by 13% to US$85.3bn; this was mainly in North America and related to lower reverse repos as we increased our placements of excess liquidity with central banks.

Loans and advances to banks were widely distributed across many countries in 2011 and decreased by 11% as funds from maturing term loans and reverse repo balances were redeployed into central banks, mainly in Europe.

The following tables analyse loans by industry sector and by the location of the principal operations of the lending subsidiary or, in the case of the operations of The Hongkong and Shanghai Banking Corporation, HSBC Bank, HSBC Bank Middle East and HSBC Bank USA, by the location of the lending branch.

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Gross loans and advances by industry sector

(Audited)

	2011 US$m	Currency effect US$m	Move-ment US$m	2010 US$m	2009 US$m	2008 US$m	2007 US$m
Personal	**393,625**	**(4,735)**	**(26,960)**	425,320	434,206	440,227	500,834
Residential mortgages[4]	**278,963**	**(1,825)**	**12,107**	268,681	260,669	243,337	269,068
Other personal[5]	**114,662**	**(2,910)**	**(39,067)**	156,639	173,537	196,890	231,766
Corporate and commercial	**472,816**	**(6,329)**	**33,633**	445,512	383,090	407,474	400,771
Manufacturing[6]	**96,054**	**(1,765)**	**6,698**	91,121	80,487	81,103	72,895
International trade and services[6]	**152,709**	**(2,074)**	**8,210**	146,573	115,641	128,737	129,143
Commercial real estate	**73,941**	**(598)**	**2,659**	71,880	69,389	70,969	72,345
Other property-related	**39,539**	**(245)**	**4,946**	34,838	30,520	30,739	33,907
Government	**11,079**	**(258)**	**2,743**	8,594	6,689	6,544	5,708
Other commercial[7]	**99,494**	**(1,389)**	**8,377**	92,506	80,364	89,382	86,773
Financial	**86,219**	**(1,874)**	**(13,632)**	101,725	96,650	101,085	99,148
Non-bank financial institutions	**85,275**	**(1,818)**	**(13,070)**	100,163	95,237	99,536	96,781
Settlement accounts	**944**	**(56)**	**(562)**	1,562	1,413	1,549	2,367
Asset-backed securities reclassified	**5,280**	**(14)**	**(598)**	5,892	7,827	7,991	
Total gross loans and advances to customers (TGLAC)	**957,940**	**(12,952)**	**(7,557)**	978,449	921,773	956,777	1,000,753
Gross loans and advances to banks	**181,112**	**(5,669)**	**(21,648)**	208,429	179,888	153,829	237,373
Total gross loans and advances	**1,139,052**	**(18,621)**	**(29,205)**	1,186,878	1,101,661	1,110,606	1,238,126
Impaired loans and advances to customers[8]	**41,584**	**(575)**	**(4,712)**	46,871	30,606	25,352	19,582
as a percentage of TGLAC	**4.3%**			4.8%	3.3%	2.6%	2.0%
Impairment allowances on loans and advances to customers	**17,511**	**(396)**	**(2,176)**	20,083	25,542	23,909	19,205
as a percentage of TGLAC	**1.8%**			2.1%	2.8%	2.5%	1.9%
Charge for impairment losses	**11,505**	**185**	**(2,228)**	13,548	24,942	24,131	17,177
New allowances net of allowance releases	**12,931**	**210**	**(1,847)**	14,568	25,832	24,965	18,182
Recoveries	**(1,426)**	**(25)**	**(381)**	(1,020)	(890)	(834)	(1,005)

For footnotes, see page 185.

Movements in the above table attributed to the reclassification of certain loans and advances to held for sale were: US$33.2bn of other personal lending, US$1.3bn of residential mortgages, US$1.3bn of

manufacturing international trade and services, and US$0.4bn of commercial real estate, US$0.5bn of loans and advances to banks and US$0.6bn related to other industry sectors.

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Gross loans and advances to customers by industry sector and by geographical region

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m	As a % of total gross loans
At 31 December 2011								
Personal	**166,147**	**63,181**	**43,580**	**5,269**	**95,336**	**20,112**	**393,625**	**41.1**
Residential mortgages[4]	**119,902**	**46,817**	**32,136**	**1,837**	**73,278**	**4,993**	**278,963**	**29.1**
Other personal[5]	**46,245**	**16,364**	**11,444**	**3,432**	**22,058**	**15,119**	**114,662**	**12.0**
Corporate and commercial	**204,984**	**91,592**	**77,887**	**21,152**	**41,271**	**35,930**	**472,816**	**49.3**
Manufacturing[6]	**45,632**	**9,004**	**16,909**	**3,517**	**7,888**	**13,104**	**96,054**	**10.0**
International trade and services[6]	**64,604**	**29,066**	**29,605**	**8,664**	**10,710**	**10,060**	**152,709**	**15.9**
Commercial real estate	**32,099**	**20,828**	**9,537**	**1,002**	**7,069**	**3,406**	**73,941**	**7.7**
Other property-related	**7,595**	**17,367**	**6,396**	**1,770**	**5,729**	**682**	**39,539**	**4.1**
Government	**3,143**	**2,918**	**962**	**1,563**	**656**	**1,837**	**11,079**	**1.2**
Other commercial[7]	**51,911**	**12,409**	**14,478**	**4,636**	**9,219**	**6,841**	**99,494**	**10.4**
Financial	**63,671**	**3,473**	**3,183**	**1,168**	**12,817**	**1,907**	**86,219**	**9.0**
Non-bank financial institutions	**63,313**	**3,192**	**2,937**	**1,162**	**12,817**	**1,854**	**85,275**	**8.9**
Settlement accounts	**358**	**281**	**246**	**6**		**53**	**944**	**0.1**
Asset-backed securities reclassified	**4,776**				**504**		**5,280**	**0.6**
TGLAC	**439,578**	**158,246**	**124,650**	**27,589**	**149,928**	**57,949**	**957,940**	**100.0**
Percentage of TGLAC by geographical region	**45.9%**	**16.5%**	**13.0%**	**2.9%**	**15.7%**	**6.0%**	**100.0%**	
Impaired loans[8]	**11,751**	**604**	**1,069**	**2,425**	**22,696**	**3,039**	**41,584**	
as a percentage of TGLAC	**2.7%**	**0.4%**	**0.9%**	**8.8%**	**15.1%**	**5.2%**	**4.3%**	
Total impairment allowances	**5,242**	**581**	**782**	**1,714**	**7,181**	**2,011**	**17,511**	
as a percentage of TGLAC	**1.2%**	**0.4%**	**0.6%**	**6.2%**	**4.8%**	**3.5%**	**1.8%**	
At 31 December 2010								
Personal	161,717	57,308	40,184	5,371	139,117	21,623	425,320	43.4
Residential mortgages[4]	111,618	42,488	28,724	1,751	78,842	5,258	268,681	27.4
Other personal[5]	50,099	14,820	11,460	3,620	60,275	16,365	156,639	16.0
Corporate and commercial	203,804	80,823	67,247	19,560	38,707	35,371	445,512	45.6
Manufacturing[6]	46,890	8,171	15,050	3,074	5,748	12,188	91,121	9.3
International trade and services[6]	65,090	25,280	26,224	8,099	10,989	10,891	146,573	15.0
Commercial real estate	30,629	19,678	8,732	1,085	8,768	2,988	71,880	7.3
Other property-related	6,401	15,232	5,426	1,785	5,109	885	34,838	3.6
Government	2,289	2,339	415	1,345	89	2,117	8,594	0.9
Other commercial[7]	52,505	10,123	11,400	4,172	8,004	6,302	92,506	9.5
Financial	70,725	3,189	2,259	1,347	21,202	3,003	101,725	10.4

Non-bank financial institutions	70,019	2,824	2,058	1,335	21,109	2,818	100,163	10.2
Settlement accounts	706	365	201	12	93	185	1,562	0.2
Asset-backed securities reclassified	5,216				676		5,892	0.6
TGLAC	441,462	141,320	109,690	26,278	199,702	59,997	978,449	100.0
Percentage of TGLAC by geographical region	45.2%	14.4%	11.2%	2.7%	20.4%	6.1%	100.0%	
Impaired loans[8]	11,394	660	1,324	2,529	27,840	3,124	46,871	
as a percentage of TGLAC	2.6%	0.5%	1.2%	9.6%	13.9%	5.2%	4.8%	
Total impairment allowances	5,663	629	959	1,652	9,170	2,010	20,083	
as a percentage of TGLAC	1.3%	0.4%	0.9%	6.3%	4.6%	3.4%	2.1%	

For footnotes, see page 185.

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Report of the Directors: Operating and Financial Review (continued)

Loans and advances to banks by geographical region

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Loans and advances to banks US$m	Impairment allowances US$m
At 31 December 2011[9]	**54,406**	**35,159**	**47,309**	**8,571**	**14,831**	**20,836**	**181,112**	**(125)**
At 31 December 2010[10]	78,239	33,585	40,437	9,335	19,479	27,354	208,429	(158)
At 31 December 2009	65,614	36,197	35,648	8,435	15,386	18,608	179,888	(107)
At 31 December 2008	62,012	29,646	28,665	7,476	11,458	14,572	153,829	(63)
At 31 December 2007	104,534	63,737	32,373	7,488	16,566	12,675	237,373	(7)

For footnote, see page 185.

Gross loans and advances to customers by country

(Audited)

	Residential mortgages US$m	Other personal US$m	Property-related US$m	Commercial, international trade and other US$m	Total US$m
At 31 December 2011					
Europe	**119,902**	**46,245**	**39,694**	**233,737**	**439,578**
UK	**111,224**	**22,218**	**29,191**	**160,236**	**322,869**
France	**3,353**	**9,305**	**8,160**	**49,572**	**70,390**
Germany	**10**	**343**	**112**	**4,518**	**4,983**
Malta	**1,708**	**567**	**520**	**1,591**	**4,386**
Switzerland	**1,803**	**10,684**	**156**	**1,918**	**14,561**
Turkey	**767**	**2,797**	**255**	**3,652**	**7,471**
Other	**1,037**	**331**	**1,300**	**12,250**	**14,918**
Hong Kong	**46,817**	**16,364**	**38,195**	**56,870**	**158,246**
Rest of Asia-Pacific	**32,136**	**11,444**	**15,933**	**65,137**	**124,650**
Australia	**9,251**	**1,327**	**2,357**	**6,073**	**19,008**
India	**830**	**461**	**809**	**3,914**	**6,014**
Indonesia	**81**	**463**	**97**	**4,577**	**5,218**
Mainland China	**2,769**	**317**	**5,078**	**15,665**	**23,829**
Malaysia	**4,329**	**2,166**	**1,351**	**5,898**	**13,744**
Singapore	**7,919**	**4,108**	**3,690**	**9,433**	**25,150**
Taiwan	**3,062**	**550**	**139**	**4,555**	**8,306**
Vietnam	**42**	**184**	**42**	**1,397**	**1,665**

Other	**3,853**	**1,868**	**2,370**	**13,625**	**21,716**
Middle East and North Africa (excluding Saudi Arabia)	**1,837**	**3,432**	**2,772**	**19,548**	**27,589**
Egypt	**2**	**441**	**100**	**2,775**	**3,318**
Qatar	**9**	**445**	**354**	**1,098**	**1,906**
UAE	**1,520**	**1,882**	**1,464**	**12,070**	**16,936**
Other	**306**	**664**	**854**	**3,605**	**5,429**
North America	**73,278**	**22,058**	**12,798**	**41,794**	**149,928**
US	**52,484**	**14,087**	**7,850**	**27,307**	**101,728**
Canada	**19,045**	**7,518**	**4,391**	**13,600**	**44,554**
Bermuda	**1,749**	**453**	**557**	**887**	**3,646**
Latin America	**4,993**	**15,119**	**4,088**	**33,749**	**57,949**
Argentina	**32**	**1,379**	**114**	**2,331**	**3,856**
Brazil	**1,657**	**9,802**	**1,660**	**18,638**	**31,757**
Mexico	**1,847**	**2,261**	**1,284**	**8,210**	**13,602**
Panama	**1,240**	**1,014**	**923**	**2,537**	**5,714**
Other	**217**	**663**	**107**	**2,033**	**3,020**
Total	**278,963**	**114,662**	**113,480**	**450,835**	**957,940**

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Gross loans and advances to customers by country (continued)

	Residential mortgages US$m	Other personal US$m	Property-related US$m	Commercial, international trade and other US$m	Total US$m
At 31 December 2010					
Europe	111,618	50,099	37,030	242,715	441,462
UK	103,037	25,636	26,002	165,283	319,958
France	3,749	9,550	8,737	56,613	78,649
Germany	11	356	79	4,015	4,461
Malta	1,656	599	563	1,643	4,461
Switzerland	1,358	10,708	114	1,837	14,017
Turkey	809	2,817	210	2,783	6,619
Other	998	433	1,325	10,541	13,297
Hong Kong	42,488	14,820	34,910	49,102	141,320
Rest of Asia-Pacific	28,724	11,460	14,158	55,348	109,690
Australia	8,405	1,267	2,346	4,867	16,885
India	920	526	680	4,583	6,709
Indonesia	74	531	115	3,374	4,094
Mainland China	2,046	310	3,836	12,932	19,124
Malaysia	3,833	2,053	1,361	4,845	12,092
Singapore	6,571	3,661	3,262	7,846	21,340
Taiwan	3,002	527	135	2,832	6,496
Vietnam	35	162	59	1,255	1,511
Other	3,838	2,423	2,364	12,814	21,439
Middle East and North Africa (excluding Saudi Arabia)	1,751	3,620	2,870	18,037	26,278
Egypt	3	396	111	2,484	2,994
Qatar	8	491	404	918	1,821
UAE	1,477	2,099	1,359	11,043	15,978
Other	263	634	996	3,592	5,485
North America	78,842	60,275	13,877	46,708	199,702
US	57,630	51,686	8,269	31,496	149,081
Canada	19,505	8,070	5,079	14,711	47,365
Bermuda	1,707	519	529	501	3,256
Latin America	5,258	16,365	3,873	34,501	59,997
Argentina	30	918	103	2,172	3,223
Brazil	1,111	10,979	1,816	17,093	30,999
Mexico	2,097	2,365	1,146	8,622	14,230
Panama	1,155	982	489	3,794	6,420
Other	865	1,121	319	2,820	5,125
Total	268,681	156,639	106,718	446,411	978,449

Areas of special interest

Wholesale lending

(Unaudited)

Wholesale lending covers the range of credit facilities granted to sovereign borrowers, banks, non-bank financial institutions, corporate entities and commercial borrowers. Our wholesale portfolios are well diversified across geographical and industry sectors, with certain exposures subject to specific portfolio controls.

During the year, we continued to reduce our sovereign and financial institution counterparty credit risk positions in peripheral eurozone countries. We also reduced our exposure to risk from financial institution counterparty positions

across the broader eurozone and from specific financial institutions in other countries. This process was particularly focused on our surplus liquidity, which resulted in significant placements directly with central banks in the most highly rated countries.

We actively sought to identify those counterparties domiciled in core European countries that had exposures to sovereigns and/or banks in peripheral eurozone countries of sufficient size to threaten their on-going viability in the event of an unfavourable conclusion to the current crisis.

This was undertaken through the analysis of publicly available information, reviews of external analyst reports and meetings with the counterparties

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officials. This process enabled us to form a view of the credit standing and the level of exposure that the counterparties have to peripheral eurozone sovereigns and banks. The majority of these counterparties are located in France, Germany and the Netherlands, where the exposures are disclosed in aggregate below. Vulnerable counterparties were identified, subject to enhanced monitoring and our exposure was managed in a way similar to the monitoring and management of direct exposures to the peripheral eurozone countries.

The overall quality of the portfolio was strong with most in-country and cross-border limits extended to countries with high-grade internal credit risk ratings. We regularly update our assessment of higher risk countries and adjust our risk appetite accordingly.

Exposures to countries in the eurozone

(Unaudited)

2011 was a turbulent year for the global markets, dominated by the continuing eurozone debt crisis that started with the global financial crisis in 2007 and, by 2011, had developed into a severe sovereign debt crisis. The measures taken by governments during that period to avoid a financial collapse resulted in higher debt levels, large fiscal deficits and, in certain cases, social and political disruption. During 2011, a number of eurozone countries came under severe financial pressure and their ability to raise, refinance and service their debt was put into question by markets, as demonstrated by the record high spreads during most of the year. Greece, Ireland and Portugal were forced to seek support packages from the European Central Bank (ECB) and the International Monetary Fund (IMF) under strict conditions, while fear of contagion to other eurozone countries forced governments to reduce debt levels through austerity measures that, at least in the short term, were seen as the cause of slow growth for some countries and stagnation in others.

Despite a number of high profile summits and meetings the EU was unable to agree and implement a strong coherent policy response to the crisis, prompting fear of default or the exit from the euro of one or more members. Under pressure during most of 2011, EU members showed an increasing willingness to agree a structured common approach, but they also demonstrated divergent opinions on the way forward and on the measures to be taken. This resulted in the three major rating agencies either downgrading, or putting on the watch list for possible downgrade, a number of sovereigns which intensified the pressure, even on the stronger eurozone countries.

The ongoing sovereign debt crisis, slow economic growth, dearth of market financing for banks and private sector deleveraging severely affected the eurozone financial system, increasing the possibility of further banking stress in the region. The banking sector within the peripheral eurozone countries was particularly under threat as the credit risk of domestic and cross-border exposures increased significantly. This prompted calls from the European Banking Authority (EBA) and the IMF for funding and liquidity support and/or the recapitalisation of certain European banks.

The ratings downgrade of a number of eurozone countries by major rating agencies in 2011 and January 2012 was generally anticipated and was, in most cases, not as large as feared, with the exception of Portugal which is now rated below investment grade. The downgrades are likely to have implications for the ratings of European banks and government guaranteed securities, as evidenced by the downgrade of the European Financial Stability Fund (EFSF).

We continue to closely monitor events and have stress-tested our capital position for potential scenarios.

The tables below summarise our exposures to selected eurozone countries, including:

- governments and central banks of selected eurozone countries along with near/quasi government agencies;

banks; and

other financial institutions and other corporates.

Exposures to banks, other financial institutions and other corporates are based on the country of domicile of the counterparty.

The following analysis of our exposures to selected European countries is made voluntarily to reflect developments in best practice disclosure. Whilst certain analysis is subject to audit and incorporated into the Group s risk management disclosure, it is not required for the purposes of compliance with IFRSs.

Basis of preparation

(Audited)

The countries presented were selected as they exhibited levels of market volatility during 2011 which exceeded other eurozone countries and demonstrated fiscal or political uncertainty. Certain of these countries also have high sovereign debt to GDP ratios and a short to medium-term maturity concentration of those liabilities.

Report of the Directors: Operating and Financial Review (continued)

The eurozone disclosure includes information about our exposures to France, Germany and the Netherlands as these countries are seen to have considerable exposure to the sovereign debt of the peripheral eurozone countries. In addition, these are countries where our total direct exposure is greater than 5% of the Group s equity at 31 December 2011. An analysis of loans and advances to customers by significant countries is provided on page 111.

The on-balance sheet exposures disclosed in the exposure tables below are presented based on the appropriate IFRSs classification. Trading assets are net of short positions as the fair value of the short positions reference the fair value of the trading assets. Derivative assets are shown gross and net of collateral and derivative liabilities that reduce the overall risk exposure.

Credit default swaps and off-balance sheet exposures

(Unaudited)

The Group purchased CDS protection on certain of its holdings of Greek government bonds. The net fair value of these CDS was US$0.5bn, and the net notional value was US$0.8bn as at 31 December 2011. The CDS were transacted with banks with investment grade credit ratings, and would pay out

in the event of default and certain other credit events. There is no significant mismatch between the maturity of the Greek government bonds and the CDS protection. Other CDS contracts disclosed in the tables below were principally entered into for customer facilitation. These CDSs are mainly entered into with banks and financial institutions where their terms are typically drawn up in accordance with the guidance set out in the 2003 ISDA Credit Derivatives Definitions and the July 2009 Supplement. The credit events that trigger the payout of CDSs may differ as they are based on the terms of each agreement between the counterparties. Such credit events normally include bankruptcy, payment default on a reference asset or assets, restructuring and repudiation or moratoria.

Off-balance sheet exposures mainly relate to commitments to lend and the amount shown in the tables represents the maximum amount that could be drawn down by the counterparty. In some instances, limitations are imposed on a counterparty s ability to draw down on a facility. These limitations are governed by the legal documentation, which differs from counterparty to counterparty. In the majority of cases, we are bound to fulfil commitments made to third parties.

Summary on-balance sheet exposures to peripheral eurozone countries

(Unaudited)

	Greece US$bn	Ireland US$bn	Italy US$bn	Portugal US$bn	Spain US$bn	Total US$bn
At 31 December 2011						
Sovereign and agencies	0.4	0.3	2.3	0.5	1.2	4.7
Banks	0.7	1.9	2.0	0.5	3.1	8.2
Other financial institutions and corporate	3.9	3.2	2.6	0.1	6.0	15.8
Personal	1.0					1.0
	6.0	5.4	6.9	1.1	10.3	29.7

Eurozone sovereigns and agencies

(Unaudited)

During 2011, Portugal joined Greece and Ireland in the list of the eurozone countries requiring rescue packages to remain solvent. Greece required a second support package, which was formalised as EU leaders announced a three-year programme totalling 109bn (US$155bn). In addition, the EFSF rules were changed to allow it to buy bonds on the secondary market, finance the recapitalisation of banks and provide pre-emptive credit lines to eurozone countries under pressure in debt markets. The announcement of the second package was followed by months of negotiations between the parties to determine its details. Final agreement was eventually reached in February 2012 ahead of the March 2012 deadline for the euro bond payment of 14.5bn (US$19bn) by the Greek government, calming fears of a disorderly default. The total

support package has increased to 130bn (US$172bn) and includes debt swap arrangements, direct support by ECB and an additional haircut by private debt holders.

In 2012, we forecast that the eurozone will continue to experience slow growth or possibly recession, with unemployment reaching record high levels and households continuing to reduce debt. We expect that the ECB, along with countries in the eurozone, will continue to focus on resolving intra-eurozone imbalances, rebuilding public finances, improving fiscal discipline, strengthening the banking system and managing cross-border risk. Concerns of contagion of the debt crisis in Greece, Ireland and Portugal to other countries, notably Italy and Spain, are likely to persist, causing the risk premium on most European countries sovereign debt to remain high. The German economy has demonstrated positive signs of stability and has

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experienced positive growth during the year and, although it has shown modest growth, the French economy is expected to stay resilient should the crisis spread to other eurozone countries.

At 31 December 2011, our exposure to the sovereign and agency debt of Greece, Ireland, Italy, Portugal and Spain was US$4.7bn, US$2.2bn lower than at the end of 2010. Of the total financial investments available for sale in these countries, approximately 46% mature within one year, 21% between one and three years and 33% in excess of three years.

At 31 December 2011, our exposure to the sovereign and agency debt of Germany, France and the Netherlands was US$87bn. Of the total financial investments available for sale in these countries, approximately 26% mature within one year, 28% between one and three years and 46% in excess of three years. Our exposure in the Netherlands predominantly comprises cash placements with the Dutch Central Bank, which in turn are put in to the euro clearing system (Target 2) managed by ECB.

Our exposure in Germany and France is commensurate to the size of our operations and is well diversified across sectors and products.

During 2011, an impairment charge of US$212m was recognised in respect of Greek sovereign and agency exposures classified as available for sale, reflecting the further deterioration in Greece s fiscal position and the expected effect of the range of recently announced support measures. The amount of the impairment charge represented the cumulative fair value loss on these securities as at the end of 2011, and does not necessarily represent the expectation of future cash losses. The impairment charge was transferred from the available-for-sale reserve to the income statement. Our sovereign exposures to Ireland, Italy, Portugal and Spain were not considered to be impaired at 31 December 2011 because, despite financial difficulties in these countries, the situation is not severe enough to conclude that loss events have occurred which will have an impact on the future cash flows of these countries sovereign securities.

Exposures to peripheral eurozone countries sovereigns and agencies

(Audited)

	Greece US$bn	Ireland US$bn	Italy US$bn	Portugal US$bn	Spain US$bn	Total US$bn
At 31 December 2011						
Cash and balances at central banks					**0.1**	**0.1**
Financial investments held to maturity			**0.1**			**0.1**
fair value			**0.1**			**0.1**
Financial investments available for sale[11]	**0.1**	**0.1**	**0.8**	**0.1**	**0.9**	**2.0**
cumulative impairment	**0.2**					**0.2**
amortised cost		**0.1**	**0.8**	**0.1**	**0.9**	**1.9**
Net trading assets	**0.3**	**0.2**	**1.4**	**0.4**	**0.1**	**2.4**
gross trading assets	**0.4**	**0.3**	**8.3**	**0.6**	**1.8**	**11.4**
short positions	**(0.1)**	**(0.1)**	**(6.9)**	**(0.2)**	**(1.7)**	**(9.0)**
Derivatives[12]					**0.1**	**0.1**
gross derivative assets		**0.3**	**0.7**	**0.3**	**0.2**	**1.5**
collateral and derivative liabilities		**(0.3)**	**(0.7)**	**(0.3)**	**(0.1)**	**(1.4)**

Total	**0.4**	**0.3**	**2.3**	**0.5**	**1.2**	**4.7**
Of which, on-balance sheet exposures held to meet insurance liabilities		**0.1**	**0.3**	**0.1**	**0.4**	**0.9**
discretionary participatory		**0.1**	**0.3**	**0.1**	**0.4**	**0.9**
Off-balance sheet exposures					**1.0**	**1.0**
commitments					**1.0**	**1.0**
Total credit default swaps						
CDS asset positions	**1.2**	**0.2**	**0.6**	**0.4**	**0.4**	**2.8**
CDS liability positions	**(0.7)**	**(0.2)**	**(0.6)**	**(0.3)**	**(0.4)**	**(2.2)**
CDS asset notionals	**1.8**	**0.9**	**3.9**	**1.2**	**3.3**	**11.1**
CDS liability notionals	**1.0**	**0.9**	**3.8**	**1.2**	**3.5**	**10.4**

For footnotes, see page 185.

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Summary balance sheet exposures to core eurozone countries sovereigns and agencies

(Audited)

	France US$bn	Germany US$bn	The Netherlands US$bn	Total US$bn
At 31 December 2011	**27**	**20**	**40**	**87**

Eurozone banks

(Unaudited)

As a direct result of the eurozone sovereign debt crisis, economic slowdown, uncertain property markets and low credit growth, banks in the eurozone area continue to face severe stress.

During the year, banks with direct exposure to eurozone sovereigns saw their costs and access to funding deteriorate. The concern about solvency of weaker banks intensified further following the rescue of Dexia Bank Belgium and the failure of MF Global Holdings in the US, which lost access to the funding markets due to its significant exposures to eurozone sovereign debt. Market volatility and funding issues were further exacerbated due to downgrades of European banks by the major credit rating agencies, citing concerns over their ability to absorb losses due to possible sovereign debt default, reliance on volatile wholesale funding markets and a perceived weakening in government support. A crisis of confidence emerged and banks became increasingly reluctant to lend to each other through the inter-bank market, prompting the ECB to take a number of extraordinary measures to ease funding pressures in the banking system. These included two unlimited liquidity operations with a three-year maturity, the widening of eligibility criteria for collateral, assistance in providing access to liquidity for more (medium-sized) banks and lowering reserve requirements from 2% to 1%. The slowdown in the inter-bank funding market and the ECB s liquidity measures resulted in the provision of a large part of eurozone market liquidity being transferred to central banks of highly rated countries, which was a further indicator of de-risking by banks in the eurozone. These measures helped to ease the liquidity crisis in the short term, though medium-term funding challenges remain.

The measures taken by policymakers and banks to strengthen the sector have had mixed results. Banks have deleveraged by selling certain types of assets and investing in safe haven assets in a flight to quality. The EBA conducted an industry-wide stress

test exercise in July 2011 with further updates in October and December 2011. Those banks in which a capital shortfall was identified were required to submit plans to respective national regulators by 20 January 2012 and reach a minimum core tier 1 capital ratio of 9% by the end of June 2012. The total capital shortfall covering 71 large banks was calculated as 109bn (US$146bn) within the peripheral eurozone countries, with Greece, Italy, Portugal and Spain comprising 68% of the estimate.

HSBC successfully passed these stress tests with a core tier 1 ratio of 10.5% under the modelled adverse scenario, exceeding the post-stress minimum core tier 1 capital requirement of 5% used in the December 2011 update to the exercise.

We expect challenging market conditions for eurozone banks to persist for most of 2012. There are significant sovereign and bank refinancing requirements and private sector deleveraging will continue, the eurozone sovereign debt crisis will remain and growth will stay low with the risk of recession in some developed economies. In addition, the pace of a multitude of regulatory reforms and related initiatives that have been

launched and/or outlined by various policymakers will gather speed in 2012, most notably in the areas of capital, liquidity and systemic risk (Basel III, CRD IV and capital surcharges), new banking structures in the UK and revised supervisory structures.

Our exposure within the eurozone is largely to the banks in stronger countries. We continue to closely monitor and manage eurozone bank exposures in the peripheral eurozone countries, and are cautious in lending to this sector. We regularly update our assessment of higher-risk eurozone banks and adjust our risk appetite accordingly. Where possible, we also seek to play a positive role in maintaining credit and liquidity supply. We have not recognised any impairment as a result of the eurozone crisis, in respect of the exposures outlined below.

Report of the Directors: Operating and Financial Review (continued)

Exposures to peripheral eurozone countries banks

(Audited)

	Greece US$bn	Ireland US$bn	Italy US$bn	Portugal US$bn	Spain US$bn	Total US$bn
At 31 December 2011						
Loans and advances	0.1	0.1	0.5	0.3	0.2	1.2
Financial investments held to maturity		0.2	0.2			0.4
fair value		0.2	0.2			0.4
Financial investments available for sale[11]		0.4	0.3		0.4	1.1
amortised cost		0.4	0.3		0.4	1.1
Net trading assets	0.4	0.9	0.6	0.1	2.0	4.0
gross trading assets	0.4	0.9	0.6	0.1	2.4	4.4
short positions					(0.4)	(0.4)
Derivatives[12]	0.2	0.3	0.4	0.1	0.5	1.5
gross derivative assets	0.7	8.3	1.9	0.2	3.6	14.7
collateral and derivative liabilities	(0.5)	(8.0)	(1.5)	(0.1)	(3.1)	(13.2)
Total	0.7	1.9	2.0	0.5	3.1	8.2
Of which, on-balance sheet exposures held to meet insurance liabilities		0.2	0.4		0.4	1.0
discretionary participatory		0.2	0.4		0.4	1.0
Off-balance sheet exposures	0.2		0.1		0.4	0.7
guarantees and other	0.2		0.1		0.4	0.7
Total credit default swaps						
CDS asset positions			0.5	0.1	0.1	0.7
CDS liability positions			(0.5)	(0.1)	(0.1)	(0.7)
CDS asset notionals			3.5	0.6	1.5	5.6
CDS liability notionals			3.5	0.5	1.4	5.4

For footnotes, see page 185.

Summary balance sheet exposures to core eurozone countries banks

(Audited)

	France US$bn	Germany US$bn	The Netherlands US$bn	Total US$bn
At 31 December 2011	47	21	15	83

Other financial institutions and other corporates

(Unaudited)

The credit quality of other financial institutions and other corporate portfolios remains strong with no significant impairments recognised in respect of them. The portfolios largely comprise large

multinational corporates and other financial institutions with significant operations outside these countries that mitigate the risk. At 31 December 2011, our exposure to Greek shipping companies amounted to US$2.0bn. We believe the industry is less sensitive to the Greek economy as it is mainly dependent on international trade.

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Exposures to peripheral eurozone countries other financial institutions and corporates

(Audited)

	Greece US$bn	Ireland US$bn	Italy US$bn	Portugal US$bn	Spain US$bn	Total US$bn
At 31 December 2011						
Loans and advances	3.8	2.1	1.4		5.6	12.9
gross	4.0	2.1	1.4		5.7	13.2
impairment allowances	(0.2)				(0.1)	(0.3)
Financial investments available for sale[11]		0.3	0.3	0.1	0.1	0.8
available-for-sale reserve		(0.1)				(0.1)
amortised cost		0.4	0.2	0.1	0.1	0.8
Net trading assets		0.3	0.2		0.1	0.6
gross trading assets		0.3	0.2		0.2	0.7
short positions					(0.1)	(0.1)
Derivatives[12]	0.1	0.5	0.7		0.2	1.5
gross derivative assets	0.1	0.7	1.0		0.2	2.0
collateral and derivative liabilities		(0.2)	(0.3)			(0.5)
Total	3.9	3.2	2.6	0.1	6.0	15.8
Of which, on-balance sheet exposures held to meet insurance liabilities			0.2	0.1	0.1	0.4
discretionary participatory			0.2	0.1	0.1	0.4
Off-balance sheet exposures	1.4	0.3	1.3		0.6	3.6
guarantees and other	0.6	0.2	0.4		0.5	1.7
commitments	0.8	0.1	0.9		0.1	1.9
Total credit default swaps						
CDS asset positions	0.1		0.3	0.1	0.1	0.6
CDS liability positions	(0.1)		(0.2)	(0.1)	(0.1)	(0.5)
CDS asset notionals	0.2	0.3	3.7	0.6	1.4	6.2
CDS liability notionals	0.3	0.3	3.5	0.7	1.3	6.1

For footnotes, see page 185.

Summary balance sheet exposures to core eurozone countries other financial institutions and corporates

(Audited)

	France US$bn	Germany US$bn	The Netherlands US$bn	Total US$bn
At 31 December 2011	35	7	9	51

Intra-Group funding to peripheral eurozone countries

(Unaudited)

We fund our business through local bank deposits and by extending intra-Group loans from parts of HSBC with surplus funds. Funding carries risk in the event of the exit of a member country from the eurozone and the redenomination to national currencies which would follow and may result in their significant depreciation. Measures taken to mitigate these risks include changes to composition of internal funding sources and seeking access to alternative external funding sources to reduce potential currency mismatches.

US budget deficit

(Unaudited)

During 2011, the US economy expanded moderately. In August 2011, Standard and Poor s (S&P) lowered its long term debt rating for the US to AA+, citing the rising public debt burden and policymaking uncertainty as the key reasons. Fitch and Moody s changed the US debt rating s outlook from stable to negative for similar reasons. To date, the effect of the US downgrade has been less severe than originally feared.

Report of the Directors: Operating and Financial Review (continued)

We expect low growth to continue in 2012 despite the projected continuing fiscal and monetary expansion and positive business outlook. However, political gridlock continues to cast doubts on the administration s ability to approve a medium-term fiscal consolidation plan aimed at reducing public debt to more sustainable levels while pursuing expansionary policies. A European banking crisis is likely to cause severe damage to the global financial system, including the US, and will certainly affect the credit supply to consumers and businesses there, despite strong liquidity and de-leveraging by US banks during 2011.

We continue to closely monitor events and have stress-tested our capital position for potential scenarios at Group level and for the US business only. These results inform Group and US-specific capital planning and risk appetite setting as part of our annual operating planning process.

Middle East and North Africa

(Unaudited)

Although significant unrest and political changes were witnessed in the Middle East and North Africa in 2011, the majority of the Group s exposures in the region were concentrated in our associate investment in Saudi Arabia and in the UAE, where the respective political landscapes remained stable and economic growth continued to recover. In the countries in which we have a presence and there was unrest or political change (or which exhibited similar socio-economic, political and demographic profiles to countries experiencing unrest), we continued to carefully monitor and respond to developments while assisting our customers in managing their own risks in the volatile environment.

We also continued to work closely with Dubai World and the various entities related to the Government of Dubai to address their prevailing issues. In March 2011, Dubai World signed a final deal with HSBC and other creditors restructuring US$25bn of its debt. The arrangement extends loan maturities for five to eight years at discounted rates, allowing Dubai World to sell off its non-core assets while focusing on its core earnings businesses.

Commercial real estate

(Unaudited)

Our exposure to the commercial real estate sector is concentrated in Hong Kong, the UK and North America. The market in Hong Kong was relatively buoyant in 2011; however, transaction volumes declined and asset prices began to stabilise following initiatives taken by supervisory authorities. The UK continued to exhibit relative strength in London and

the South East, though many other regions were negatively affected by weak growth in the UK economy. We are closely monitoring re-financing requirements in the UK market over the next two to three years. In North America, the market has continued to be relatively stable, in part supported by the low levels of interest rates.

On a constant currency basis, the aggregate of our commercial real estate and other property-related lending was US$113bn at 31 December 2011, an increase of 7% compared with 31 December 2010, representing 12% of total loans and advances to customers. In 2011, credit quality across this sector showed some deterioration from 2010 and there remains risk of stress in certain markets. Accordingly, across our portfolios, credit risk is mitigated by long-standing and conservative policies on asset origination which focus on relationships with long-term customers and limited initial leverage. Group Risk, in conjunction with major subsidiaries, designates real estate as a Controlled Sector and, accordingly, implements enhanced exposure approval, monitoring and reporting procedures. We set and monitor risk appetite limits for the sector at both Group and regional levels to detect and prevent higher risk concentrations. A quarterly report comparing the risk-weighted exposures of the regions and global businesses with these appetite limits is provided to senior management. While individual regions may differ with regard to local market regulatory and legal structures and real estate market characteristics, typically, origination LTV ratios would be less than 65% across the Group where loans are secured on commercial real estate assets. Lending to the sector also includes lending to large real estate developers which is typically not secured directly by charges over the underlying real estate assets.

Personal lending

(Unaudited)

We provide a broad range of secured and unsecured personal lending products to meet customer needs. Given the diverse nature of the markets in which we operate, the product is not standard across all countries but is tailored to meet local demands while using appropriate distribution channels and, wherever possible, global IT platforms.

Personal lending includes advances to customers for asset purchases, such as residential property and motor vehicles, where the loans are typically secured by the assets being acquired. We also offer loans secured on existing assets, such as first and second liens on residential property; unsecured lending products such as overdrafts, credit cards and payroll loans; and debt consolidation loans which may be secured or unsecured.

Report of the Directors: Operating and Financial Review (continued)

Group credit policy prescribes the range of acceptable residential property LTV thresholds with the acceptable maximum upper limit for new loans set between 75% and 95%. Specific LTV thresholds and debt-to-income ratios are managed at regional and country levels and, although such parameters must adhere with Group policy, strategy and risk appetite, they differ in the various locations in which we operate in order to reflect different economic and housing market conditions, regulations, portfolio performance, pricing and other product features.

In 2011, credit quality in most personal lending portfolios improved, reflecting a recovery of economic conditions in many markets. Loan impairment charges declined, particularly in those countries which had previously been most affected by rising unemployment and house price depreciation.

In recent years, the Group has undertaken a review of consumer finance activities and has reduced the sale of consumer finance and higher-risk personal lending products in favour of lower-risk facilities and loans secured by owner-occupied residential properties. Most notably, we have curtailed the use of third party sales agents for lending products and the sale of second lien mortgages has been significantly restricted, contributing to the balance reductions set out on page 123. Individual businesses continue to monitor, review and amend their debt-to-income ratios, LTV thresholds and other lending criteria to reflect risk appetite, portfolio performance and regulatory requirements in different countries.

In the US, the origination of new personal lending is extremely limited as we have progressively closed the consumer finance distribution network since 2007, completely discontinuing all new consumer finance real estate originations following the closure of the Consumer Lending branch network at the beginning of 2009. As a result, we are managing sizeable reductions in customer balances across HSBC Finance portfolios as detailed on page 122.

In the UK, we reduced our risk appetite. Underwriting was enhanced across all UK businesses, most notably through the use of improved credit bureau information and the

centralisation of the approval process. A range of account management tools were deployed with the aim of identifying and supporting customers who appear to be encountering financial hardship.

In Hong Kong, we adopted more conservative LTV thresholds and debt-to-income ratios, partially in response to regulatory requirements, and increased our focus on offering lending products to our existing customer base, particularly within the higher quality Premier and Advance segments.

The commentary that follows is on a constant currency basis.

At 31 December 2011, total personal lending was US$394bn, 6% lower than at 31 December 2010. Excluding the reclassification of balances held for sale, total personal lending grew, primarily in the UK and Hong Kong residential mortgage segment. Within our personal lending portfolios, total loan impairment charges of US$9.3bn were 18% lower than in 2010 with the most significant fall in the US reflecting the continued run-off of the CML portfolio and lower balances and improved delinquency rates in our Card and Retail Services business.

Total personal lending in the UK increased by 4% from 31 December 2010 to US$133bn, due to an increase in residential mortgage balances, driven by successful marketing initiatives and competitive pricing focused on our target customers. (UK mortgage lending is discussed in greater detail on page 122). This was partly offset by a 13% fall in other personal lending balances, reflecting the continued shift from unsecured products such as credit cards and personal loans.

In Hong Kong, total personal lending grew by 10% to US$63bn, due to growth in residential mortgage lending, mainly in the first half of 2011. Personal lending balances in Rest of Asia-Pacific also reflected a strong property sector with residential mortgage lending growth of 13%, most

notably in Singapore and Australia.

Total personal lending in the US at 31 December 2011 was US$67bn, a decrease of 39% compared with the end of 2010 reflecting the reclassification of balances to held for sale and the run-off of the CML portfolio.

For an analysis of loan impairment allowances and impaired loans, see page 134.

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Report of the Directors: Operating and Financial Review (continued)

Exposures to countries in the eurozone

(Unaudited)

Our retail activities within the eurozone countries are limited, with our only significant exposures in France and Greece. In France, our exposure to personal lending at 31 December 2011 was US$14bn. This exposure was mainly in residential mortgages, loans secured by a national guarantee

scheme and unsecured personal loans, and both delinquency and impairment charges remained low. Our exposure within Greece totalled US$1.0bn, substantially in the form of residential mortgages. The portfolio remained well secured and delinquencies stable as we took measures to manage and contain the risks therein.

Total personal lending

(Unaudited)

	UK US$m	Rest of Europe US$m	US[13] US$m	Rest of North America US$m	Other regions[14] US$m	Total US$m
At 31 December 2011						
Residential mortgages	111,224	8,678	52,484	20,794	85,783	278,963
Other personal lending	22,218	24,027	14,087	7,971	46,359	114,662
motor vehicle finance		24	20	29	4,494	4,567
credit cards	11,279	2,192	833	1,262	13,922	29,488
second lien mortgages	694		7,063	468	233	8,458
other	10,245	21,811	6,171	6,212	27,710	72,149
Total personal lending	133,442	32,705	66,571	28,765	132,142	393,625
Impairment allowances						
Residential mortgages	(383)	(58)	(4,551)	(27)	(302)	(5,321)
Other personal lending	(745)	(366)	(1,659)	(109)	(1,560)	(4,439)
motor vehicle finance		(4)			(164)	(168)
credit cards	(177)	(148)	(46)	(35)	(428)	(834)
second lien mortgages	(42)	(1)	(740)	(9)		(792)
other	(526)	(213)	(873)	(65)	(968)	(2,645)
Total impairment allowances on personal lending	(1,128)	(424)	(6,210)	(136)	(1,862)	(9,760)
as a percentage of total personal lending	0.8%	1.3%	9.3%	0.5%	1.4%	2.5%

At 31 December 2010						
Residential mortgages	103,037	8,581	57,630	21,212	78,221	268,681
Other personal lending	25,636	24,463	51,686	8,589	46,265	156,639
motor vehicle finance		35	72	55	5,886	6,048
credit cards	11,612	1,916	33,744	1,334	13,778	62,384
second lien mortgages	846	2	9,322	578	422	11,170
other	13,178	22,510	8,548	6,622	26,179	77,037
Total personal lending	128,673	33,044	109,316	29,801	124,486	425,320
Impairment allowances						
Residential mortgages	(275)	(58)	(3,592)	(25)	(297)	(4,247)
Other personal lending	(1,348)	(467)	(4,436)	(179)	(1,616)	(8,046)
motor vehicle finance		(5)			(244)	(249)
credit cards	(506)	(216)	(2,256)	(62)	(483)	(3,523)
second lien mortgages	(58)		(889)	(19)		(966)
other	(784)	(246)	(1,291)	(98)	(889)	(3,308)
Total impairment allowances on personal lending	(1,623)	(525)	(8,028)	(204)	(1,913)	(12,293)
as a percentage of total personal lending	1.3%	1.6%	7.3%	0.7%	1.5%	2.9%

For footnotes, see page 185.

Mortgage lending

(Unaudited)

We offer a wide range of mortgage products designed to meet customer needs, including capital repayment, interest-only, affordability and offset

mortgages. The commentary that follows is on a constant currency basis.

At 31 December 2011, the total mortgage lending balance, comprising residential and second lien lending, was US$287bn, 3% higher than at the end of 2010. Our most significant concentrations of mortgage lending were in the UK, the US and Hong Kong.

Report of the Directors: Operating and Financial Review (continued)

US mortgage lending

US mortgage lending balances, including second lien mortgages, were US$59.5bn at 31 December 2011, a decline of 11% compared with the end of 2010. Overall, US mortgage lending represented 15% of our total personal lending compared with 16% at 31 December 2010.

Mortgage lending in HSBC Finance was US$44.1bn at 31 December 2011, 11% of our gross loans and advances to personal customers. These balances declined by 13% from 31 December 2010 as the run-off of the CML portfolio continued. However, despite the continued low interest rate environment, our loan repayment rates declined compared with historical experience, in part due to our ongoing efforts to assist customers avoid foreclosure through our loan modification programmes which have resulted in slower repayment rates.

HSBC Finance US mortgage lending[15]

(Unaudited)

	At 31 December 2011			At 31 December 2010		
	Mortgage Services US$m	**Consumer Lending US$m**	**Total US$m**	Mortgage Services US$m	Consumer Lending US$m	Total US$m
First lien	**13,141**	**26,467**	**39,608**	15,300	30,016	45,316
Second lien	**1,724**	**2,796**	**4,520**	2,269	3,349	5,618
	14,865	**29,263**	**44,128**	17,569	33,365	50,934
Impairment allowances	**1,846**	**3,242**	**5,088**	1,837	2,474	4,311
as a percentage of the above balances	**12.4%**	**11.1%**	**11.5%**	10.5%	7.4%	8.5%

For footnotes, see page 185.

At HSBC Bank USA, mortgage lending balances were US$15.4bn at 31 December 2011, a reduction of 4% compared with the end of 2010. This was primarily due to the reclassification of balances relating to the pending sale of certain non-strategic branches to assets held for sale in the third quarter of 2011, partly offset by an increase in new mortgage sales to our Premier customers.

As previously reported, the Federal Reserve Board completed an industry-wide examination into foreclosure practices in 2010. The resulting Servicing Consent Order required us to take prescribed actions to address certain deficiencies in our foreclosure processes, as well as review all foreclosures pending or completed between January 2009 and December 2010. We continue to work closely with the regulators to align our processes as required and are implementing operational changes as necessary. Although we have resumed foreclosures in 48 states, it will be a number of months before we fully resume all foreclosure activities in all states, as we need to ensure that all necessary enhancements have been satisfactorily implemented.

During 2011, certain courts and state legislatures issued new rules relating to foreclosures. In some courts, scrutiny of documentation increased, while in others additional verification of information

was required prior to foreclosure. This combination of factors led to a significant backlog of foreclosures which will take some time to resolve, and may result in additional delays which could have an adverse effect on house prices resulting in higher loss severities.

For discussion of credit trends in the US mortgage lending portfolio and the steps taken to mitigate risk, see US personal lending credit quality on page 124.

Mortgage lending rest of the world

Mortgage lending in the UK was US$112bn at 31 December 2011, our largest concentration of this exposure, representing 12% of total gross lending to customers. The balance was 8% higher than at the end of 2010.

In the UK, the majority of mortgage lending was to existing customers holding current or savings account relationships with HSBC. We continued to restrict lending for the purchase of residential property for the purpose of rental, and almost all new business was originated through our own sales force, with self-certification of income not permitted. These lending practices helped to ensure that our UK mortgage portfolio remained of high quality, and our average LTV ratios for new business and our total mortgage books were 53% and 52%, respectively.

Report of the Directors: Operating and Financial Review (continued)

Loan impairment charges and delinquency levels in our UK mortgage book remained at very low levels, reflecting the strong credit quality of the portfolio and the low interest rate environment which helped to make mortgage repayments more affordable for customers, some of whom were actively reducing their outstanding debt levels.

In Hong Kong, mortgage lending was US$46.8bn, an increase of 10% compared with the end of 2010. It was supported by the low interest rate environment and the strength of the local property market. The strong growth in the property market led the Hong Kong Monetary Authority (HKMA)

to introduce measures in both the second half of 2010 and June 2011 such as increasing deposit requirements, reducing the maximum LTV ratios for new loans and capping the maximum debt-to-income ratios. These resulted in a reduction in property prices in the second half of the year and lower sales volumes. The quality of our mortgage book remained strong with an average LTV ratio of 49% on new mortgage sales and 37% on our total mortgage books.

The following table shows the levels of mortgage lending products in our various portfolios in the US, the UK and the rest of the Group.

Mortgage lending products

(Unaudited)

	UK US$m	Rest of Europe US$m	US[13] US$m	Rest of North America US$m	Other regions[14] US$m	Total US$m
At 31 December 2011						
Residential mortgages	**111,224**	**8,678**	**52,484**	**20,794**	**85,783**	**278,963**
Second lien mortgages	**694**		**7,063**	**468**	**233**	**8,458**
Total mortgage lending	**111,918**	**8,678**	**59,547**	**21,262**	**86,016**	**287,421**
Second lien as a percentage of total mortgage lending	**0.6%**	**0.0%**	**11.9%**	**2.2%**	**0.3%**	**2.9%**
Impairment allowances						
Residential mortgages	**(383)**	**(58)**	**(4,551)**	**(27)**	**(302)**	**(5,321)**
Second lien mortgages	**(42)**	**(1)**	**(740)**	**(9)**		**(792)**
Total impairment allowances on mortgage lending	**(425)**	**(59)**	**(5,291)**	**(36)**	**(302)**	**(6,113)**
Interest-only (including offset) mortgages	**46,886**	**48**		**667**	**1,256**	**48,857**
Affordability mortgages, including ARMs	**177**	**496**	**17,089**	**277**	**6,894**	**24,933**
Other	**106**				**189**	**295**
Total interest-only and affordability mortgages	**47,169**	**544**	**17,089**	**944**	**8,339**	**74,085**
as a percentage of total mortgage lending	**42.1%**	**6.3%**	**28.7%**	**4.4%**	**9.7%**	**25.8%**
At 31 December 2010						
Residential mortgages	103,037	8,581	57,630	21,212	78,221	268,681
Second lien mortgages	846	2	9,322	578	422	11,170

Total mortgage lending	103,883	8,583	66,952	21,790	78,643	279,851
Second lien as a percentage of total mortgage lending	0.8%	0.0%	13.9%	2.7%	0.5%	4.0%
Impairment allowances						
Residential mortgages	(275)	(58)	(3,592)	(25)	(297)	(4,247)
Second lien mortgages	(58)		(889)	(19)		(966)
Total impairment allowances on mortgage lending	(333)	(58)	(4,481)	(44)	(297)	(5,213)
Interest-only (including offset) mortgages	45,039	51		908	1,282	47,280
Affordability mortgages, including ARMs	1,089	326	18,494	274	7,855	28,038
Other	102				183	285
Total interest-only and affordability mortgages	46,230	377	18,494	1,182	9,320	75,603
as a percentage of total mortgage lending	44.5%	4.4%	27.6%	5.4%	11.9%	27.0%

For footnotes, see page 185.

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US personal lending

(Unaudited)

Credit quality

During 2011, economic conditions in the US remained challenging. However, they began to show signs of improvement during the fourth quarter as employment growth accelerated, in part due to seasonal hiring, and increased consumer spending. House prices remained under pressure during 2011 due to foreclosure levels, which remained high, despite the industry-wide delays in foreclosure processing.

Unemployment rates, which are a major factor in the deterioration of credit quality, remained high at 8.5% in December 2011, down from 9.4% in December 2010. Unemployment rates were at or above the US national average in 17 states.

A future improvement in the US economy remains dependant upon a recovery in the housing market, a fall in unemployment rates, the stabilisation of energy prices and improved consumer confidence. Any further weakening in these factors may continue to adversely affect consumer payment patterns and credit quality.

Mortgage lending

In 2011, we further reduced our mortgage exposure in the US as balances continued to run-off in the CML portfolio, as discussed on page 122. At 31 December 2011, residential mortgage lending balances were US$52.5bn, a decline of 9% compared with the end of 2010. The ratio of impairment allowances to total mortgage lending in HSBC Finance increased from 8.5% at 31 December 2010 to 11.5% at 31 December 2011. This increase largely reflected the effects of the delays in foreclosure activity and the increased forbearance activity within the portfolio.

Real estate markets in the US have been affected by stagnation or declines in property values. As a result, LTV ratios for our real estate secured loans have generally deteriorated since origination. Lending balances with LTV ratios of greater than 100% have historically had a greater likelihood of becoming delinquent, resulting in higher loss severity which could adversely affect our loan impairment allowances. For more information on residential mortgages by levels of collateral, see page 144.

In the CML portfolio, two months or more delinquent balances increased compared with the end of 2010. This was due to the temporary suspension of foreclosure activities, which resulted in a slowing in the rate at which lending balances were transferred to foreclosed. As a result, in our Consumer Lending

portfolio, two months or more delinquent balances increased in dollar terms from US$4.9bn at 31 December 2010 to US$5.1bn at 31 December 2011, while in our Mortgage Services portfolio they remained unchanged at US$2.8bn.

At HSBC Bank USA, two months or more delinquency rates increased from 7.9% to 8.2% at 31 December 2011, reflecting the suspension of foreclosure activities.

Second lien mortgage loans have a risk profile characterised by higher LTV ratios because in the majority of cases the loans were taken out to complete the refinancing of properties. Loss experience on default of second lien loans has typically approached 100% of the amount outstanding, as any equity in the property is initially applied to the first lien loan. The majority of second lien loans are to customers that hold a first lien mortgage issued by a third party. Impairment allowances for these loans are determined by applying a roll-rate migration analysis which captures the propensity of these loans to default based on past experience. Approximately 97% of our US second lien mortgages, where the first lien mortgages are held or serviced by us and have a delinquency status of 90 days or more past due, are themselves 90 days or more past due. Once we assume a second lien mortgage loan is likely to progress to write-off, the loss severity assumed in establishing our impairment

allowance is close to 100%. In the US, second lien mortgage balances declined by 24% to US$7.1bn at 31 December 2011, representing 12% of the overall US mortgage lending portfolio. Two months or more delinquent balances were US$0.7bn at 31 December 2011 compared with US$0.8bn at 31 December 2010.

Prior to foreclosure, carrying amounts of the loans in excess of fair value less costs to sell are written down to the discounted cash flows expected to be recovered, including from the sale of the property. Broker price opinions are obtained and updated every 180 days and real estate price trends are reviewed quarterly to reflect any improvement or additional deterioration. Our methodology is regularly validated by comparing the discounted cash flows expected to be recovered based on current market conditions (including estimated cash flows from the sale of the property) to the updated broker price opinion, adjusted for the estimated historical difference between interior and exterior appraisals. The fair values of foreclosed properties are initially determined based on broker price opinions. Within 90 days of foreclosure, a more detailed property valuation is performed reflecting information obtained from a physical interior inspection of the

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property and additional loan impairment allowances or write-downs are recorded as appropriate. Updates to the valuation are performed no less than once every 45 days until the property is sold, with declines recorded through an impairment allowance on the property. Increases to the valuation are recorded to the extent of cumulative losses previously recognised through the impairment allowance on the property.

In late 2010, we temporarily suspended all new foreclosure proceedings and in early 2011 ceased foreclosures where judgement had yet to be entered while we enhanced our processes. As a result, and together with an increase in foreclosed property sales, the number of foreclosed properties at HSBC Finance decreased compared with the end of December 2010.

The average total loss on foreclosed properties and the average loss on sale of foreclosed properties both increased compared with the end of 2010. This was a result of the continued decline in house prices, as well as a greater mix of foreclosed properties being sold which we have held for longer periods of time. Typically the longer the holding period, the greater the loss we recognise by the time of sale. See

the table HSBC Finance foreclosed properties in the US below for more detail.

Since their introduction in 2010, HSBC Finance has increased the use of deed-in-lieu and short sales to assist our real estate secured receivable customers. Under a deed-in-lieu agreement, the borrower agrees to surrender the deed to the property without being subject to foreclosure proceedings and HSBC Finance releases the borrower from further obligation. Under a short sale, the property is offered for sale to potential buyers at a price which has been pre-negotiated between HSBC Finance and the borrower. This pre-negotiated price is based on updated property valuations and the expectation of future cash flows from the customer. Short sales also release the borrower from further obligations. HSBC s total losses on deed-in-lieu and short sales are generally lower than losses from foreclosed loans, or loans where we have previously elected not to pursue foreclosure, and the practices generally obtain resolution of the delinquent receivable over a shorter period of time than the normal foreclosure proceedings. HSBC Finance currently expects that the use of deed-in-lieu and short sales will continue to be significant in the future as it works with its customers.

HSBC Finance foreclosed properties in the US

(Unaudited)

		Half-year ended		
		31 Dec	30 Jun	
	2011	**2011**	**2011**	2010
Number of foreclosed properties at end of period	**3,511**	**3,511**	**6,982**	10,940
Number of properties added to foreclosed inventory in the year/quarter	**11,187**	**3,116**	**8,071**	20,489
Average loss on sale of foreclosed properties[16]	**8%**	**9%**	**8%**	5%
Average total loss on foreclosed properties[17]	**56%**	**57%**	**55%**	51%
Average time to sell foreclosed properties (days)	**185**	**200**	**168**	161

For footnotes, see page 185.

Credit cards

In the second half of 2011, we announced the sale of our Card and Retail Services business, which includes both our credit card and private label operations. We have reclassified the associated balances to assets held for sale. We will continue to offer all card products and services during transition. HSBC Bank USA continues to offer credit cards to branch-based customers and corporate cards to commercial and wholesale banking clients.

Two months or more delinquency rates in our credit card portfolio declined from 4.7% at 31 December 2010 to 3.8% at

31 December 2011 while, in our private label cards portfolio, two months or more delinquency rates decreased from 3.0% at 31 December 2010 to 2.5% at 31 December 2011 reflecting an increasing willingness on the part of customers to make repayments and reduce outstanding credit card debt levels.

Personal non-credit card

Personal non-credit card lending balances in the US decreased significantly, largely due to continued run-off. As a result two months or more delinquency balances declined from US$0.8bn at 31 December 2010 to US$0.5bn at 31 December 2011.

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Two months and over contractual delinquency in the US

(Unaudited)

	At 31 December		
	2011	2010	2009
	US$m	US$m	US$m
In Personal Lending in the US			
Residential mortgages	**9,065**	8,632	9,551
Of which:			
Mortgage services	**2,783**	2,757	3,093
Consumer lending	**5,139**	4,861	5,380
Other mortgage lending	**1,143**	1,014	1,078
Second lien mortgage lending	**674**	847	1,194
Of which:			
Mortgage services	**157**	245	384
Consumer lending	**344**	423	642
Other mortgage lending	**173**	179	168
Vehicle finance			267
Credit card	**714**	957	1,798
Private label	**316**	404	622
Personal non-credit card	**513**	811	1,548
Total	**11,282**	11,651	14,980
	%[18]	%[18]	%[18]
Residential mortgages	**17.1**	15.0	14.5
Second lien mortgage lending	**8.5**	9.1	10.1
Vehicle finance			4.6
Credit card	**3.8**	4.7	7.4
Private label	**2.5**	3.0	4.1
Personal non-credit card	**8.3**	9.5	12.6
Total	**11.4**	10.7	11.1

For footnote, see page 185.

Credit quality of financial instruments

(Audited)

The five classifications describing the credit quality of our lending, debt securities portfolios and derivatives are defined in the Appendix to Risk on page 188. Additional credit quality information in respect of our consolidated holdings of ABSs is provided on page 152.

During 2011, we amended our presentation of impaired loans for portfolios with significant levels of forbearance to provide more relevant information on the effect of forbearance on the credit risk of loans and advances. This change in presentation does not affect the accounting policy for the recognition of loan impairment allowances. Further details are provided on page 133.

For the purpose of the following disclosure, retail loans which are past due up to 89 days and are not otherwise classified as impaired in accordance with our disclosure convention (see page 133), are not disclosed within the expected loss (EL) grade to which they relate, but are separately classified as past due but not impaired.

2011 compared with 2010

We assess credit quality on all financial instruments which are subject to credit risk, as shown in the table on page 127. The balance of these financial instruments was US$2,413bn, an increase of 5% in 2011, of which US$1,649bn or 68% was classified as strong. This percentage was broadly in line with 2010. The proportion of financial instruments classified as good and satisfactory remained broadly stable at 16% and 12%, respectively, while the proportion of sub-standard financial instruments was 2% in both 2011 and 2010.

Derivative assets increased by 33% to US$346bn. This increase was mainly in Europe, reflecting an increase in the fair value of interest rate contracts compounded by an increase in the notional value of outstanding contracts during the period. The credit quality of our derivatives portfolio remained strong with 81% of balances in this classification, broadly in line with 2010.

Cash and balances at central banks, on which credit quality has been assessed, more than doubled to US$130bn. This increase was mainly in Europe and in North America as we deposited a larger portion of our excess liquidity with central banks in these regions. As the increases in placements are with central banks considered strong, the proportion of balances classified as strong increased from 90% to 98%.

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Loans and advances held at amortised cost, on which credit quality has been assessed, decreased by 4% to US$1,121bn. The decline was mainly in North America, following the reclassification of certain lending balances to assets held for sale. Despite the reclassification of balances, the proportion of the Group s loans and advances held at amortised cost and categorised as strong and good were broadly in line with the end of 2010, at 54% and 22% respectively.

Trading assets, on which credit quality has been assessed, decreased by 10% to US$309bn in 2011. This reflected a reduction in our holdings of government and highly-rated corporate debt securities and equity positions, notably in Europe. Despite the decline in balances, the proportion of balances classified as strong remained stable at 75%.

The following tables set out our distribution of financial instruments by measures of credit quality:

Distribution of financial instruments by credit quality

(Audited)

	Neither past due nor impaired				Past due but not		Impair-ment	
	Strong US$m	Good US$m	Satisfactory US$m	Sub-standard US$m	impaired US$m	Impaired US$m	allowances[19] US$m	Total US$m
At 31 December 2011								
Cash and balances at central banks	**126,926**	**2,678**	**263**	**35**				**129,902**
Items in the course of collection from other banks	**7,707**	**150**	**350**	**1**				**8,208**
Hong Kong Government certificates of indebtedness	**20,922**							**20,922**
Trading assets[20]	**231,594**	**37,182**	**39,171**	**1,502**				**309,449**
treasury and other eligible bills	**33,199**	**538**	**564**	**8**				**34,309**
debt securities	**103,163**	**8,497**	**18,188**	**639**				**130,487**
loans and advances to banks	**49,021**	**20,699**	**5,186**	**619**				**75,525**
loans and advances to customers	**46,211**	**7,448**	**15,233**	**236**				**69,128**
Financial assets designated at fair value[20]	**7,176**	**4,728**	**830**	**192**				**12,926**
	123							**123**

treasury and other eligible bills								
debt securities	**6,148**	**4,728**	**767**	**191**				**11,834**
loans and advances to banks	**55**		**63**	**1**				**119**
loans and advances to customers	**850**							**850**
Derivatives[20]	**279,557**	**45,858**	**18,627**	**2,337**				**346,379**
Loans and advances held at amortised cost	**609,081**	**245,352**	**194,661**	**28,210**	**20,009**	**41,739**	**(17,636)**	**1,121,416**
loans and advances to banks	**144,815**	**28,813**	**6,722**	**568**	**39**	**155**	**(125)**	**180,987**
loans and advances to customers[21]	**464,266**	**216,539**	**187,939**	**27,642**	**19,970**	**41,584**	**(17,511)**	**940,429**
Financial investments	**340,173**	**24,757**	**22,139**	**3,532**		**2,233**		**392,834**
treasury and other similar bills	**58,627**	**3,348**	**3,144**	**104**				**65,223**
debt securities	**281,546**	**21,409**	**18,995**	**3,428**		**2,233**		**327,611**
Assets held for sale	**14,365**	**12,587**	**7,931**	**536**	**2,524**	**1,479**	**(1,614)**	**37,808**
disposal groups	**14,317**	**12,587**	**7,931**	**536**	**2,522**	**1,467**	**(1,614)**	**37,746**
non-current assets held for sale	**48**				**2**	**12**		**62**
Other assets	**11,956**	**6,526**	**12,379**	**1,193**	**421**	**517**		**32,992**
endorsements and acceptances	**1,789**	**4,075**	**4,629**	**504**	**10**	**3**		**11,010**
accrued income and other	**10,167**	**2,451**	**7,750**	**689**	**411**	**514**		**21,982**
Total financial instruments	**1,649,457**	**379,818**	**296,351**	**37,538**	**22,954**	**45,968**	**(19,250)**	**2,412,836**

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Distribution of financial instruments by credit quality (continued)

	Neither past due nor impaired[8]				Past due		Impair-	
				Sub-	but not		ment	
	Strong	Good	Satisfactory	standard	impaired[8]	Impaired[8]	allowances[19]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m	US$m
At 31 December 2010								
Cash and balances at central banks	51,682	3,100	2,461	140				57,383
Items in the course of collection from other banks	5,631	101	340					6,072
Hong Kong Government certificates of indebtedness	19,057							19,057
Trading assets[20]	256,576	41,620	43,278	2,492				343,966
treasury and other eligible bills	23,663	1,000	957					25,620
debt securities	141,837	8,254	17,222	955				168,268
loans and advances to banks	55,534	9,980	4,865	77				70,456
loans and advances to customers	35,542	22,386	20,234	1,460				79,622
Financial assets designated at fair value[20]	8,377	4,640	6,536	40				19,593
treasury and other eligible bills	158		1					159
debt securities	7,310	4,368	6,530	40				18,248
loans and advances to banks	38	272	5					315
loans and advances to customers	871							871
Derivatives[20]	199,920	45,042	13,980	1,815				260,757
Loans and advances held at amortised cost	646,296	250,393	183,165	37,231	22,729	47,064	(20,241)	1,166,637
loans and advances to banks	166,943	33,051	6,982	1,152	108	193	(158)	208,271
loans and advances to customers[21]	479,353	217,342	176,183	36,079	22,621	46,871	(20,083)	958,366
Financial investments	345,265	23,253	17,168	4,479	16	2,591		392,772
treasury and other similar bills	52,423	2,702	1,882	115		7		57,129
debt securities	292,842	20,551	15,286	4,364	16	2,584		335,643
Other assets	9,752	6,067	12,212	1,510	513	317		30,371
endorsements and acceptances	2,074	3,305	4,227	493	9	8		10,116
accrued income and other	7,678	2,762	7,985	1,017	504	309		20,255
Total financial instruments	1,542,556	374,216	279,140	47,707	23,258	49,972	(20,241)	2,296,608

For footnotes, see page 185.

Past due but not impaired gross financial instruments

(Audited)

Past due but not impaired loans are those for which the customer is in the early stages of delinquency and has failed to make a payment, or a partial payment, in accordance with the contractual terms of the loan agreement. This is typically where a loan is less than 90 days past due and there are no other indicators of impairment.

Further examples of exposures past due but not impaired include individually assessed mortgages that are in arrears more than 90 days where there are no other indicators of impairment,

but where the value of collateral is sufficient to repay both the principal debt and all potential interest for at least one year; and short-term trade facilities past due more than 90 days for technical reasons such as delays in documentation, but where there is no concern over the creditworthiness of the counterparty. Where groups of loans are collectively assessed for impairment, collective impairment allowances are recognised for loans classified as past due but not impaired.

At 31 December 2011, US$20.0bn of loans and advances held at amortised cost were classified as past due but not impaired (2010: US$22.7bn). The largest concentration of these balances is in HSBC Finance. The decrease compared with 2010 was primarily due to the reclassification of the Card and Retail Services business to held for sale and the continued run-off of the CML portfolio.

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Past due but not impaired loans and advances to customers and banks by geographical region[8]

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2011	**1,990**	**1,107**	**2,319**	**1,165**	**10,216**	**3,212**	**20,009**
At 31 December 2010	2,516	1,158	2,092	1,318	12,751	2,894	22,729

Past due but not impaired loans and advances to customers and banks by industry sector[8]

(Audited)

	At 31 December 2011 US$m	At 31 December 2010 US$m
Banks	**39**	108
Customers	**19,970**	22,621
Personal	**13,951**	17,258
Corporate and commercial	**5,855**	5,267
Financial	**164**	96
	20,009	22,729

For footnote, see page 185.

Ageing analysis of days past due but not impaired gross financial instruments

(Audited)

	Up to 29 days US$m	30-59 days US$m	60-89 days US$m	90-179 days US$m	180 days and over US$m	Total US$m
At 31 December 2011						
Loans and advances held at amortised cost[8]	**14,239**	**3,680**	**1,727**	**223**	**140**	**20,009**
loans and advances to banks	**39**					**39**
loans and advances to customers	**14,200**	**3,680**	**1,727**	**223**	**140**	**19,970**

Assets held for sale	**1,563**	**644**	**307**	**8**	**2**	**2,524**
disposal groups	**1,563**	**644**	**307**	**7**	**1**	**2,522**
non-current assets held for sale				**1**	**1**	**2**
Other assets	**225**	**80**	**37**	**22**	**57**	**421**
endorsements and acceptances	**7**	**2**		**1**		**10**
other	**218**	**78**	**37**	**21**	**57**	**411**
	16,027	**4,404**	**2,071**	**253**	**199**	**22,954**
At 31 December 2010						
Loans and advances held at amortised cost[8]	15,576	4,272	2,238	482	161	22,729
loans and advances to banks	108					108
loans and advances to customers	15,468	4,272	2,238	482	161	22,621
Other assets	278	123	57	26	45	529
endorsements and acceptances	7			1	1	9
other	271	123	57	25	44	520
	15,854	4,395	2,295	508	206	23,258

For footnote, see page 185.

Renegotiated loans and forbearance

(Audited)

Current policies and procedures regarding renegotiated loans and forbearance are described in the Appendix to Risk on page 188.

The contractual terms of a loan may be modified for a number of reasons including changing market conditions, customer retention and other factors not related to the current or potential credit deterioration

of a customer. When the contractual payment terms of a loan have been modified because we have significant concerns about the borrower s ability to meet contractual payments when due, these loans are classified as renegotiated loans . For the purposes of this disclosure the term forbearance is synonymous with the renegotiation of loans for these purposes.

In the *Annual Report and Accounts 2011*, the Group has separately presented all renegotiated loans by credit quality classification and has adopted a

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more stringent impaired loan disclosure convention for portfolios with significant levels of forbearance as described on page 133.

The following tables show the Group s holdings of renegotiated loans and advances to customers by industry sector, geography and credit quality classification.

Renegotiated loans and advances to customers

(Audited)

	At 31 December 2011				At 31 December 2010			
	Neither past due nor impaired US$m	**Past due but not impaired US$m**	**Impaired US$m**	**Total US$m**	Neither past due nor impaired US$m	Past due but not impaired US$m	Impaired US$m	Total US$m
Retail	**8,133**	**4,401**	**19,125**	**31,659**	7,690	4,339	23,406	35,435
Residential Mortgages	**5,916**	**3,560**	**15,932**	**25,408**	5,244	3,381	18,137	26,762
Other personal	**2,217**	**841**	**3,193**	**6,251**	2,446	958	5,269	8,673
Commercial real estate	**2,793**	**9**	**3,248**	**6,050**	2,877	12	2,401	5,290
Corporate and commercial	**3,432**	**461**	**3,376**	**7,269**	4,125	186	2,501	6,812
Financial	**249**		**491**	**740**	17		565	582
Governments	**113**	**2**	**132**	**247**	51		7	58
	14,720	**4,873**	**26,372**	**45,965**	14,760	4,537	28,880	48,177
Total renegotiated loans and advances to customers as a percentage of total gross loans and advances to customers				**4.8%**				5.0%

Renegotiated loans and advances to customers by geography

(Unaudited)

	2011 US$m	**2010 US$m**

Europe	**11,464**	10,692
Hong Kong	**447**	420
Rest of Asia-Pacific	**448**	679
Middle East and North Africa	**2,655**	1,866
North America	**28,475**	31,990
Latin America	**2,476**	2,530
Total	**45,965**	48,177
Total impairment allowances on renegotiated loans	**7,670**	7,482
Individually assessed	**2,311**	1,657
Collectively assessed	**5,359**	5,825

2011 compared with 2010

(Unaudited)

Renegotiated loans totalled US$46.0bn at 31 December 2011 (2010: US$48.1bn). The most significant volume of renegotiation activity took place in North America and, at 31 December 2011, amounted to US$28.5bn or 62% of total renegotiated loans (2010: US$32.0bn or 66%), substantially all of which were retail loans held by HSBC Finance. Of the total renegotiated loans in North America, US$17.8bn were presented as impaired at 31 December 2011 (2010: US$22.0bn), and the ratio of total impairment allowances to impaired loans at 31 December 2011 was 28% (2010: 25%).

Europe was the next largest region for renegotiation activity which, at 31 December 2011, amounted to US$11.5bn (2010: US$10.7bn), constituting 25% of total renegotiated loans (2010: 22%).

Of the total renegotiated loans in Europe, US$6.0bn were presented as impaired at 31 December 2011 (2010: US$4.8bn), and the ratio of total impairment allowances to impaired loans at 31 December 2011 was 30% (2010: 28%). The renegotiated loans in Europe were largely concentrated in the commercial real estate sector 41% (2010: 39%) and the corporate and commercial sector 32% (2010: 31%). The commercial real estate sector, particularly in the UK, faced a weakening in property values and a reduction in institutions funding commercial real estate lending. The commercial real estate mid-market sector continued to experience higher levels of renegotiation activity than is evident with larger corporates, where borrowers are generally better capitalised and have access to wider funding market opportunities. In all cases, in assessing the acceptability of renegotiated loans, we consider the ability to service interest as a

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minimum and reduce capital repayments as available. Despite Europe, and the UK in particular, holding the single largest retail lending portfolio in the Group, renegotiations of retail loans in this region were limited due to the quality of the residential mortgage book.

Forbearance activity within the Middle East and Latin America (primarily in Mexico and Brazil) was predominately undertaken in the commercial real estate and corporate and commercial sectors. Forbearance activity within Hong Kong and Rest of Asia-Pacific was insignificant.

HSBC Finance loan modifications and re-ageing

(Unaudited)

HSBC Finance maintains loan modification and re-age (loan renegotiation) programmes in order to manage customer relationships, improve collection opportunities and, if possible, avoid foreclosure.

Since 2006, HSBC Finance has implemented an extensive loan renegotiation programme, and a significant portion of its loan portfolio has been subject to renegotiation at some stage in the life of the customer relationship as a consequence of the economic conditions in the US and the nature of HSBC Finance s customer base.

From late 2009 and continuing into 2011, the volume of loans that qualify for a new modification has reduced significantly. We expect this to continue to decline as HSBC Finance believes a decreasing percentage of its customers with unmodified loans would benefit from loan modification in a way that would avoid non-payment of future cash flows. In addition, volumes of new loan modifications are expected to decrease due to improvements in economic conditions over the long-term, the cessation of new real estate secured and personal non-credit card receivables originations, the continued run-off of the portfolio and, beginning in the second quarter of 2010, more stringent qualifying payment requirements for loan modifications.

Overview by type of loan renegotiation programme in HSBC Finance

A temporary modification is a change to the contractual terms of a loan that results in the giving up of a right to contractual cash flows over a pre-defined period of time. With a temporary modification the loan is expected to revert back to the original contractual terms including the interest rate charged after the modification period. An example is reduced interest payments.

A substantial number of HSBC Finance modifications involve interest rate reductions. These modifications lower the amount of interest income HSBC Finance is contractually entitled to receive in future periods. Historically, modifications have generally been for a period of six months although extended modification periods are now more common.

Loans that have been temporarily modified within HSBC Finance remain classified as impaired until they have demonstrated a history of payment performance against the original terms for typically 18 months after the modification date.

A permanent modification is a change to the contractual terms of a loan that results in giving up a right to contractual cash flows over the life of the loan. An example is a permanent reduction in the interest rate charged.

Permanent or very long-term modifications, which are due to an underlying hardship event, remain classified as impaired for their full life.

The term re-age is a renegotiation whereby the contractual delinquency status of a loan is reset to current after demonstrating payment performance. The overdue principal and/or interest is deferred and paid at a later date. Loan re-ages enable customers that have been unable to make a small number of payments to have their loan delinquency status reset to current, thus remediating overdue balances that affect their credit score.

Loans that have been re-aged remain classified as impaired until they have demonstrated a history of payment performance against the original contractual terms for at least 12 months.

A temporary or permanent modification may also lead to a re-ageing of the loan although a loan may be re-aged without any modification to the original terms and conditions of the loan.

Qualifying criteria

For an account to qualify for renegotiation it must meet certain criteria. However, HSBC Finance retains the right to decline a renegotiation. The extent to which HSBC Finance renegotiates accounts that are eligible under its existing policies will vary depending upon its view of prevailing economic conditions and other factors which may change from year to year. In addition, exceptions to policies and practices may be made in specific situations in response to legal or regulatory agreements or orders.

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Renegotiated real estate secured and personal non-credit card receivables are not eligible for a subsequent renegotiation until 12 or 6 months, respectively, with a maximum of five renegotiation actions within a five-year period. Borrowers must be approved for a modification and generally make two minimum qualifying monthly payments within 60 days to activate a modification.

In certain circumstances where the debt has been restructured in bankruptcy proceedings, fewer or no payments may be required. Accounts whose borrowers are subject to a Chapter 13 plan filed with a bankruptcy court generally may be re-aged upon receipt of one qualifying payment, whereas accounts whose borrowers have filed for Chapter 7 bankruptcy protection may be re-aged upon receipt of a signed reaffirmation agreement. In addition, for some products, accounts may be re-aged without receipt of a payment in certain special circumstances (e.g. in the event of a natural disaster or a hardship programme).

Review of loan classification methodology

In the third quarter of 2011, HSBC Finance undertook a review of its loan classification methodology to provide greater differentiation of loans based on their credit risk characteristics. This review was performed partly as a result of updated

US guidance on troubled debt restructurings and because an increasing percentage of the portfolio has been subject to forbearance in recent years, with the closure of the portfolio to new business. The review involved extensive statistical analysis of actual default experience in the portfolio. Amongst other improvements, this review resulted in changes to further differentiate the credit characteristics of forbearance cases, including those which return to performing status following forbearance. The review included consideration of the application of the Group s accounting policy for the recognition of impairment allowances for the CML portfolio, and changes to improve assumptions about default and severity rates for the purposes of measuring impairment allowances. The consequent changes did not result in a material change to impairment allowances recorded by HSBC Finance under IFRSs. However, the Group s revised impaired loan disclosure convention was adopted.

At 31 December 2011, renegotiated real estate secured accounts represented 86% (2010: 85%) of North America s total renegotiated loans, and US$16bn (2010: US$18.2bn) of renegotiated real estate secured loans in HSBC Finance were classified as impaired. Further details of HSBC Finance s real estate secured accounts and renegotiation programmes are provided below.

Gross loan portfolio of HSBC Finance real estate secured accounts

(Unaudited)

	Re-aged[22] US$m	Modified and re-aged US$m	Modified US$m	Total re-negotiated loans US$m	Total non-renegotiated loans US$m	Total gross loans US$m	Total impairment allowances US$m	Impairment allowances/ gross loans %
31 December 2011	10,265	12,829	1,494	24,588	19,540	44,128	5,088	12

31 December 2010	10,693	14,053	2,286	27,032	23,902	50,934	4,311	8

For footnote, see page 185.

Number of renegotiated real estate secured accounts remaining in HSBC Finance s portfolio

(Unaudited)

	Number of renegotiated loans			
	Re-aged (000s)	Modified and re-aged (000s)	Modified (000s)	Total (000s)
31 December 2011	**121**	**112**	**14**	**246**
31 December 2010	123	115	20	258

During 2011, the aggregate number of renegotiated loans reduced, despite renegotiation activity continuing, due to the run-off of the portfolio. Within the constraints of our Group credit policy, HSBC Finance s policies allow for multiple renegotiations under certain circumstances, and a number of accounts received a second (or further)

renegotiation during the year which did not appear in the statistics presented above. These statistics present a loan as an addition to the volume of renegotiated loans on its first renegotiation only. At 31 December 2011, renegotiated loans were 56% (2010: 53%) of HSBC Finance s real estate secured accounts.

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Corporate and Commercial forbearance

(Unaudited)

For the current policies and procedures regarding forbearance in the corporate and commercial sector, see the Appendix to Risk on page 188.

The majority of the increase in renegotiated loans activity for the commercial real estate sector in 2011 arose in Europe, which increased by US$617m. This increase predominately related to the renegotiation of a large exposure together with high levels of forbearance in the UK towards the end of 2011 reflecting current economic conditions, including a weakening in property values and a reduction in institutions funding commercial real estate lending.

In the corporate and commercial sector the increase in renegotiated loans in 2011 was again a result of increased forbearance activity in Europe. The increase related to renegotiations of a small number of larger lending arrangements provided to European corporate entities and economic pressures in Europe more generally. This was partially off-set by repayments and write-offs of renegotiated loans in Europe, Rest of Asia-Pacific and Latin America.

In the financial sector the increase in renegotiated loans in 2011 primarily related to financial difficulties in one financial sector entity. In the government sector renegotiation activity was wholly due to increases in Latin America caused by term extension restructurings of municipal and local authority facilities.

Impaired loans disclosure

(Audited)

During 2011 we adopted a revised disclosure convention for the presentation of impaired loans and advances which affects the disclosure of loans and advances in the geographical regions with significant levels of forbearance activity. The previous impaired loan disclosure convention was that impaired loans and advances were those classified as CRR9, CRR10, EL9 or EL10 and all retail loans 90 days or more past due, unless individually they had been assessed as not impaired. Renegotiated loans that did not meet the above criteria were classified as neither past due nor impaired or past due but not impaired as appropriate, however these loans were assessed for impairment in accordance with the Group s accounting policy on the recognition of impairment allowances, as described on page 193.

The revised disclosure convention continues to be based on internal credit rating grades and, for retail exposures, 90 days or more past due status.

However, it introduces a more stringent approach to the assessment of whether renegotiated loans are presented as impaired. Management believes that this revised approach better reflects the nature of risks and inherent credit quality in our loan portfolio as it is more closely calibrated to the types of forbearance concession granted and applies stricter requirements for the performance of renegotiated loans before they may be presented as no longer impaired. It also reflects developments in industry best practice disclosure, as well as a refinement of loan segmentation in our North America consumer lending business. The revised disclosure convention affects the disclosure presentation of impaired loans but does not affect the accounting policy for the recognition of impairment allowances.

Under this revised disclosure convention, impaired loans and advances are those that meet any of the following criteria:

- loans and advances classified as CRR 9, CRR 10, EL 9 or EL 10 (a description of our internal credit rating grades is provided on page 191);

- retail exposures 90 days or more past due, unless individually they have been assessed as not impaired; or

- renegotiated loans and advances that have been subject to a change in contractual cash flows as a result of a concession which the lender would not otherwise consider, and where it is probable that without the concession the borrower would be unable to meet its contractual payment obligations in full, unless the concession is insignificant and there are no other indicators of impairment. Renegotiated loans remain classified as impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, and there are no other indicators of impairment.

For loans that are assessed for impairment on a collective basis, the evidence to support reclassification as no longer impaired typically comprises a history of payment performance against the original or revised terms, depending on the nature and volume of forbearance and the credit risk characteristics surrounding the renegotiation. For loans that are assessed for impairment on an individual basis, all available evidence is assessed on a case by case basis.

In HSBC Finance, where a significant majority of HSBC s loan forbearance activity occurs, the demonstrated history of payment performance is with reference to the original terms of the contract, reflecting the higher credit risk characteristics of this

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portfolio. The payment performance periods are monitored to ensure they remain appropriate to the levels of recidivism observed within the portfolio.

Further disclosure about loans subject to forbearance is provided on page 129. Renegotiated loans and forbearance disclosures are subject to evolving industry practice and regulatory guidance.

Impaired loan comparative data for 31 December 2010 have been restated to reflect the revised impaired loans disclosure convention. Restatement of comparative data prior to 31 December 2010 is not practicable as sufficient information is not available to determine what assumptions management would have made in applying the revised disclosure convention for those

comparative periods. This includes information about assumptions that would have been made in establishing the revised, more stringent period of payment performance for renegotiated loans before they are regarded as unimpaired. The difficulty associated with determining these estimates relates principally to retail portfolios that are assessed for impairment on a collective basis; these estimates become more difficult when a longer period of time has passed since the credit condition occurred.

The following table shows the effect of the revised disclosure convention on total reported impaired loans and advances to customers for geographical regions with significant levels of forbearance.

Impaired loans and advances to customers

(Audited)

	At 31 December	
	2011	2010
	US$m	US$m
At 31 December previous disclosure convention	**27,211**	28,091
Reclassified from neither past due nor impaired	**7,895**	11,200
Europe	**509**	838
Middle East and North Africa	**61**	63
North America	**6,688**	9,638
Latin America	**637**	661
Reclassified from past due but not impaired	**6,478**	7,580
Europe		
Middle East and North Africa	**30**	33
North America	**6,310**	7,475
Latin America	**138**	72
At 31 December revised disclosure convention	**41,584**	46,871

Impairment of loans and advances

Impaired loans and advances to customers and banks by industry sector[8]

(Audited)

	Impaired loans and advances at 31 December 2011			Impaired loans and advances at 31 December 2010		
	Individually assessed US$m	**Collectively assessed US$m**	**Total US$m**	Individually assessed US$m	Collectively assessed US$m	Total US$m
Banks	**155**		**155**	193		193
Customers	**16,554**	**25,030**	**41,584**	16,058	30,813	46,871
personal	**2,473**	**24,070**	**26,543**	2,443	29,997	32,440
corporate and commercial	**12,898**	**960**	**13,858**	12,499	816	13,315
financial	**1,183**		**1,183**	1,116		1,116
	16,709	**25,030**	**41,739**	**16,251**	**30,813**	**47,064**

For footnote, see page 185.

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Impairment allowances

(Audited)

The tables below analyse by geographical region the impairment allowances recognised for impaired

loans and advances that are either individually assessed or collectively assessed, and collective impairment allowances on loans and advances classified as not impaired.

Impairment allowances on loans and advances to customers by geographical region

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2011							
Gross loans and advances to customers[8]							
Individually assessed impaired loans[23]	10,490	519	963	2,187	1,832	563	16,554
Collectively assessed[24]	429,088	157,727	123,687	25,402	148,096	57,386	941,386
Impaired loans[23]	1,261	85	106	238	20,864	2,476	25,030
Non-impaired loans[25]	427,827	157,642	123,581	25,164	127,232	54,910	916,356
TGLAC	439,578	158,246	124,650	27,589	149,928	57,949	957,940
Impairment allowances	5,242	581	782	1,714	7,181	2,011	17,511
Individually assessed	3,754	288	505	1,250	416	324	6,537
Collectively assessed	1,488	293	277	464	6,765	1,687	10,974
Net loans and advances	434,336	157,665	123,868	25,875	142,747	55,938	940,429
	%	%	%	%	%	%	%
Individually assessed allowances as a percentage of individually assessed loans and advances	35.8	55.5	52.4	57.2	22.7	57.4	39.5
Collectively assessed allowances as a percentage of collectively assessed loans and advances	0.3	0.2	0.2	1.8	4.6	2.9	1.2
	1.2	0.4	0.6	6.2	4.8	3.5	1.8

Total allowances as a percentage of TGLAC							
At 31 December 2010							
Gross loans and advances to customers[8]	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Individually assessed impaired loans[23]	9,400	637	1,185	2,167	1,886	783	16,058
Collectively assessed[24]	432,062	140,683	108,505	24,111	197,816	59,214	962,391
Impaired loans[23]	1,994	23	139	362	25,954	2,341	30,813
Non-impaired loans[25]	430,068	140,660	108,366	23,749	171,862	56,873	931,578
TGLAC	441,462	141,320	109,690	26,278	199,702	59,997	978,449
Impairment allowances	5,663	629	959	1,652	9,170	2,010	20,083
Individually assessed	3,563	345	629	1,163	390	367	6,457
Collectively assessed	2,100	284	330	489	8,780	1,643	13,626
Net loans and advances	435,799	140,691	108,731	24,626	190,532	57,987	958,366
	%	%	%	%	%	%	%
Individually assessed allowances as a percentage of individually assessed loans and advances	37.9	54.2	53.1	53.7	20.7	46.9	40.2
Collectively assessed allowances as a percentage of collectively assessed loans and advances	0.5	0.2	0.3	2.0	4.4	2.8	1.4
Total allowances as a percentage of TGLAC	1.3	0.4	0.9	6.3	4.6	3.4	2.1

For footnotes, see page 185.

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Movement in impairment allowances on loans and advances to customers and banks

(Audited)

	Banks individually assessed US$m	Customers Individually assessed US$m	Customers Collectively assessed US$m	Total US$m
2011				
At 1 January	**158**	**6,457**	**13,626**	**20,241**
Amounts written off	**(16)**	**(1,633)**	**(10,831)**	**(12,480)**
Recoveries of loans and advances previously written off		**191**	**1,235**	**1,426**
Charge to income statement	**(16)**	**1,931**	**9,590**	**11,505**
Exchange and other movements[26]	**(1)**	**(409)**	**(2,646)**	**(3,056)**
At 31 December	**125**	**6,537**	**10,974**	**17,636**
Impairment allowances on loans and advances to customers		**6,537**	**10,974**	**17,511**
personal		**694**	**9,066**	**9,760**
corporate and commercial		**5,231**	**1,820**	**7,051**
financial		**612**	**88**	**700**
	%	**%**	**%**	**%**
As a percentage of loans and advances[27,28]	**0.09**	**0.71**	**1.20**	**1.67**
	US$m	US$m	US$m	US$m
2010				
At 1 January	107	6,494	19,048	25,649
Amounts written off	(9)	(2,441)	(16,850)	(19,300)
Recoveries of loans and advances previously written off	2	143	875	1,020
Charge to income statement	12	2,613	10,923	13,548
Exchange and other movements	46	(352)	(370)	(676)
At 31 December	158	6,457	13,626	20,241
Impairment allowances on loans and advances to customers		6,457	13,626	20,083
personal		615	11,678	12,293
corporate and commercial		5,274	1,863	7,137
financial		568	85	653
	%	%	%	%
As a percentage of loans and advances[27,28]	0.11	0.70	1.49	1.91

For footnotes, see page 185.

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Movement in impairment allowances by industry sector

(Audited)

	2011 US$m	2010 US$m	2009 US$m	2008 US$m	2007 US$m
Impairment allowances at 1 January	**20,241**	25,649	23,972	19,212	13,585
Amounts written off	**(12,480)**	(19,300)	(24,840)	(17,955)	(12,844)
Personal	**(10,431)**	(16,458)	(22,703)	(16,625)	(11,670)
residential mortgages	**(2,662)**	(4,163)	(4,704)	(2,110)	(930)
other personal	**(7,769)**	(12,295)	(17,999)	(14,515)	(10,740)
Corporate and commercial	**(2,009)**	(2,789)	(1,984)	(1,294)	(1,163)
manufacturing and international trade and services[5]	**(1,137)**	(1,050)	(1,093)	(789)	(897)
commercial real estate and other property-related	**(392)**	(1,280)	(327)	(115)	(98)
other commercial	**(480)**	(459)	(564)	(390)	(168)
Financial[29]	**(40)**	(53)	(153)	(36)	(11)
Recoveries of amounts written off in previous years	**1,426**	1,020	890	834	1,005
Personal	**1,175**	846	712	686	837
residential mortgages	**86**	93	61	19	19
other personal	**1,089**	753	651	667	818
Corporate and commercial	**242**	156	170	142	157
manufacturing and international trade and services[5]	**135**	92	123	76	74
commercial real estate and other property-related	**20**	21	9	6	29
other commercial	**87**	43	38	60	54
Financial[29]	**9**	18	8	6	11
Charge to income statement[30]	**11,505**	13,548	24,942	24,131	17,177
Personal	**9,318**	11,187	19,781	20,950	15,968
residential mortgages	**4,103**	3,461	4,185	5,000	1,840
other personal	**5,215**	7,726	15,596	15,950	14,128
Corporate and commercial	**2,114**	2,198	4,711	2,879	1,176
manufacturing and international trade and services[5]	**901**	909	2,392	1,573	897
commercial real estate and other property-related	**764**	660	1,492	755	152
other commercial	**449**	629	827	551	127
Financial[29]	**73**	163	450	302	36
Governments					(3)
Exchange and other movements	**(3,056)**	(676)	685	(2,250)	289
At 31 December	**17,636**	20,241	25,649	23,972	19,212
Impairment allowances against banks:					
individually assessed	**125**	158	107	63	7
Impairment allowances against customers:					
individually assessed	**6,537**	6,457	6,494	3,284	2,699
collectively assessed	**10,974**	13,626	19,048	20,625	16,506
At 31 December	**17,636**	20,241	25,649	23,972	19,212
	%	%	%	%	%

Impairment allowances against customers as a percentage of loans and advances to customers:					
individually assessed	**0.68**	0.66	0.70	0.34	0.27
collectively assessed	**1.15**	1.39	2.07	2.16	1.65
At 31 December	**1.83**	2.05	2.77	2.50	1.92

For footnotes, see page 185.

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Movement in impairment allowances by industry sector and by geographical region

(Audited)

	2011						
	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
Impairment allowances at 1 January	**5,740**	**629**	**959**	**1,669**	**9,234**	**2,010**	**20,241**
Amounts written off	**(2,781)**	**(210)**	**(554)**	**(187)**	**(6,830)**	**(1,918)**	**(12,480)**
Personal	**(1,685)**	**(116)**	**(391)**	**(172)**	**(6,591)**	**(1,476)**	**(10,431)**
residential mortgages	**(25)**		**(6)**	**(2)**	**(2,545)**	**(84)**	**(2,662)**
other personal[5]	**(1,660)**	**(116)**	**(385)**	**(170)**	**(4,046)**	**(1,392)**	**(7,769)**
Corporate and commercial	**(1,066)**	**(94)**	**(161)**	**(15)**	**(233)**	**(440)**	**(2,009)**
manufacturing and international trade and services	**(554)**	**(64)**	**(120)**	**(4)**	**(100)**	**(295)**	**(1,137)**
commercial real estate and other property-related	**(265)**	**(6)**	**(13)**	**(10)**	**(83)**	**(15)**	**(392)**
other commercial[7]	**(247)**	**(24)**	**(28)**	**(1)**	**(50)**	**(130)**	**(480)**
Financial[29]	**(30)**		**(2)**		**(6)**	**(2)**	**(40)**
Recoveries of amounts written off in previous years	**572**	**47**	**185**	**102**	**132**	**388**	**1,426**
Personal	**525**	**31**	**168**	**53**	**101**	**297**	**1,175**
residential mortgages	**21**	**4**	**3**		**39**	**19**	**86**
other personal[5]	**504**	**27**	**165**	**53**	**62**	**278**	**1,089**
Corporate and commercial	**44**	**16**	**12**	**49**	**30**	**91**	**242**
manufacturing and international trade and services	**19**	**16**	**8**	**2**	**8**	**82**	**135**
commercial real estate and other property-related	**7**		**1**		**8**	**4**	**20**
other commercial[7]	**18**		**3**	**47**	**14**	**5**	**87**
Financial[29]	**3**		**5**		**1**		**9**
Charge to income statement[30]	**1,902**	**117**	**274**	**292**	**7,050**	**1,870**	**11,505**
Personal	**610**	**77**	**215**	**124**	**6,887**	**1,405**	**9,318**
residential mortgages	**98**	**(10)**	**5**	**42**	**3,899**	**69**	**4,103**
other personal[5]	**512**	**87**	**210**	**82**	**2,988**	**1,336**	**5,215**
Corporate and commercial	**1,277**	**37**	**55**	**146**	**122**	**477**	**2,114**
manufacturing and international trade and services	**416**	**57**	**35**	**25**	**42**	**326**	**901**
commercial real estate and other property-related	**498**		**9**	**150**	**48**	**59**	**764**
other commercial[7]	**363**	**(20)**	**11**	**(29)**	**32**	**92**	**449**
Financial[29]	**15**	**3**	**4**	**22**	**41**	**(12)**	**73**
Exchange and other movements	**(141)**	**(2)**	**(82)**	**(145)**	**(2,347)**	**(339)**	**(3,056)**
At 31 December	**5,292**	**581**	**782**	**1,731**	**7,239**	**2,011**	**17,636**
Impairment allowances against banks:							
individually assessed	**50**			**17**	**58**		**125**
Impairment allowances against customers:							
individually assessed	**3,754**	**288**	**505**	**1,250**	**416**	**324**	**6,537**
collectively assessed[31]	**1,488**	**293**	**277**	**464**	**6,765**	**1,687**	**10,974**

At 31 December	**5,292**	**581**	**782**	**1,731**	**7,239**	**2,011**	**17,636**
	%	%	%	%	%	%	%
Impairment allowances against customers as a percentage of loans and advances to customers:							
individually assessed	**0.85**	**0.18**	**0.41**	**4.53**	**0.28**	**0.56**	**0.68**
collectively assessed[31]	**0.34**	**0.19**	**0.22**	**1.68**	**4.51**	**2.91**	**1.15**
At 31 December	**1.19**	**0.37**	**0.63**	**6.21**	**4.79**	**3.47**	**1.83**

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	2010						
	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
Impairment allowances at 1 January	6,227	804	996	1,393	13,676	2,553	25,649
Amounts written off	(3,001)	(265)	(678)	(386)	(12,601)	(2,369)	(19,300)
Personal	(1,447)	(150)	(561)	(375)	(12,070)	(1,855)	(16,458)
residential mortgages	(49)	(1)	(10)		(4,027)	(76)	(4,163)
other personal[5]	(1,398)	(149)	(551)	(375)	(8,043)	(1,779)	(12,295)
Corporate and commercial	(1,539)	(109)	(110)	(11)	(507)	(513)	(2,789)
manufacturing and international trade and services	(385)	(90)	(46)	(10)	(174)	(345)	(1,050)
commercial real estate and other property-related	(1,022)	(18)	(18)		(194)	(28)	(1,280)
other commercial[7]	(132)	(1)	(46)	(1)	(139)	(140)	(459)
Financial[29]	(15)	(6)	(7)		(24)	(1)	(53)
Recoveries of amounts written off in previous years	287	39	188	57	182	267	1,020
Personal	251	32	168	53	134	208	846
residential mortgages	29	4	3		30	27	93
other personal[5]	222	28	165	53	104	181	753
Corporate and commercial	33	7	7	4	46	59	156
manufacturing and international trade and services	16	7	5	2	19	43	92
commercial real estate and other property-related	6				11	4	21
other commercial[7]	11		2	2	16	12	43
Financial[29]	3		13		2		18
Charge to income statement[30]	2,532	137	428	623	8,304	1,524	13,548
Personal	1,263	78	297	226	8,138	1,185	11,187
residential mortgages	153	(17)	11	46	3,189	79	3,461
other personal[5]	1,110	95	286	180	4,949	1,106	7,726
Corporate and commercial	1,080	72	146	304	269	327	2,198
manufacturing and international trade and services	395	21	100	165	25	203	909
commercial real estate and other property-related	360	(7)	12	117	178		660
other commercial[7]	325	58	34	22	66	124	629
Financial[29]	189	(13)	(15)	93	(103)	12	163
Exchange and other movements	(305)	(86)	25	(18)	(327)	35	(676)
At 31 December	5,740	629	959	1,669	9,234	2,010	20,241
Impairment allowances against banks:							
individually assessed	77			17	64		158
Impairment allowances against customers:							
individually assessed	3,563	345	629	1,163	390	367	6,457
collectively assessed[31]	2,100	284	330	489	8,780	1,643	13,626
At 31 December	5,740	629	959	1,669	9,234	2,010	20,241
	%	%	%	%	%	%	%
Impairment allowances against customers as a percentage of loans and advances to customers:							
individually assessed	0.81	0.24	0.57	4.43	0.20	0.61	0.66
collectively assessed[31]	0.48	0.20	0.30	1.86	4.40	2.74	1.39

At 31 December	1.29	0.44	0.87	6.29	4.60	3.35	2.05

For footnotes, see page 185.

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Impairment charge

Individually and collectively assessed impairment charge to the income statement by industry sector

(Unaudited)

	2011			2010		
	Individually assessed	**Collectively assessed**	**Total**	Individually assessed	Collectively assessed	Total
	US$m	**US$m**	**US$m**	US$m	US$m	US$m
Banks	**(16)**		**(16)**	12		12
Personal	**141**	**9,177**	**9,318**	180	11,007	11,187
Residential mortgages	**104**	**3,999**	**4,103**	137	3,324	3,461
Other personal[5]	**37**	**5,178**	**5,215**	43	7,683	7,726
Corporate and commercial	**1,703**	**411**	**2,114**	2,190	8	2,198
Manufacturing and international trade and services	**572**	**329**	**901**	997	(88)	909
Commercial real estate and other property-related	**768**	**(4)**	**764**	680	(20)	660
Other commercial[7]	**363**	**86**	**449**	513	116	629
Financial	**87**	**2**	**89**	243	(92)	151
Total charge to income statement	**1,915**	**9,590**	**11,505**	2,625	10,923	13,548

For footnote, see page 185.

Net loan impairment charge to the income statement

(Unaudited)

	2011	2010	2009	2008	2007
	US$m	US$m	US$m	US$m	US$m
Individually assessed impairment allowances	**1,915**	2,625	4,458	2,064	796
New allowances	**2,904**	3,617	5,173	2,742	1,533
Release of allowances no longer required	**(798)**	(847)	(581)	(565)	(608)
Recoveries of amounts previously written off	**(191)**	(145)	(134)	(113)	(129)
Collectively assessed impairment allowances	**9,590**	10,923	20,484	22,067	16,381
New allowances net of allowance releases	**10,825**	11,798	21,240	22,788	17,257
Recoveries of amounts previously written off	**(1,235)**	(875)	(756)	(721)	(876)
Total charge for impairment losses	**11,505**	13,548	24,942	24,131	17,177
Banks	**(16)**	12	70	54	
Customers	**11,521**	13,536	24,872	24,077	17,177
At 31 December					

Impaired loans[8]	**41,739**	47,064	30,845	25,422	19,594
Impairment allowances	**17,636**	20,241	25,649	23,972	19,212

For footnote, see page 185.

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Net loan impairment charge to the income statement by geographical region

(Unaudited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
2011							
Individually assessed impairment allowances	**1,262**	**18**	**67**	**199**	**243**	**126**	**1,915**
New allowances	**1,670**	**79**	**207**	**328**	**398**	**222**	**2,904**
Release of allowances no longer required	**(378)**	**(41)**	**(114)**	**(80)**	**(111)**	**(74)**	**(798)**
Recoveries of amounts previously written off	**(30)**	**(20)**	**(26)**	**(49)**	**(44)**	**(22)**	**(191)**
Collectively assessed impairment allowances	**640**	**99**	**207**	**93**	**6,807**	**1,744**	**9,590**
New allowances net of allowance releases	**1,181**	**126**	**366**	**147**	**6,894**	**2,111**	**10,825**
Recoveries of amounts previously written off	**(541)**	**(27)**	**(159)**	**(54)**	**(87)**	**(367)**	**(1,235)**
Total charge for impairment losses	**1,902**	**117**	**274**	**292**	**7,050**	**1,870**	**11,505**
Banks	**(11)**				**(5)**		**(16)**
Customers	**1,913**	**117**	**274**	**292**	**7,055**	**1,870**	**11,521**
At 31 December 2011							
Impaired loans[8]	**11,819**	**608**	**1,070**	**2,445**	**22,758**	**3,039**	**41,739**
Impairment allowances	**5,292**	**581**	**782**	**1,731**	**7,239**	**2,011**	**17,636**
2010							
Individually assessed impairment allowances	1,445	45	198	502	348	87	2,625
New allowances	1,874	111	311	561	580	180	3,617
Release of allowances no longer required	(394)	(54)	(84)	(55)	(196)	(64)	(847)
Recoveries of amounts previously written off	(35)	(12)	(29)	(4)	(36)	(29)	(145)
Collectively assessed impairment allowances	1,087	92	230	121	7,956	1,437	10,923
New allowances net of allowance releases	1,339	119	389	174	8,102	1,675	11,798
Recoveries of amounts previously written off	(252)	(27)	(159)	(53)	(146)	(238)	(875)
Total charge for impairment losses	2,532	137	428	623	8,304	1,524	13,548
Banks	2			2	8		12
Customers	2,530	137	428	621	8,296	1,524	13,536
At 31 December 2010							
Impaired loans[8]	11,500	665	1,324	2,549	27,902	3,124	47,064
Impairment allowances	5,740	629	959	1,669	9,234	2,010	20,241

For footnote, see page 185.

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

(Unaudited)

	2011	2010	2009	2008	2007
	%	%	%	%	%
New allowances net of allowance releases	**1.34**	1.65	2.92	2.54	2.09
Recoveries	**(0.15)**	(0.12)	(0.10)	(0.09)	(0.12)
Total charge for impairment losses	**1.19**	1.53	2.82	2.45	1.97
Amount written off net of recoveries	**1.14**	2.08	2.71	1.75	1.36

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Charge for impairment losses as a percentage of average gross loans and advances to customers by geographical region

(Unaudited)

	Europe %	Hong Kong %	Rest of Asia-Pacific %	MENA %	North America %	Latin America %	Total %
2011							
New allowances net of allowance releases	**0.59**	**0.11**	**0.38**	**1.46**	**4.01**	**3.54**	**1.34**
Recoveries	**(0.14)**	**(0.03)**	**(0.15)**	**(0.38)**	**(0.07)**	**(0.61)**	**(0.15)**
Total charge for impairment losses	**0.45**	**0.08**	**0.23**	**1.08**	**3.94**	**2.93**	**1.19**
Amount written off net of recoveries	**0.52**	**0.11**	**0.31**	**0.32**	**3.74**	**2.39**	**1.14**
2010							
New allowances net of allowance releases	0.74	0.15	0.66	2.71	4.02	3.41	1.65
Recoveries	(0.07)	(0.03)	(0.20)	(0.23)	(0.09)	(0.51)	(0.12)
Total charge for impairment losses	0.67	0.12	0.46	2.48	3.93	2.90	1.53
Amount written off net of recoveries	0.71	0.19	0.53	1.32	5.89	4.01	2.08

Loans and advances to customers are excluded from average balances when reclassified to held for sale. Including these loans and advances to customers the North America new

allowances net of allowance releases would be 3.77%, recoveries 0.07%, and amounts written off net of recoveries 3.51%.

Reconciliation of reported and constant currency changes in impaired loans by geographical region[8]

(Unaudited)

	31 Dec 10 as reported US$m	Constant currency effect US$m	31 Dec 10 at 31 Dec 11 exchange rates US$m	Movement on a constant currency basis US$m	31 Dec 11 as reported US$m	Reported change %	Movement on a constant currency basis %
Europe	11,500	**(211)**	**11,289**	**530**	**11,819**	**3%**	**5%**
Hong Kong	665	**3**	**668**	**(60)**	**608**	**(9%)**	**(9%)**

Rest of Asia-Pacific	1,324	**(55)**	**1,269**	**(199)**	**1,070**	**(19%)**	**(16%)**
Middle East and North Africa	2,549	**(6)**	**2,543**	**(98)**	**2,445**	**(4%)**	**(4%)**
North America	27,902	**(19)**	**27,883**	**(5,125)**	**22,758**	**(18%)**	**(18%)**
Latin America	3,124	**(299)**	**2,825**	**214**	**3,039**	**(3%)**	**8%**
	47,064	**(587)**	**46,477**	**(4,738)**	**41,739**	**(11%)**	**(10%)**

For footnote, see page 185.

2011 compared with 2010

(Unaudited)

On a reported basis, loan impairment charges to the income statement of US$11.5bn in 2011 declined by 15% compared with 2010 and by 16% on a constant currency basis. During 2011, we revised our disclosure convention for impaired loans for regions with material levels of forbearance which resulted in an increase in the population of impaired loans. Impaired loan comparative data for 2010 has been restated to reflect the change in disclosure convention. On a reported basis our restated impaired loans were US$41.7bn, 11% lower than at 31 December 2010.

The following commentary is on a constant currency basis.

New loan impairment allowances were US$13.7bn, a decline of 12% compared with 2010, reflecting lower lending balances in our US consumer finance portfolios. Releases and recoveries of US$2.2bn were 17% higher, mainly in Europe and Latin America reflecting improvements in our collections operations.

Impaired loans were 4% of total gross loans and advances at the end of 2011, in line with 31 December 2010.

In **Europe**, new loan impairment allowances were US$2.9bn, 14% lower than 2010. Individually assessed new loan impairment allowances decreased, mainly in the UK, as the credit quality of our lending portfolio improved, partly offset by an increase in allowances in respect of a small number of CMB

Report of the Directors: Operating and Financial Review (continued)

customers in Greece. New collectively assessed loan impairment allowances also declined, mainly in the UK personal lending book, as a result of improved delinquency rates, reflecting improved quality in both the secured and unsecured portfolios, and a range of successful actions taken to mitigate credit risk within RBWM including a focus on monitoring and identifying customers facing financial difficulty at an earlier stage. In addition, lower new loan impairment allowances reflected a reduction in unsecured lending balances. Impaired loans of US$11.8bn were 5% higher than at 31 December 2010.

Releases and recoveries in Europe were US$949m, an increase of 36% compared with the end of 2010 due to successful actions taken to mitigate credit risk as described above.

In **Hong Kong**, new loan impairment allowances fell by 10% compared with 2010 driven by a reduction in new loan impairment allowances against specific exposures. This was partly offset by a rise in new collectively assessed loan impairment allowances following a more significant release of allowances in 2010, as well as strong growth in lending balances. Impaired loans declined by 9% from 31 December 2010, reflecting loans whose performance improved following the renegotiation of terms and are therefore regarded as no longer impaired.

Releases and recoveries in Hong Kong were US$88m, 4% lower than at the end of 2010.

New loan impairment allowances in **Rest of Asia-Pacific** decreased by 22% to US$573m. The decline reflected lower new collectively assessed loan impairment allowances, mainly in India, where lending balances fell as certain higher risk unsecured portfolios were managed down. New individually assessed loan impairment allowances also decreased, mainly in Singapore, due to lower new loan impairment allowances raised against a single GB&M customer compared with 2010. Impaired loans in the region decreased by 16% from the end of 2010 to US$1.1bn at the end of 2011, mainly in India due to the repayment or write-off of previously impaired loans.

Releases and recoveries in the region increased by 5%, mainly due to the increased release of individually assessed allowances, principally in Australia and India.

In the **Middle East and North Africa**, new loan impairment allowances declined by 35% to US$475m in 2011. New individually assessed loan impairment allowances fell, as charges in 2011 were

restricted to a small number of corporate exposures and significant charges recorded in 2010 following the restructuring of corporate exposures in the UAE did not recur. New collectively assessed loan impairment allowances also declined, primarily in the UAE, due to lower delinquencies reflecting a repositioning of the loan book to reduce our exposure to unsecured lending and focus on higher quality customers. Impaired loans declined by 4% from 31 December 2010 due to improved delinquency in line with stricter credit criteria, as referred to above.

Releases and recoveries in the region increased by 63% to US$183m in 2011 due to improved economic conditions.

In **North America**, new loan impairment allowances declined markedly, reducing by 16% to US$7.3bn. New collectively assessed loan impairment allowances declined, mainly in the CML portfolio, reflecting continued run-off and, in our Card and Retail Services business, lower balances, as well as improved delinquency rates as overall credit quality improved. This was partly offset by additional new loan impairment allowances related to the effects of the delays in foreclosure activity. Releases and recoveries in North America declined by 36% to US$242m. This reflected both the improvement in economic conditions in 2010, which enabled a high volume of customers who were in financial difficulty to make repayments, and the continued reductions in outstanding balances in 2011 as the CML portfolio continued to run off.

Impaired loans decreased by 18% from the end of 2010 to US$22.8bn, due to the continued run-off of the CML portfolio and the reclassification of balances relating to the pending sale of our Card and Retail Services business. This was partly offset by the effects of the delays in foreclosure processing which slowed the rate at which lending balances were transferred to foreclosed.

In **Latin America**, new loan impairment allowances increased by 21% to US$2.3bn. The increase in new loan impairment allowances was primarily in Brazil reflecting strong lending growth in RBWM and CMB, as well as a rise in delinquency rates, notably in the second half of 2011. This was partly offset by lower new collectively assessed loan impairment allowances in Mexico, driven by the managed decline of the riskier elements of the credit cards portfolio. Impaired loans were 8% higher than at the end of 2010 driven by increased delinquency observed during the year.

Releases and recoveries in Latin America increased by 36% from the end of 2010 to US$463m, largely reflecting an increase in the volume of accounts that are delinquent.

Report of the Directors: Operating and Financial Review (continued)

For an analysis of loan impairment charges and other credit risk provisions by global business, see page 57.

2010 compared with 2009

(Unaudited)

During 2011, we adopted a revised disclosure convention for the presentation of impaired loans. Comparative data for 31 December 2010 have been restated to reflect the revised disclosure convention, however, restatement of data prior to 2010 is not practicable. In the commentary below, movements in the balances of impaired loans have been discussed under the previous disclosure convention.

Loan impairment charges of US$13.5bn declined by 46% on both a reported and an underlying basis compared with 2009. Reported impaired loans were US$28.3bn at 31 December 2010, a decrease of 8% on both bases. The following commentary is on a constant currency basis.

New allowances for loan impairment charges were US$15.4bn, a decline of 42% compared with 2009, while releases and recoveries of US$1.9bn were 23% higher.

Impaired loans were 2.4% of total gross loans and advances at 31 December 2010, compared with 2.8% at 31 December 2009.

In **Europe**, new loan impairment allowances were US$3.2bn, 34% lower than in 2009, reflecting a more stable credit environment across many countries in the region. Individually assessed loan impairment allowances declined, mainly in the UK, reflecting an improvement in credit conditions. Significantly, impairment charges in 2009 against specific customers in the property sector did not recur. Collectively assessed loan impairment allowances also declined due to a fall in delinquency levels as our customers continued to benefit from the low interest rate environment and the general improvement in economic conditions. In our personal lending portfolios, new collectively assessed loan impairment allowances declined, reflecting lower levels of unsecured lending and tightened underwriting criteria. Impaired loans of US$10.7bn were 3% higher than at the end of 2009.

In Europe, releases and recoveries increased by 32% to US$681m.

In **Hong Kong**, new loan impairment allowances declined by 58% to US$230m and impaired loans fell by 21% from the end of 2009 to US$665m. New loan impairment allowances

declined in both the personal and commercial lending portfolios, reflecting the economic recovery and improvement in credit conditions in the territory and fewer customer downgrades, partly offset by an increase in lending balances.

Releases and recoveries in Hong Kong were US$93m, 5% lower than in 2009.

New loan impairment allowances in **Rest of Asia-Pacific** declined by 40% to US$700m. The decline reflected lower new collective impairment allowances in India due to improved delinquency rates and lower balances as certain unsecured portfolios and higher risk elements of the credit card portfolio were managed down. In addition, new individually assessed impairment allowances also declined, mainly in India, due to the non-recurrence of large impairments, notably on certain technology-related exposures. These were partly offset by a significant loan impairment charge against a single customer. Impaired loans in the region increased by 3% to US$1.3bn at the end of 2010.

Releases and recoveries in the region rose by 19% due to releases in the construction and software industries in India and higher recoveries of amounts previously written off, notably in Australia.

In the **Middle East and North Africa**, new loan impairment allowances were US$735m, 47% lower than in 2009. The decrease was largely due to a decline in new collectively assessed loan impairment allowances net of allowance releases against the personal and commercial lending portfolios as delinquency rates improved, with a decline in personal balances in line with the managing down of our exposure to higher risk unsecured personal lending. The lower allowances also reflected an overall improvement in economic conditions across the region. There were also declines in new individually assessed loan impairment charges as new charges for 2010 were restricted to a small number of large corporate exposures. Impaired loans rose by 47% from 31 December 2009 to US$2.5bn due to credit deterioration in a small number of specific exposures, and debt restructuring in the UAE.

Releases and recoveries in the Middle East and North Africa more than doubled from 2009 to US$112m due to the release of judgemental impairment allowances reflecting improved economic conditions during 2010.

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In **North America**, new loan impairment allowances declined markedly, reducing by 44% to US$8.7bn. In our HSBC Finance portfolios, lower new loan impairment allowances in Card and Retail Services reflected a reduction in lending balances and an improvement in delinquency rates. In our Consumer Lending and Mortgage Services portfolios, new loan impairment allowances also fell as the portfolio continued to run-off. In addition, total loss severities on foreclosed loans improved compared with 2009 reflecting the increase in the number of properties for which we accepted a deed-in-lieu of foreclosure, or a short sale, both of which result in lower losses compared with loans which are subjected to a formal foreclosure process.

In our corporate and commercial portfolios in North America, new loan impairment allowances declined, reflecting lower balances due to customer deleveraging and improved credit quality which, along with the improved economy, resulted in credit upgrades on certain accounts and fewer customer downgrades.

In North America, impaired loans decreased by 19% from the end of 2009 to US$10.8bn, while releases and recoveries rose by 80% compared with 2009 to US$378m.

In **Latin America**, new loan impairment allowances declined by 42% to US$1.9bn, while impaired loans declined by 23% to US$2.4bn as economic conditions in the region improved. Lower new loan impairment allowances in the personal lending portfolios were due to lower credit card balances in Mexico as we repositioned the portfolio to target higher quality customers and, to a lesser extent, in Brazil, due to the managed reduction in consumer finance balances. In addition, in the commercial lending portfolios in Brazil lower new impairment allowances reflected an improvement in economic conditions.

Releases and recoveries in Latin America declined by 21% from 2009 to US$331m.

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Collateral

Collateral and other credit enhancements held

(Audited)

Loans and advances held at amortised cost

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

Depending on its form, collateral can have a significant financial effect in mitigating our exposure to credit risk.

The tables below provide a quantification of the value of fixed charges we hold over a borrower s specific asset (or assets) where we have a history of enforcing, and are able to enforce, the collateral in satisfying a debt in the event of the borrower failing to meet its contractual obligations, and where the collateral is cash or can be realised by sale in an established market. The collateral valuation in the tables below exclude any adjustments for obtaining and selling the collateral.

We may also manage our risk by employing other types of collateral and credit risk enhancements, such as second charges, other liens and unsupported guarantees, but the valuation of such mitigants is less certain and their financial effect has not been quantified. In particular, loans shown in the tables below as not collateralised may benefit from such credit mitigants.

Personal lending

Residential mortgage loans including loan commitments by level of collateral

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2011							
Fully collateralised	**125,702**	**46,532**	**38,381**	**1,761**	**60,794**	**4,891**	**278,061**
Loan to Value (LTV) ratio:							
less than 25%	**9,898**	**5,364**	**2,383**	**58**	**3,576**	**282**	**21,561**
25% to 50%	**31,601**	**19,643**	**9,978**	**336**	**10,593**	**1,350**	**73,501**
51% to 75%	**52,656**	**17,748**	**18,006**	**895**	**25,138**	**2,221**	**116,664**

76% to 90%	**23,919**	**2,884**	**7,624**	**304**	**13,590**	**876**	**49,197**
91% to 100%	**7,628**	**893**	**390**	**168**	**7,897**	**162**	**17,138**
Partially collateralised							
greater than 100% LTV	**3,275**	**484**	**295**	**174**	**12,503**	**102**	**16,833**
collateral value	**2,821**	**466**	**37**	**135**	**10,566**	**24**	**14,049**
Total residential mortgages	**128,977**	**47,016**	**38,676**	**1,935**	**73,297**	**4,993**	**294,894**
At 31 December 2010							
Fully collateralised	115,700	43,948	34,674	1,490	66,542	5,086	267,440
LTV ratio:							
less than 25%	9,531	4,815	2,082	58	3,779	282	20,547
25% to 50%	27,740	15,984	8,733	235	10,973	1,272	64,937
51% to 75%	46,395	19,574	15,912	634	25,750	2,310	110,575
76% to 90%	23,044	2,569	7,661	409	16,091	1,003	50,777
91% to 100%	8,990	1,006	286	154	9,949	219	20,604
Partially collateralised							
greater than 100% LTV	4,156	18	176	404	12,327	173	17,254
collateral value	3,705	15	45	152	10,539	88	14,544
Total residential mortgages	**119,856**	**43,966**	**34,850**	**1,894**	**78,869**	**5,259**	**284,694**

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The above table shows residential mortgage lending including off-balance sheet loan commitments by level of collateral. Off-balance sheet commitments include loans that have been approved but which the customer has not yet drawn, and the undrawn portion of loans that have a flexible drawdown facility such as the off-set mortgage product. The collateral included in the table above consists of first charges on real estate.

The LTV ratio is calculated as the gross on-balance sheet carrying amount of the loan and any off-balance sheet loan commitment at the balance sheet date divided by the value of collateral. The methodologies for obtaining residential property collateral values vary throughout the Group, but are typically determined through a combination of professional appraisals, house price indices or statistical analysis. Valuations must be updated on a regular basis and, as a minimum, at intervals of every three years. Valuations are conducted more frequently when market conditions or portfolio performance are subject to significant change or when a loan is identified and assessed as impaired.

Other personal lending

Other personal lending consists primarily of overdrafts, credit cards and second lien mortgage portfolios. Second lien lending is supported by collateral but the claim on the collateral is subordinate to the first lien charge. The majority of our second lien portfolios were originated in North America where loss experience on defaulted second lien loans has typically approached 100%; consequently, we do not generally attach any significant financial value to this type of collateral. Credit cards and overdrafts are generally unsecured.

Corporate, commercial and financial (non-bank) lending

Collateral held is analysed separately below for commercial real estate and for other corporate, commercial and financial (non-bank) lending. This reflects the difference in collateral held on the portfolios. In each case, the analysis includes off-balance sheet loan commitments, primarily undrawn credit lines.

Commercial real estate loans and advances including loan commitments by level of collateral

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2011							
Rated CRR/EL 1 to 7	**33,376**	**25,202**	**10,934**	**746**	**10,238**	**4,841**	**85,337**
Not collateralised	**5,730**	**12,552**	**2,973**	**631**	**97**	**2,136**	**24,119**
Fully collateralised	**24,547**	**11,734**	**6,929**	**65**	**8,506**	**1,706**	**53,487**
Partially collateralised (A)	**3,099**	**916**	**1,032**	**50**	**1,635**	**999**	**7,731**
collateral value on A	**1,775**	**591**	**280**	**39**	**311**	**559**	**3,555**
Rated CRR/EL 8 to 10	**3,768**	**4**	**75**	**310**	**1,057**	**326**	**5,540**
Not collateralised	**434**	**2**	**10**	**55**	**135**	**127**	**763**
Fully collateralised	**1,413**	**2**	**23**	**74**	**521**	**196**	**2,229**
Partially collateralised (B)	**1,921**	**0**	**42**	**181**	**401**	**3**	**2,548**

collateral value on B	**1,083**	**0**	**26**	**89**	**246**	**1**	**1,445**
Total commercial real estate loans and advances	**37,144**	**25,206**	**11,009**	**1,056**	**11,295**	**5,167**	**90,877**
At 31 December 2010							
Rated CRR/EL 1 to 7	32,192	24,463	9,829	1,015	8,009	4,341	79,849
Not collateralised	6,153	10,693	2,600	722	388	2,004	22,560
Fully collateralised	22,904	12,227	6,972	65	6,837	1,574	50,579
Partially collateralised (C)	3,135	1,543	257	228	784	763	6,710
collateral value on C	1,800	955	124	149	288	310	3,626
Rated CRR/EL 8 to 10	2,810	3	113	271	1,241	403	4,841
Not collateralised	249	1	8	40	60	99	457
Fully collateralised	1,164	2	41	14	533	255	2,009
Partially collateralised (D)	1,397		64	217	648	49	2,375
collateral value on D	867		44	206	430	29	1,576
Total commercial real estate loans and advances	35,002	24,466	9,942	1,286	9,250	4,744	84,690

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The collateral included in the table above consists of fixed first charges on real estate and charges over cash for the commercial real estate sector.

Facilities are disclosed as not collateralised for this sector if they are unsecured or benefit from credit risk mitigation from guarantees, which are not quantified for the purposes of this disclosure. Lending to major property companies in Hong Kong is, by market practice, typically secured by guarantees or is unsecured. In Europe, facilities of a working capital nature are generally not secured by a first fixed charge and are therefore disclosed as not collateralised.

The value of commercial real estate collateral is determined through a combination of professional and internal valuations and physical inspection. Due to the complexity of collateral valuations for commercial real estate, local valuation policies determine the frequency of review based on local market conditions. Revaluations are sought with greater frequency where, as part of the regular credit assessment of the obligor, material concerns arise in relation to the transaction which may reflect on the underlying performance of the collateral, or in circumstances where an obligor s credit quality has declined sufficiently to cause concern that the principal payment source may not fully meet the obligation (i.e. the obligor s credit quality classification indicates it is at the lower end e.g. sub-standard, or approaching impaired).

Other corporate, commercial and financial (non-bank) loans and advances including loan commitments by level of

collateral

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2011							
Rated CRR/EL 8 to 10	**8,715**	**512**	**1,098**	**2,253**	**2,448**	**2,538**	**17,564**
Not collateralised	**5,583**	**349**	**795**	**1,695**	**801**	**1,546**	**10,769**
Fully collateralised	**1,765**	**63**	**147**	**60**	**441**	**602**	**3,078**
Partially collateralised (A)	**1,367**	**100**	**156**	**498**	**1,206**	**390**	**3,717**
collateral value on A	**558**	**55**	**76**	**103**	**541**	**214**	**1,547**
At 31 December 2010							
Rated CRR/EL 8 to 10	11,962	675	1,256	2,336	2,947	1,902	21,078
Not collateralised	8,363	489	933	1,779	1,059	843	13,466
Fully collateralised	1,903	51	142	60	670	854	3,680
Partially collateralised (B)	1,696	135	181	497	1,218	205	3,932
collateral value on B	627	81	80	103	422	114	1,427

The collateral used in the assessment of the above primarily includes first legal charges over real estate and charges over cash in the commercial and industrial sector, and charges over cash and marketable financial instruments in the financial sector. Government sector lending is generally unsecured.

It should be noted that the table above excludes other types of collateral which are commonly taken for corporate and commercial lending such as unsupported guarantees and floating charges over the assets of a customer s business. While such mitigants have value, often providing rights in insolvency, their assignable value is insufficiently certain and they are assigned no value for disclosure purposes.

As with commercial real estate, the value of real estate collateral included in the table above is generally determined through a combination of professional and internal valuations and physical inspection. The frequency of revaluation is

undertaken on a similar basis to commercial real estate loans and advances; however, for financing activities in corporate and commercial lending that are not predominantly commercial real estate-oriented, collateral value is not as strongly correlated to principal repayment performance. Collateral values will generally be refreshed when an obligor s general credit performance deteriorates and it is necessary to assess the likely performance of secondary sources of repayment should reliance upon them prove necessary. For this reason, the table above reports values only for customers with CRR 8 to 10, reflecting that these loans and advances generally have valuations which are of comparatively recent vintage. For the purposes of the table above, cash is valued at its nominal value and marketable securities at their fair value.

The difference between the collateral value and the value of partially collateralised lending disclosed in the tables above cannot be directly compared to any impairment allowances recognised in respect of

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impaired loans, as the loans may be performing in accordance with their contractual terms. Where loans are not performing in accordance with their contractual terms, the recovery of cash flows may be affected by other cash resources of the customer, or other credit risk enhancements not quantified for the purposes of the tables above. The Group s policy for determining impairment allowances,

including the effect of collateral on these impairment allowances, is provided on page 190.

Loans and advances to banks

The following table shows loans and advances to banks including off-balance sheet loan commitments by level of collateral.

Loans and advances to banks including loan commitments by level of collateral

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2011							
Not collateralised	**25,896**	**34,892**	**42,586**	**9,337**	**14,132**	**19,516**	**146,359**
Fully collateralised	**31,515**	**1,365**	**6,927**	**32**	**978**	**1,238**	**42,055**
Partially collateralised (A)	**146**	**50**	**445**	**0**	**784**	**114**	**1,539**
collateral value on A	**104**	**50**	**207**	**0**	**702**	**88**	**1,151**
Total	**57,557**	**36,307**	**49,958**	**9,369**	**15,894**	**20,868**	**189,953**
At 31 December 2010							
Not collateralised	31,225	34,336	32,631	10,416	16,829	22,436	147,873
Fully collateralised	50,316	154	9,558	188	3,101	4,937	68,254
Partially collateralised (B)	91		28		959	3	1,081
collateral value on B	64		24		956		1,044
Total	81,632	34,490	42,217	10,604	20,889	27,376	217,208

The collateral used in the assessment of the above relates primarily to cash and marketable securities. Loans and advances to banks are typically unsecured. Certain products such as reverse repos and stock borrowing are effectively collateralised and have been included in the above as fully collateralised. The fully collateralised loans and advances to banks for Europe in the table above consist primarily of reverse repurchase agreements and stock borrowing.

Derivatives

The ISDA Master Agreement is our preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of OTC products is conducted, and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement if either party defaults or another pre-agreed termination event occurs. It is common, and our preferred practice, for the parties to execute a Credit Support Annex (CSA) in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the counterparty risk inherent in outstanding positions. The majority of our CSAs are with financial institutional clients.

A description of the derivative offset amount in the Maximum exposure to credit risk table is provided on page 107.

Other credit risk exposures

In addition to collateralised lending described above, other credit enhancements are employed and methods used to mitigate credit risk arising from financial assets. These are described in more detail below.

Government, bank and other financial institution issued securities may benefit from additional credit enhancement, notably through government guarantees that reference these assets. Details of government guarantees are included in Notes 15, 19 and 21 on the Financial Statements. Corporate issued debt securities are primarily unsecured. Debt securities issued by banks and financial institutions include ABSs and similar instruments, which are supported by underlying pools of financial assets. Credit risk associated with ABSs is reduced through the purchase of CDS protection. Disclosure of the Group s holdings of ABSs and associated CDS protection is provided on page 152.

Trading assets include loans and advances held with trading intent, the majority of which consist of

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reverse repos and stock borrowing which, by their nature, are collateralised. Collateral accepted as security that the Group is permitted to sell or repledge under these arrangements is described in Note 37 on the Financial Statements. Trading assets also include money market term placements which are unsecured.

The Group s maximum exposure to credit risk includes financial guarantees and similar arrangements that it issues or enters into, and loan commitments that it is irrevocably committed to. Depending on the terms of the arrangement, the bank may have recourse to additional credit mitigation in the event that a guarantee is called upon or a loan commitment is drawn and subsequently defaults. Further information about these arrangements is provided in Note 41 on the Financial Statements.

Collateral and other credit enhancements obtained

(Audited)

The carrying amount of assets obtained by taking possession of collateral held as security, or calling upon other credit enhancements, is as follows:

	Carrying amount at 31 December[32]	
	2011 US$m	2010 US$m
Nature of assets		
Residential property	**420**	1,155
Commercial and industrial property	**64**	104
Other	**17**	2
	501	1,261

For footnote, see page 185.

The significant reduction in residential properties was due to the suspension of foreclosure activities at the end of 2010 and during the first half of 2011. See page 122.

We make repossessed properties available for sale in an orderly fashion, with the proceeds used to reduce or repay the outstanding indebtedness. If excess funds arise after the debt has been repaid, they are made available to repay other secured lenders with lower priority or returned to the customer. We do not generally occupy repossessed properties for our business use.

HSBC Holdings

(Audited)

Risk on an enterprise-wide basis in HSBC Holdings is overseen by the HSBC Holdings Asset and Liability Committee (ALCO). The major risks faced by HSBC Holdings are credit risk and market risk (in the form of interest rate risk and foreign exchange risk), of which the most significant is credit risk.

Credit risk in HSBC Holdings primarily arises from transactions with Group subsidiaries and from guarantees issued in support of obligations assumed by certain Group operations in the normal conduct of their business.

These risks are reviewed and managed within regulatory and internal limits for exposures by our Global Risk function, which provides high-level centralised oversight and management of our credit risks worldwide.

HSBC Holdings maximum exposure to credit risk at 31 December 2011 is shown below. Its financial assets principally represent claims on Group subsidiaries in Europe and North America. No collateral or other credit enhancements were held by HSBC Holdings in respect of its transactions with subsidiaries.

All of the derivative transactions are with HSBC undertakings which are banking counterparties (2010: 100%).

HSBC Holdings maximum exposure to credit risk

(Audited)

	2011	2010
	US$m	US$m
Cash at bank and in hand:		
balances with HSBC undertakings	**316**	459
Derivatives	**3,568**	2,327
Loans and advances to HSBC undertakings	**28,048**	21,238
Financial investments	**1,078**	2,025
Financial guarantees and similar contracts	**49,402**	46,988
Loan and other credit-related commitments	**1,810**	2,720
	84,222	75,757

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The credit quality of the loans and advances to HSBC undertakings is assessed as strong/good, with 100% of the exposure being neither past due nor impaired (2010: 100%). The credit ratings of the financial investments held by HSBC Holdings are within the S&P ratings range of A to A (2010: A to BBB+).

Country distribution of outstandings

and cross-border exposures

(Unaudited)

We control the risk associated with cross-border lending through a centralised structure of internal country limits. Exposures to individual countries and cross-border exposure in the aggregate are kept under continual review.

The following table summarises the aggregate of our in-country foreign currency and cross-border outstandings by type of borrower to countries which individually represent in excess of 0.75% of our total assets. The classification is based on the country of residence of the borrower but also recognises the transfer of country risk in respect of third-party guarantees, eligible collateral held and residence of the head office when the borrower is a branch. In accordance with the Bank of England Country Exposure Report (Form CE) guidelines, outstandings comprise loans and advances (excluding settlement accounts), amounts receivable under finance leases, acceptances, commercial bills, certificates of deposit (CD s) and debt and equity securities (net of short positions), and exclude accrued interest and intra-HSBC exposures.

In-country foreign currency and cross-border amounts outstanding

(Unaudited)

	Banks US$bn	Government and official institutions US$bn	Other US$bn	Total US$bn
At 31 December 2011				
UK	**9.5**	**4.5**	**53.7**	**67.7**
US	**8.1**	**40.8**	**16.7**	**65.6**
France	**11.0**	**11.3**	**10.0**	**32.3**
Hong Kong	**7.2**	**1.2**	**17.7**	**26.1**
Mainland China	**25.4**	**7.6**	**13.3**	**46.3**
Japan	**8.6**	**25.8**	**0.9**	**35.3**
Germany	**9.7**	**7.2**	**5.0**	**21.9**
At 31 December 2010				
UK	27.6	6.3	51.6	85.5
US	13.6	37.6	17.6	68.8
France	23.8	11.1	11.2	46.1
Hong Kong	15.4	1.6	17.2	34.2

Mainland China	21.5	1.2	9.1	31.8
Japan	14.0	16.2	1.3	31.5
Germany	17.8	4.2	9.4	31.4
At 31 December 2009				
UK	37.5	7.0	38.0	82.5
US	10.7	29.3	25.7	65.7
France	27.0	10.7	7.7	45.4
Germany	21.9	15.0	4.5	41.4
The Netherlands[1]	10.3	1.7	7.6	19.6

1 *These balances were between 0.75% and 1% of total assets. All other balances were above 1%.*

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Securitisation exposures and other

structured products

(Audited)

This section contains information about our exposure to the following:

- asset-backed securities (ABS s), including mortgage-backed securities (MBS s) and related collateralised debt obligations (CDO s);
- direct lending at fair value through profit or loss;
- monolines;
- credit derivative product companies;
- leveraged finance transactions; and
- representations and warranties related to mortgage sales and securitisation activities.

Within the above is included information on the GB&M legacy credit activities in respect of Solitaire Funding Limited (Solitaire), the securities investment conduits (SIC s), the asset-backed securities trading portfolios and derivative transactions with monoline insurers. Further information in respect of Solitaire and the SICs is provided in Note 43 to the Financial Statements.

Business model

(Unaudited)

MBSs and other ABSs are held in Balance Sheet Management and as part of our investment portfolios in order to earn net interest income and management fees. Some are also held in the trading portfolio and hedged through credit derivative protection with the intention of earning the spread differential over the life of the instruments.

Our investment portfolios include SICs and money market funds, as described in Note 43 on the Financial Statements. We also originate leveraged finance loans for the purpose of syndicating or selling them down to generate trading profit or holding them to earn interest margin over their lives.

Accounting policies

Our accounting policies for the classification and valuation of financial instruments are in accordance with the requirements of IAS 32 Financial Instruments: Presentation and IAS 39 Financial Instruments: Recognition and Measurement , as described in Note 2 on the Financial Statements, and the use of assumptions and estimates in respect of the valuation of financial instruments is described in Note 16 on the Financial Statements.

Exposure in 2011

(Audited)

2011 saw increased uncertainty and concerns around sovereign credit risk, and a more pessimistic outlook for the US housing market and, as a result, there was no reoccurrence of the price appreciation across the range of ABS asset classes seen in 2010. The level of net write-downs to the income statement increased to US$0.3bn (2010: no net write-downs). However, unrealised losses in our available-for-sale portfolios reduced in the year from US$6.4bn to US$5.1bn, mainly as a result of price appreciation on assets issued by US government agency and sponsored enterprises and a reduction of the reserve through impairments taken to the income statement.

Within the following table are assets held in the GB&M legacy credit portfolio with a carrying value of US$35.4bn (2010: US$47.1bn).

A summary of the nature of HSBC s exposures is provided in the Appendix to Risk on page 188.

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Overall exposure of HSBC

(Audited)

	At 31 December 2011		At 31 December 2010	
	Carrying amount[33] US$bn	Including sub-prime and Alt-A US$bn	Carrying amount[33] US$bn	Including sub-prime and Alt-A US$bn
Asset-backed securities ('ABSs')	**65.6**	**6.9**	73.9	8.5
fair value through profit or loss	**3.0**	**0.2**	10.8	0.3
available for sale[34]	**54.6**	**5.7**	54.7	7.1
held to maturity[34]	**2.0**	**0.2**	2.2	0.2
loans and receivables	**6.0**	**0.8**	6.2	0.9
Direct lending at fair value through profit or loss	**1.2**	**0.8**	1.6	1.2
Total ABSs and direct lending at fair value through profit or loss	**66.8**	**7.7**	75.5	9.7
Less securities subject to risk mitigation from credit derivatives with monolines and other financial institutions	**(1.9)**	**(0.2)**	(8.3)	(0.4)
	64.9	**7.5**	67.2	9.3
Leveraged finance loans	**3.6**		4.9	
fair value through profit or loss	**0.2**		0.3	
loans and receivables	**3.4**		4.6	
	68.5	**7.5**	72.1	9.3
Exposure including securities mitigated by credit derivatives with monolines and other financial institutions	**70.4**	**7.7**	80.4	9.7

For footnotes, see page 185.

ABSs classified as available for sale

Our principal holdings of available-for-sale ABSs are in GB&M through special purpose entities ('SPE's) which were established from the outset with the benefit of external investor first loss

protection support, together with positions held directly and by Solitaire, where we provide first loss protection of US$1.2bn through credit enhancement and a liquidity facility.

Movement in the available-for-sale reserve

(Audited)

	2011			2010		
	Directly held/ Solitaire[35]	**SPEs**	**Total**	Directly held/ Solitaire[35]	SPEs	Total
	US$m	**US$m**	**US$m**	US$m	US$m	US$m
Available-for-sale reserve at 1 January	**(4,102)**	**(2,306)**	**(6,408)**	(7,349)	(4,864)	(12,213)
Increase/(decrease) in fair value of securities	**622**	**(137)**	**485**	2,175	1,543	3,718
Impairment charge:						
borne by HSBC	**383**	**26**	**409**	444		444
allocated to capital note holders[36]		**313**	**313**		531	531
Repayment of capital	**162**	**183**	**345**	540	187	727
Other movements	**(150)**	**(140)**	**(290)**	88	297	385
Available-for-sale reserve at 31 December	**(3,085)**	**(2,061)**	**(5,146)**	(4,102)	(2,306)	(6,408)

For footnotes, see page 185.

Securities investment conduits

(Audited)

The total carrying amount of ABSs held through SPEs in the above table represents holdings in which significant first loss protection is provided through capital notes issued by SICs, excluding Solitaire.

At each reporting date, we assess whether there is any objective evidence of impairment in the value of the ABSs held by SPEs. Impairment charges incurred on these assets are offset by a credit to the impairment line for the amount of the loss allocated to capital note holders, subject to the carrying amount of the capital notes being sufficient to offset the loss. During the year

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impairment charges in one SPE, Mazarin, exceeded the carrying value of the capital notes liability and a charge of US$26m (2010: nil) was borne by

HSBC as shown in the table below. In respect of the SICs, the capital notes held by third parties are expected to absorb the cash losses in the vehicles.

Available-for-sale reserve and economic first loss protection in SICs, excluding Solitaire

(Audited)

	SICs excluding Solitaire at 31 December	
	2011	2010
	US$m	US$m
Available-for-sale reserve	**(2,701)**	(2,666)
related to ABSs	**(2,061)**	(2,306)
Economic first loss protection	**2,286**	2,246
Carrying amount of capital notes liability	**154**	254
Impairment charge for the year:		
borne by HSBC	**26**	
allocated to capital note holders	**313**	531

Impairment methodologies

(Audited)

The accounting policy for impairment and indicators of impairment is set out in Note 2 on the Financial Statements.

A summary of our impairment methodologies is provided in the Appendix to Risk on page 188.

Impairment and cash loss projections

(Unaudited)

At each reporting date, management undertakes a stress analysis. This exercise comprises a shift of projections of future loss severities, default rates and prepayment rates. The results of the analysis at 30 June 2011 indicated that further impairment charges of US$900m and expected cash

losses of US$400m could arise over the next two to three years.

This exercise was re-performed at 31 December 2011 and the results remain consistent with the June 2011 guidance.

For the purposes of identifying impairment at the reporting date, the future projected cash flows reflect the effect of loss events that have occurred at or prior to the reporting date. For the purposes of performing stress tests to estimate potential future impairment charges, the projected future cash flows reflect additional assumptions about future loss events after the balance sheet date.

This analysis makes assumptions in respect of the future behaviour of loss severities, default rates and prepayment rates. Movements in the parameters are not independent of each other. For example, increased default rates and increased loss severities, which would imply greater impairments,

generally arise under economic conditions that give rise to reduced levels of prepayment, reducing the potential for impairment charges. Conversely, economic conditions which increase the rates of prepayment are generally associated with reduced default rates and decreased loss severities.

At 31 December 2011, the incurred and projected impairment charges, measured in accordance with accounting requirements, significantly exceeded the expected cash losses on the securities. Over the lives of the available-for-sale ABSs the cumulative impairment charges will converge towards the level of cash losses. In respect of the SICs, in particular, the capital notes held by third parties are expected to absorb the cash losses arising in the vehicles.

Analysis of exposures and significant movements

(Audited)

Sub-prime residential mortgage-related assets

The assets in the table below included US$2.4bn (2010: US$3.1bn) relating to US-originated assets and US$1.0bn (2010: US$1.1bn) relating to UK non-conforming residential mortgage-related assets.

At 31 December 2011, 25% (US$0.9bn) of our sub-prime residential mortgage-related assets were rated AA or AAA (2010: 38% (US$1.7bn). Of the non-high grade assets held of US$2.7bn (2010: US$2.8bn), US$1.2bn (2010: US$1.5bn) related to US-originated assets.

There was a reduction in market prices for sub-prime assets during the course of 2011, particularly in the latter stages of the year; this effect was coupled with principal paydowns. Further net

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Carrying amount of HSBC s consolidated holdings of ABSs, and direct lending held at fair value through profit or loss[33]

(Audited)

	Trading US$m	Available for sale US$m	Held to maturity US$m	Designated at fair value through profit or loss US$m	Loans and receivables US$m	Total US$m	Of which held through consolidated SPEs US$m	Gross principal[37] US$m	Credit default swap protection[38] US$m	Net principal exposure[39] US$m
At 31 December 2011										
Mortgage-related assets:										
Sub-prime residential	896	2,134			598	3,628	2,367	6,222	275	5,947
Direct lending	733					733	487	1,684		1,684
MBSs and MBS CDOs	163	2,134			598	2,895	1,880	4,538	275	4,263
US Alt-A residential	190	3,516	166		243	4,115	2,827	8,610	100	8,510
Direct lending	114					114		119		119
MBSs	76	3,516	166		243	4,001	2,827	8,491	100	8,391
US Government agency and sponsored enterprises:										
MBSs	38	26,152	1,813			28,003		26,498		26,498
Other residential	670	3,286			978	4,934	2,098	5,702		5,702
Direct lending	314					314		309		309
MBSs	356	3,286			978	4,620	2,098	5,393		5,393
Commercial property										
MBSs and MBS CDOs	300	7,240		107	1,816	9,463	5,795	11,222		11,222
	2,094	42,328	1,979	107	3,635	50,143	13,087	58,254	375	57,879
Leveraged finance-related assets:										
ABSs and ABS CDOs	362	5,566			347	6,275	4,324	7,112	782	6,330
Student loan-related assets:										
ABSs and ABS CDOs	179	4,665			153	4,997	4,114	6,681	199	6,482
Other assets:										
ABSs and ABS CDOs	1,477	2,044		94	1,818	5,433	1,473	7,539	1,391	6,148
	4,112	54,603	1,979	201	5,953	66,848	22,998	79,586	2,747	76,839

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	Trading US$m	Available for sale US$m	Held to maturity US$m	Designated at fair value through profit or loss US$m	Loans and receivables US$m	Total US$m	Of which held through consolidated SPEs US$m	Gross principal[37] US$m	Credit default swap protection[38] US$m	Net principal exposure[39] US$m
At 31 December 2010										
Mortgage-related assets:										
Sub-prime residential	1,297	2,565			652	4,514	2,763	7,427	348	7,079
Direct lending	1,078					1,078	632	2,233		2,233
MBSs and MBS CDOs	219	2,565			652	3,436	2,131	5,194	348	4,846
US Alt-A residential	180	4,545	191		270	5,186	3,651	10,065	100	9,965
Direct lending	96					96		108		108
MBSs	84	4,545	191		270	5,090	3,651	9,957	100	9,857
US Government agency and sponsored enterprises:										
MBSs	657	21,699	2,032			24,388	6	23,739		23,739
Other residential	1,075	4,024			1,111	6,210	2,669	6,995		6,995
Direct lending	417					417		424		424
MBSs	658	4,024			1,111	5,793	2,669	6,571		6,571
Commercial property										
MBSs and MBS CDOs	546	8,160		111	1,942	10,759	6,441	12,625	421	12,204
	3,755	40,993	2,223	111	3,975	51,057	15,530	60,851	869	59,982
Leveraged finance-related assets:										
ABSs and ABS CDOs	392	5,418			414	6,224	3,886	7,148	788	6,360
Student loan-related assets:										
ABSs and ABS CDOs	163	5,178			150	5,491	4,251	7,161	100	7,061
Other assets:										
ABSs and ABS CDOs	1,936	3,103		6,017	1,710	12,766	2,526	15,497	7,765	7,732
	6,246	54,692	2,223	6,128	6,249	75,538	26,193	90,657	9,522	81,135

For footnotes, see page 185.

The above table excludes leveraged finance transactions, which are shown separately on page 156.

impairment of US$42m on assets was recognised in 2011 (2010: US$48m) as losses were incurred under current accounting impairment rules. Our expectation of cash losses on the underlying assets did not increase from that at 31 December 2010. Of the above impairment, there were US$5m of write-backs (2010: US$54m impairment) in the SICs.

US Alt-A residential mortgage-related assets

During 2011, principal paydowns along with general spread widening, particularly in the latter stages of the year, contributed to a reduction in the carrying values for Alt-A assets from the levels seen in 2010. Further impairments of US$687m (2010: US$884m) were recorded as losses were incurred under the accounting rules described above. Of this impairment, US$344m (2010: US$450m) occurred in the SICs, of which US$318m (2010: US$450m) was borne by the capital note holders.

At 31 December 2011, 9% (US$0.4bn) of these assets were rated AA or AAA (2010: 9% (US$0.5bn)).

Commercial property mortgage-related assets

Of our total of US$9.5bn (2010: US$10.8bn) of commercial property mortgage-related assets, US$4.9bn related to US-originated assets (2010: US$5.2bn). Spreads tightened on both US and non-US commercial property mortgage-related assets during 2011. Impairments of US$36m (2010: US$5m) were recognised in 2011.

Transactions with monoline insurers

(Audited)

HSBC s exposure to derivative transactions entered into directly with monolines

Our principal exposure to monolines is through a number of OTC derivative transactions, mainly CDSs. We entered into these CDSs primarily to purchase credit protection against securities held at the time within the trading portfolio.

During 2011, the notional value of derivative contracts with monolines and our overall credit exposure to monolines decreased primarily as a number of transactions were commuted. The table below sets out the fair value, essentially the replacement cost, of the remaining derivative transactions at 31 December 2011, and hence the amount at risk if the CDS protection purchased were to be wholly ineffective because, for example, the monoline insurer was unable to meet its obligations. In order to further analyse that risk, the value of protection purchased is shown subdivided between those monolines that were rated by S&P at BBB or above at 31 December 2011, and those that were below BBB (BBB is the S&P cut-off for an investment grade classification). The Credit valuation adjustment column indicates the valuation adjustment taken against the net exposures, and reflects our best estimate of the likely loss of value on purchased protection arising from the deterioration in creditworthiness of the monolines. These valuation adjustments, which reflect a measure of the irrecoverability of the protection purchased, have been charged to the income statement.

HSBC s exposure to derivative transactions entered into directly with monoline insurers

(Audited)

	Notional amount US$m	Net exposure before credit valuation adjustment[40] US$m	Credit valuation adjustment[41] US$m	Net exposure after credit valuation adjustment US$m
At 31 December 2011				
Derivative transactions with monoline counterparties				
Monoline investment grade (BBB or above)	**4,936**	**873**	**(87)**	**786**
Monoline sub-investment grade (below BBB)	**1,552**	**370**	**(217)**	**153**
	6,488	**1,243**	**(304)**	**939**
At 31 December 2010				
Derivative transactions with monoline counterparties				
Monoline investment grade (BBB or above)	5,179	876	(88)	788
Monoline sub-investment grade (below BBB)	2,290	648	(431)	217
	7,469	1,524	(519)	1,005

For footnotes, see page 185.

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Market prices are generally not readily available for CDSs, so they are valued on the basis of market prices of the referenced securities.

Our monoline credit valuation adjustment calculation utilises a number of approaches which depend upon the internal credit rating of the monoline. Our assignment of internal credit ratings is based upon detailed credit analysis, and may differ from external ratings. The net effect of utilising the methodology adopted for highly-rated monolines across all monolines would be a reduction in credit valuation adjustment of US$76m (2010: US$94m). The net effect of utilising a methodology based on CDS spreads would be an increase in credit valuation adjustment of US$178m (2010: US$8m).

Credit valuation adjustments for monolines

For highly-rated monolines, the standard credit valuation adjustment methodology (as described on page 350) applies, with the exception that the future exposure profile is deemed to be constant (equal to the current market value) over the weighted average life of the referenced security, and the credit valuation adjustment cannot fall below 10% of the mark-to-market exposure.

In respect of monolines where default has either occurred or there is a strong possibility of default in the near term, the adjustment is determined based on the estimated probabilities of various potential scenarios, and the estimated recovery in each case.

For other monoline exposures, the credit valuation adjustment follows the methodology for highly-rated monolines, adjusted to include the probability of a claim arising in respect of the referenced security, and applies implied probabilities of default where the likelihood of a claim is believed to be high.

HSBC s exposure to direct lending and irrevocable commitments to lend to monoline insurers

We had no liquidity facilities to monolines at 31 December 2011 (2010: nil).

HSBC s exposure to debt securities which benefit from guarantees provided by monolines

Within both the trading and available-for-sale portfolios, we hold bonds that are wrapped with a credit enhancement from a monoline. As the bonds are traded explicitly with the benefit of this enhancement, any deterioration in the credit profile

of the monoline is reflected in market prices and, therefore, in the carrying amount of these securities at 31 December 2011. For wrapped bonds held in our trading portfolio, the mark-to-market movement is reflected through the income statement. For wrapped bonds held in the AFS portfolio, the mark-to-market movement is reflected in equity unless there is objective evidence of impairment, in which case the impairment loss is reflected in the income statement. No wrapped bonds were included in the reclassification of financial assets described in Note 18 on the Financial Statements.

HSBC s exposure to credit derivative product companies

Credit derivative product companies (CDPC s) are independent companies that specialise in selling credit default protection on corporate exposures. At 31 December 2011, we had purchased from CDPCs credit protection with a notional value of US$4.4bn (2010: US$4.9bn) which had a fair value of US$0.4bn (2010: US$0.2bn), against which a credit valuation adjustment (a provision) of US$0.1bn was held (2010: US$0.1bn). At 31 December 2011, none of our exposure was to CDPCs with investment grade ratings (2010: nil).

Leveraged finance transactions

(Audited)

Leveraged finance transactions include sub-investment grade acquisition or event-driven financing. The following table shows our exposure to leveraged finance transactions arising from primary transactions. Our additional exposure to leveraged finance loans through holdings of ABSs from our trading and investment activities is shown in the table on page 152.

We held leveraged finance commitments of US$3.7bn at 31 December 2011 (2010: US$5.1bn), of which US$3.3bn (2010: US$4.6bn) was funded.

At 31 December 2011, our principal exposures were to companies in two sectors: US$1.3bn to data processing (2010: US$2.8bn) and US$1.9bn to communications and infrastructure (2010: US$1.8bn).

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HSBC s exposure to leveraged finance transactions

(Audited)

	At 31 December 2011			At 31 December 2010		
	Funded exposures[42]	**Unfunded exposures[42]**	**Total exposures**	Funded exposures[42]	Unfunded exposures[42]	Total exposures
	US$m	**US$m**	**US$m**	US$m	US$m	US$m
Europe	**2,795**	**253**	**3,048**	3,337	298	3,635
Rest of Asia-Pacific				17	22	39
North America	**445**	**126**	**571**	1,066	185	1,251
	3,240	**379**	**3,619**	4,420	505	4,925
Held within:						
loans and receivables	**3,120**	**328**	**3,448**	4,199	393	4,592
fair value through profit or loss	**120**	**51**	**171**	221	112	333

For footnotes, see page 185.

Representations and warranties related to mortgage sales and securitisation activities

(Audited)

We have been involved in various activities related to the sale and securitisation of residential mortgages which are not recognised on our balance sheet. These activities include:

- the purchase of US$24bn of third-party originated mortgages by HSBC Bank USA and the securitisation of these by HSBC Securities (USA) Inc. (HSI) between 2005 and 2007;

- HSI acting as underwriter for third-party issuance of private label MBSs with an original issuance value of US$37bn, most of which were sub-prime; and

- the origination and sale by HSBC Bank USA of mortgage loans, primarily to government sponsored entities.

In sales and securitisations of mortgage loans, various representations and warranties regarding the loans may be made to purchasers of the mortgage loans and MBSs. In respect of the purchase and securitisation of third party originated mortgages and the underwriting of third party MBSs, the obligation to repurchase loans in the event of a breach of loan level representations and warranties resides predominantly with the organisation that originated the loan.

Participants in the US mortgage securitisation 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 US mortgage market such as servicers, originators, underwriters, trustees or sponsors of securitisations. Further information is provided in Note 44 on the Financial Statements.

At 31 December 2011, a liability of US$237m was recognised in respect of various representations and warranties relating to the origination and sale by HSBC Bank USA of mortgage loans, primarily to government sponsored entities (2010: US$262m). These relate to, among other things, the ownership of the loans, the validity of the liens, the loan selection and origination process and compliance with the origination criteria established by the agencies. In the event of a breach of our representations and warranties, HSBC Bank USA may be obliged to repurchase the loans with identified defects or to indemnify the buyers. The liability is estimated based on the level of outstanding repurchase demands, the level of outstanding requests for loan files and estimated future demands in respect of mortgages sold to date which are either two or more payments delinquent or expected to become delinquent at an estimated conversion rate. Repurchase demands of US$113m were outstanding at 2011 (2010: US$115m).

Report of the Directors: Operating and Financial Review (continued)

Upon receipt of a repurchase demand, we perform a detailed evaluation of the request. In many 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 takes roughly 12 months. 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 realised loss on the sale of a property (make-whole payment).

To date, repurchase demands we have received primarily relate to prime loans sourced during 2004

through 2008 from the legacy broker channel which we exited from 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 US$19.3bn at 31 December 2011, including US$12.1bn of loans sourced from our legacy broker channel.

The trend in repurchase demands received on loans sold to GSEs and other third parties by loan origination vintage, outstanding repurchase demands and movement in repurchase liabilities are as follows:

Trend in repurchase demands received by loans sold to GSEs and other third parties by origination vintage

	At 31 December	At 31 December	At 31 December
	2011		2010
	US$m		US$m
Pre-2004	**5**		14
2004	**13**		31
2005	**24**		24
2006	**56**		41
2007	**146**		161
2008	**98**		112
Post-2008	**68**		34
Total repurchase demands received	**410**		417

Outstanding repurchase demands received from GSEs and other third parties

	At 31 December	**At 31 December** At 31 December	**At 31 December**
	2011		2010
	US$m		US$m
GSEs	**78**		92
Others	**35**		23
Total	**113**		115

Movement in repurchase liability for loans sold to GSEs and other third parties

	At 31 December **2011**	At 31 December	At 31 December 2010
	US$m		US$m
At 1 January	**262**		66
Increase in liability recorded through earnings	**92**		341
Realised losses	**(117)**		(145)
At 31 December	**237**		262

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 estimate of the liability for a mortgage loan repurchase requires significant judgement. Because these estimates are influenced by factors outside our control, there is uncertainty inherent in them, making it reasonably possible that the estimates could change.

Risk elements in the loan portfolio

(Unaudited)

The disclosure of credit risk elements in this section reflects US accounting practice and classifications. The purpose of the disclosure is to present within the US disclosure framework those elements of the loan portfolios with a greater risk of loss. The three main classifications of credit risk elements presented are:

- impaired loans;
- unimpaired loans contractually past due 90 days or more as to interest or principal; and

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troubled debt restructurings not included in the above.

In the following tables, we present information on our impaired loans and advances in accordance with the classification approach described on page 133.

During the year we adopted a revised disclosure convention for impaired loans and advances. This revised disclosure convention affects the disclosure of loans and advances in the geographical regions with material levels of forbearance activity. The impaired loan disclosure convention continues to be based on internal credit rating grades and, for retail exposures, 90 days or more past due, but a more stringent approach has been introduced to the presentation of renegotiated loans as impaired. Management believes that this revised approach better reflects the nature of risks and inherent credit quality in our loan portfolio as it is more closely calibrated to the types of forbearance concessions granted and applies stricter requirements for the performance of renegotiated loans before they may be considered as not impaired. It also reflects developments in industry disclosure best practice, as well as a refinement of loan segmentation in our North America consumer lending business described on page 133. The revised disclosure convention affects the disclosure presentation of impaired loans but does not affect the accounting policy for the recognition of impairment allowances under IFRS.

Impaired loan comparative data for 31 December 2010 have been restated to reflect the revised impaired loans disclosure convention. Restatement of comparative data prior to 31 December 2010 is not practicable as sufficient information is not available to determine what assumptions management would have made in applying the revised disclosure convention for these comparative periods. This includes information about assumptions that would have been made in establishing the revised, more stringent period of payment performance for renegotiated loans before they are regarded as unimpaired. The difficulty associated with determining these estimates relates principally to retail portfolios that are assessed for impairment on a collective basis; these estimates become more difficult where a longer period of time has passed since the credit condition occurred. For further detail on the impaired loans restatement see page 133.

Interest forgone on impaired and restructured loans

Interest income that would have been recognised under the original terms of impaired and restructured

loans amounted to approximately US$3.6bn in 2011 (2010: US$2.2bn). The table below analyses this by geographic region.

	2011 US$m	2010 US$m
Europe	**266**	303
Hong Kong	**62**	33
Rest of Asia-Pacific	**109**	79
Middle East and North Africa	**140**	157
North America	**2,498**	1,322
Latin America	**545**	315
	3,620	**2,209**

Interest income from such loans of approximately US$1.9bn was recorded in 2011 (2010: US$1.2bn). The table below analyses this by geographic region.

	2011 US$m	2010 US$m

Europe	**69**	59
Hong Kong	**6**	25
Rest of Asia-Pacific	**49**	67
Middle East and North Africa	**33**	21
North America	**1,310**	905
Latin America	**391**	139
	1,858	**1,216**

The change in our impaired loans disclosure convention described above has increased the amount of loans disclosed as impaired. The effect of this change on 2011 reported numbers was to increase interest earned on impaired loans and restructured loans from US$1.3bn to US$1.9bn. Comparatives have not been restated as restatement of comparative data prior to 31 December 2010 is impracticable.

Impaired loans

A loan is impaired, and an impairment allowance is recognised, when there is objective evidence of a loss event that has an effect on the cash flows of the loan which can be reliably estimated. Impaired loans are presented for disclosure purposes in accordance with the convention described on page 133. In accordance with IFRS, we recognise interest income on assets after they have been written down as a result of an impairment loss.

The amount of impaired loans at 31 December 2011 was US$5.3bn lower than at 31 December 2010. This reduction occurred primarily in North America following reclassification of loans in the Card and Retail Services business to assets held for sale, the write-off of loans where there is no realistic prospect of recovery, and the return of certain loans to unimpaired status after the demonstration of a significant reduction in the risk of non-payment of future cash-flows.

Report of the Directors: Operating and Financial Review (continued)

Unimpaired loans past due 90 days or more

Examples of unimpaired loans past due 90 days or more include individually assessed mortgages that are in arrears more than 90 days where there are no other indicators of impairment, but where the value of collateral is sufficient to repay both the principal debt and all potential interest for at least one year; and short-term trade facilities past due more than 90 days for technical reasons such as delays in documentation, but where there is no concern over the creditworthiness of the counterparty.

Troubled debt restructurings

Under US GAAP, a troubled debt restructuring (TDR) is a loan whose terms have been modified for economic or legal reasons related to the borrower s financial difficulties which results in the lender granting a concession to the borrower that the lender would not otherwise consider. The SEC requires separate disclosure of any loans which meet the definition of a TDR that are not included in the previous two loan categories. These are classified as TDR s in the table on page 156e. Loans that have been identified as a TDR under the US guidance retain this designation until they are repaid or are derecognised. This treatment differs from the Group s impaired loans disclosure convention under IFRS under which a loan may return to unimpaired status after demonstrating a significant reduction in the risk of non-payment of future cash-flows. As a result reported TDRs include those loans that have returned to unimpaired status under the Group s disclosure convention for renegotiated loans.

As stated above the impaired loans balances prior to 2010 have not been restated in accordance with the new impaired loan disclosure convention for geographical regions with material levels of forbearance activity, therefore, prior to 2010 the amount of TDRs not included in the classifications above are higher.

In April 2011, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update, Clarifications to Accounting for Troubled Debt Restructurings by Creditors (ASU) which provides additional guidance to assist in determining whether a restructuring of a receivable meets the criteria to be considered a TDR. The effect of implementing this guidance was to increase the number of loans that meet the criteria to be classified as a TDR. The US guidance applied to loan restructurings taking place after 1 January 2011.

However, as a result of the Group s change in disclosure convention for the presentation of impaired loans under IFRSs, a greater number of renegotiated loans are now disclosed as impaired, particularly in respect of HSBC Finance in the US, and this change has been applied to renegotiated loans outstanding as at 31 December 2010. Previous years have not been restated. As a result of this change, at 31 December 2010, US$7.3bn of loans previously disclosed as TDRs outside the impaired loans classification have been reclassified as impaired in the table on page 156e.

The amount of TDRs at 31 December 2011 was US$385million higher than at 31 December 2010. The increase reflects the impact of the adoption of the new US TDR guidance in 2011 and the effect of certain loans in North America returning to unimpaired status after the demonstration of a significant reduction in the risk of non-payment of future cash-flows while retaining TDR status. Other movements include an increase in reported TDRs in the Middle East and North Africa mainly resulting from a newly restructured exposure, and a reduction in Latin America mainly due to the repayment of a single large restructuring and exchange differences.

Potential problem loans

Credit risk elements also cover potential problem loans. These are loans where information on possible credit problems among borrowers causes management to seriously doubt their ability to comply with the loan repayment terms. There are no potential problem loans other than those identified in the table of risk elements set out below, and as discussed in the credit risk section in Areas of special interest on page 112.

Areas of special interest includes further disclosure about certain homogeneous groups of loans which are collectively assessed for impairment, and represent the Group s most significant exposures to potential problem loans, including affordability mortgages and ARMs. Collectively assessed loans and advances, although typically not classified as impaired until more than 90 days past due, are assessed collectively for losses

that have been incurred but have not yet been individually identified. This policy is further described on page 298.

Renegotiated loans and forbearance on page 129 includes disclosure about the credit quality of loans whose contractual terms have been changed at some point in the life of the loan because of

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significant concerns about the borrower s ability to make contractual payments when due. Where renegotiated loans are not classified as impaired, this is because they exhibit a lower risk of non-payment of future cash flows than those presented as

impaired. However, some of these loans may have a higher risk of becoming delinquent in the future, and may therefore be potential problem loans.

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Analysis of risk elements in the loan portfolio by geographical region

(Unaudited)

	At 31 December				
	2011	2010	2009	2008	2007
	US$m	US$m	US$m	US$m	US$m
Impaired loans					
Europe	**11,819**	11,500	10,873	6,844	6,266
Hong Kong	**608**	665	846	852	433
Rest of Asia-Pacific	**1,070**	1,324	1,201	835	779
Middle East and North Africa	**2,445**	2,549	1,666	279	309
North America	**22,758**	27,902	13,308	14,285	9,662
Latin America	**3,039**	3,124	2,951	2,327	2,145
	41,739	47,064	30,845	25,422	19,594
Unimpaired loans contractually past due 90 days or more as to principal or interest					
Europe	**41**	65	57	635	202
Hong Kong	**3**	7	4	43	49
Rest of Asia-Pacific	**21**	40	36	84	94
Middle East and North Africa	**214**	263	215	190	62
North America	**74**	265	217	108	24
Latin America	**10**	3	40	21	421
	363	643	569	1,081	852
Troubled debt restructurings (not included in the classifications above)					
Europe	**753**	592	436	366	648
Hong Kong	**108**	205	236	165	146
Rest of Asia-Pacific	**122**	198	135	90	23
Middle East and North Africa	**444**	141	103	29	11
North America	**2,300**	1,970	9,613	5,618	3,322
Latin America	**1,037**	1,274	1,518	1,067	848
	4,764	4,380	12,041	7,335	4,998
Trading loans classified as in default					
North America	**230**	412	798	561	675
Risk elements on loans[80]					
Europe	**12,613**	12,157	11,366	7,845	7,116
Hong Kong	**719**	877	1,086	1,060	628
Rest of Asia-Pacific	**1,213**	1,562	1,372	1,009	896
Middle East and North Africa	**3,103**	2,953	1,984	498	382
North America	**25,362**	30,549	23,936	20,572	13,683
Latin America	**4,086**	4,401	4,509	3,415	3,414
	47,096	52,499	44,253	34,399	26,119
Assets held for resale					
Europe	**60**	47	52	81	59
Hong Kong	**4**	2	10	26	29

Rest of Asia-Pacific	**10**	5	8	11	5
Middle East and North Africa		2	2	2	2
North America	**359**	1,084	707	1,758	1,172
Latin America	**69**	121	153	113	101
	502	1,261	932	1,991	1,368
Total risk elements					
Europe	**12,673**	12,204	11,418	7,926	7,175
Hong Kong	**723**	879	1,096	1,086	657
Rest of Asia-Pacific	**1,223**	1,567	1,380	1,020	901
Middle East and North Africa	**3,103**	2,955	1,986	500	384
North America	**25,721**	31,633	24,643	22,330	14,855
Latin America	**4,155**	4,522	4,662	3,528	3,515
	47,598	53,760	45,185	36,390	27,487
	%	%	%	%	%
Loan impairment allowances as a percentage of risk elements on loans[81]	**37.6**	38.9	59.0	70.8	75.5

For footnotes, see page 185.

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Liquidity and funding

(Audited)

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

Our liquidity and funding risk management framework

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

We expect our operating entities to manage liquidity and funding risk on a standalone basis employing a centrally imposed framework and limit structure which is adapted to variations in business mix and underlying markets. Our operating entities are required to maintain strong liquidity positions and to manage the liquidity profiles of their assets, liabilities and commitments with the objective of ensuring that their cash flows are balanced under various severe stress scenarios and that all their anticipated obligations can be met when due.

There were no material changes to our policies and practices for the management of liquidity and funding risks in 2011.

A summary of our current policies and practices regarding liquidity and funding is provided in the Appendix to Risk on page 188.

Liquidity and funding in 2011

(Audited)

The liquidity position of the Group strengthened in 2011, and we continued to enjoy strong inflows of customer deposits and maintained good access to wholesale markets. During 2011, customer accounts grew by 2% while customer advances fell by 2%, leading to a decrease in our

advances-to-deposits ratio to 75%. Despite a highly competitive environment in Asia, our customer accounts grew by 8% due to growth in deposits in Hong Kong dollars and offshore renminbi.

Market conditions

2011 was another challenging year for banks in the wholesale funding markets. Despite a strong first quarter, the total volume of term debt issued by banks in 2011 was low by recent historical standards, with a particularly marked slowdown in the second half of the year.

Developments in the eurozone sovereign debt crisis continued to dominate the markets. In May 2011, Portugal became the third eurozone country to seek financial support from the ECB and the IMF. Conditions deteriorated markedly over the summer with sharp increases in CDS premia for eurozone peripheral countries. This prompted European authorities to propose a package of measures in October including a near doubling of the capacity of the European Financial Stability Facility.

In December, with the crisis reaching systemic levels, the ECB injected liquidity into the European banking sector via an unprecedented 489bn (US$632bn) 3-year Long-Term Refinancing Operation (LTRO), and committed to conduct a similar operation in February 2012. This intervention by the ECB had a positive effect on bank CDS levels, as well as on general funding conditions. We support the ECB in its efforts to stabilise the capital markets. Given the lack of stigma in participating and the attractive pricing, and with the outlook for capital markets remaining uncertain, we considered it prudent for our Continental Europe operations to anticipate future funding requirements by participating in the LTRO, receiving 5.2bn (US$6.7bn) in total, mainly in France.

Report of the Directors: Operating and Financial Review (continued)

Effect on HSBC s liquidity and funding position

We issue wholesale securities to supplement our customer deposits and change the currency mix, maturity profile or location of our liabilities. We continued to have good access to debt capital markets during 2011, with Group entities issuing US$22bn of term debt securities in the public capital markets at competitive prices in a range of currencies, maturities, obligations and markets. Of this amount, over 90% was unsecured funding. Our ability to access capital markets even in very challenging conditions was best demonstrated by the successful issuance of US$1.65bn of 10 and 30 year unsecured senior bonds by HSBC Holdings in November 2011. In general, the prices of our debt securities have not been unduly affected by the market turmoil.

Our European subsidiaries continued to maintain a liquidity profile within our risk appetite despite the ongoing eurozone crisis.

Contractual maturity of financial liabilities

(Audited)

The balances in the table below will not agree directly with those in our consolidated balance sheet as the table incorporates, on an undiscounted basis, all cash flows relating to principal and future coupon payments (except for trading liabilities and trading derivatives). In addition, loan and other credit-related commitments and financial guarantees and similar contracts are generally not recognised on our balance sheet. Trading liabilities and trading derivatives are included in the On demand time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. We classify the undiscounted cash flows payable under hedging derivative liabilities according to their contractual maturities. The undiscounted cash flows potentially payable under financial guarantees and similar contracts are classified on the basis of the earliest date they can be called.

Cash flows payable by HSBC under financial liabilities by remaining contractual maturities

(Audited)

	On demand US$m	Due within 3 months US$m	Due between 3 and 12 months US$m	Due between 1 and 5 years US$m	Due after 5 years US$m
At 31 December 2011					
Deposits by banks	**47,659**	**59,096**	**3,578**	**11,048**	**997**
Customer accounts	**914,762**	**252,226**	**72,993**	**20,508**	**1,094**
Trading liabilities	**265,192**				
Financial liabilities designated at fair value	**7,066**	**930**	**9,789**	**39,915**	**57,295**
Derivatives	**340,394**	**394**	**497**	**2,858**	**1,007**

Debt securities in issue	**117**	**48,465**	**27,520**	**57,507**	**7,019**
Subordinated liabilities	**6**	**528**	**1,834**	**9,616**	**47,715**
Liabilities of disposal groups held for sale[43]	**3,108**	**1,721**	**1,045**	**211**	**150**
Other financial liabilities	**25,452**	**28,137**	**5,845**	**2,023**	**1,377**
	1,603,756	**391,497**	**123,101**	**143,686**	**116,654**
Loan and other credit-related commitments	**355,366**	**65,245**	**94,120**	**111,061**	**29,113**
Financial guarantees and similar contracts	**12,460**	**7,585**	**12,107**	**5,899**	**1,273**
	1,971,582	**464,327**	**229,328**	**260,646**	**147,040**
At 31 December 2010					
Deposits by banks	42,481	70,072	8,393	7,949	1,346
Customer accounts	881,575	244,501	89,557	23,209	3,483
Trading liabilities	300,703				
Financial liabilities designated at fair value	7,421	3,786	7,825	35,583	61,575
Derivatives	255,046	531	1,143	2,065	942
Debt securities in issue	1,320	48,062	41,939	62,148	16,255
Subordinated liabilities	34	1,491	1,863	10,001	51,293
Other financial liabilities	24,834	24,378	7,944	2,184	824
	1,513,414	392,821	158,664	143,139	135,718
Loan and other credit-related commitments	524,394	51,732	14,023	11,964	400
Financial guarantees and similar contracts	18,491	9,233	12,231	7,082	2,399
	2,056,299	453,786	184,918	162,185	138,517

For footnote, see page 185.

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Report of the Directors: Operating and Financial Review (continued)

Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice. However, in practice, short-term deposit balances remain stable as inflows and outflows broadly match and a significant portion of loan commitments expire without being drawn upon. We therefore manage our balance sheet on both contractual and behaviouralised bases. Each operating entity determines the behaviouralisation of its products within the guidelines set out in our liquidity framework and as approved by its ALCO.

Although on a contractual basis 86% of our liabilities are due within one year, only approximately half of our behaviouralised liabilities are expected to fall due within this one-year period.

The management of liquidity risk

(Audited)

Advances to core funding ratio

The three principal banking entities listed in the table below represented 61% of our total core deposits at

31 December 2011 (2010: 62%). The distinction between core and non-core deposits generally means that our measure of advances to core funding is more restrictive than that which can be inferred from the published financial statements. Loans and advances to customers in these principal banking entities were overwhelmingly financed by reliable and stable sources of funding. We would meet any unexpected net cash outflows by using our cash and balances at central banks, selling or entering into repos of the securities within our liquid asset buffers or accessing additional funding sources such as the interbank market. Collateralised lending markets could also be accessed over the longer term.

Of particular note was the strong funding position of The Hongkong and Shanghai Banking Corporation, as reflected in the advances to core funding ratio in the table below, which allowed us to take advantage of loan growth opportunities in Asia while still maintaining ratios well below the Group s average.

HSBC s principal banking entities the management of liquidity risk[44]

(Audited)

	Advances to core funding ratio during:		Stressed one month coverage ratio during:	
	2011	2010	**2011**	2010
	%	%	**%**	%
HSBC Bank plc[45]				
Year-end	**99.8**	103.0	**116.2**	111.1
Maximum	**103.4**	109.7	**118.1**	111.3
Minimum	**98.4**	102.6	**109.4**	103.2
Average	**100.8**	106.0	**112.5**	108.2
The Hongkong and Shanghai Banking Corporation[45]				

Year-end	**75.0**	70.3	**122.9**	144.6
Maximum	**78.9**	70.3	**144.6**	165.4
Minimum	**70.3**	55.5	**116.4**	132.6
Average	**75.9**	63.6	**124.0**	148.8
HSBC Bank USA[46]				
Year-end	**85.7**	98.3	**117.7**	108.5
Maximum	**89.5**	104.3	**128.3**	118.5
Minimum	**79.8**	94.2	**108.5**	105.3
Average	**84.6**	98.0	**118.9**	112.3
Total of HSBC s other principal banking entities[47]				
Year-end	**86.4**	89.1	**117.6**	119.6
Maximum	**90.2**	89.1	**120.4**	126.5
Minimum	**86.4**	85.7	**116.2**	118.1
Average	**88.9**	87.0	**117.9**	122.2

For footnotes, see page 185.

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Stressed one month coverage ratio

The stressed one month coverage ratios tabulated above are derived from projected cash flow scenario analyses described in the Appendix to Risk on page 188, and express the stressed cash inflows as a percentage of stressed cash outflows over a one month time horizon. Group sites are required to target a ratio of 100% or more.

HSBC Finance

As HSBC Finance is unable to accept standard retail customer deposits, it takes funding from the professional markets. At 31 December 2011, US$51bn (2010: US$65bn) of HSBC Finance s liabilities were drawn from professional markets and affiliates, utilising a range of products, maturities and currencies. HSBC Finance uses a number of measures to monitor funding risk, including projected cash flow scenario analysis and caps placed on the amount of unsecured term funding that can mature in any rolling three-month and rolling 12-month periods. HSBC Finance also maintains access to committed sources of secured funding and has in place committed backstop lines for short-term refinancing commercial paper (CP) programmes. A CP programme is a short-term, unsecured funding tool used to manage day to day cash flow needs. In agreement with the rating agencies, issuance under this programme will not exceed 100% of committed bank backstop lines.

The need for HSBC Finance to refinance maturing term funding is largely mitigated by the continued run-down of its balance sheet and the proposed sale of the Card and Retail Services business, which should complete in the second quarter of 2012 and is expected to generate additional funding of approximately US$12bn. During 2011, the shelf registration statement under which HSBC Finance has historically issued long-term debt expired and we chose not to renew it.

HSBC Finance funding

(Audited)

	At 31 December	
	2011	2010
	US$bn	US$bn
Maximum amounts of unsecured term funding maturing in any rolling:		
3 month period	**5.1**	5.1
12 month period	**9.7**	10.8
Unused committed sources of secured funding[48]	**0.5**	0.5
Committed backstop lines from non-Group entities in support of CP programmes	**4.0**	4.3

For footnote, see page 185.

Encumbered assets

(Audited)

Encumbered assets are assets which have been pledged or used as collateral or which legally we may not be able to use to secure funding. It remains a strength that only a small percentage of our assets are encumbered and that the majority of our assets are available as security for all our creditors. The majority of the encumbrance arises due to our repo activity within Europe and the US in GB&M, which is largely self-funding.

Our encumbered assets on an IFRSs basis are disclosed in Note 37 on the Financial Statements. Assets not included in Note 37 but which would generally not be used to secure funding include assets backing insurance and investment contracts (see Balance sheet of insurance manufacturing on page 173) and Hong Kong government certificates of indebtedness which secure Hong Kong currency notes in circulation, which are included on the face of the consolidated balance sheet. Additionally, properties with net book values of US$33m (2010: US$31m) are considered encumbered.

Report of the Directors: Operating and Financial Review (continued)

Diversity of funding sources

(Audited)

Our primary sources of funding are current accounts and savings deposits payable on demand or short notice. As part of our liquidity and funding risk management, we do not rely on securitisations, covered bond issuance programmes or repurchase agreements as an important source of funding. Repurchase agreements entered into are generally short-term in nature maturing in 90 days or less. We are a net cash provider to the repo market.

Our sources and uses of funding, which provide a consolidated view of how our balance sheet is funded, should be read with consideration of our risk management framework which requires our operating entities to manage liquidity and funding risk on a standalone basis. Notwithstanding the above, the material difference between funding sources and uses is an illustration of the strength of our liquidity position.

Funding sources

	At 31 December	
	2011	2010
	US$bn	US$bn
Customer accounts	**1,253.9**	1,227.7
Deposits by banks	**112.8**	110.6
Debt securities	**131.0**	145.4
Financial liabilities designated at fair value	**85.7**	88.1
Equity	**166.1**	154.9
	1,749.5	1,726.7

Funding usage

	At 31 December	
	2011	2010
	US$bn	US$bn
Loans and advances to customers	**940.4**	958.4
Loans and advances to banks	**181.0**	208.3
Financial investments held to maturity	**21.2**	19.5
	1,142.6	1,186.2

Contingent liquidity risk

(Audited)

Contingent liquidity risk is the risk associated with the need to provide additional funds to clients. The client-originated exposure relates to multi-seller conduits, which were established to enable clients to access a flexible market-based source of finance (see page 404). HSBC-managed asset exposures are differentiated in that they relate to consolidated SICs which issue debt secured by ABSs (see page 403). Other conduit exposures relate to third-party sponsored conduits (see page 405). Single issuer liquidity facilities are provided directly to clients rather than via any form of conduit. These facilities are split by the addition of the five largest specific facilities and the single largest market sector.

The Group s contractual exposures at 31 December monitored under the contingent liquidity risk limit structure

(Audited)

	HSBC Bank		HSBC Bank USA		HSBC Bank Canada		The Hongkong and Shanghai Banking Corporation	
	2011	2010	**2011**	2010	**2011**	2010	**2011**	2010
	US$bn	US$bn	**US$bn**	US$bn	**US$bn**	US$bn	**US$bn**	US$bn
Conduits								
Client-originated assets[49]								
total lines	**12.8**	8.4	**0.9**	3.9	**0.7**	0.2		
largest individual lines	**0.7**	0.7	**0.3**	0.4	**0.5**	0.1		
HSBC-managed assets[50]								
total lines	**22.1**	25.6						
Other conduits[51]								
total lines			**1.4**	1.4				
Single-issuer liquidity facilities								
five largest[52]	**3.4**	4.2	**5.7**	5.3	**1.8**	2.0	**1.9**	1.4
largest market sector[53]	**7.5**	8.4	**6.5**	4.9	**3.8**	3.8	**2.5**	2.4

For footnotes, see page 185.

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Report of the Directors: Operating and Financial Review (continued)

HSBC Holdings

(Audited)

During 2011, HSBC Holdings continued to have full access to debt capital markets at market rates and issued US$5.3bn of senior debt (2010: nil). The eligibility requirements for non-equity instruments under Basel III rules have not been clearly defined in the UK, so HSBC Holdings issued no capital instruments in 2011 (2010: US$5.0bn).

The balances in the following table do not agree directly with those in the balance sheet of HSBC Holdings as the table incorporates, on an undiscounted basis, all cash flows relating to

principal and future coupon payments (except for trading derivatives).

In addition, loan and other credit-related commitments and financial guarantees and similar contracts are generally not recognised on the balance sheet. Trading derivatives are included in the On demand time bucket, and not by contractual maturity, because trading derivatives are typically held for short periods of time. The undiscounted cash flows potentially payable under financial guarantees and similar contracts are classified on the basis of the earliest date they can be called.

Cash flows payable by HSBC Holdings under financial liabilities by remaining contractual maturities

(Audited)

	On demand US$m	Due within 3 months US$m	Due between 3 and 12 months US$m	Due between 1 and 5 years US$m	Due after 5 years US$m
At 31 December 2011					
Amounts owed to HSBC undertakings		1,174	17	1,428	
Financial liabilities designated at fair value		281	3,530	4,987	28,988
Derivatives	1,067				
Debt securities in issue		35	104	1,975	1,490
Subordinated liabilities		216	649	3,461	27,558
Other financial liabilities		1,460			
	1,067	3,166	4,300	11,851	58,036
Loan commitments	1,810				
Financial guarantees and similar contracts	49,402				
	52,279	3,166	4,300	11,851	58,036
At 31 December 2010					

Amounts owed to HSBC undertakings		163	1,332	1,453	
Financial liabilities designated at fair value		219	658	5,810	24,215
Derivatives	827				
Debt securities in issue		35	106	2,110	1,559
Subordinated liabilities		219	657	3,504	28,670
Other financial liabilities		1,782			
	827	2,418	2,753	12,877	54,444
Loan commitments	2,720				
Financial guarantees and similar contracts	46,988				
	50,535	2,418	2,753	12,877	54,444

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Market risk

(Audited)

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

Exposure to market risk

Exposure to market risk is separated into two portfolios:

- *Trading portfolios* include positions arising from market-making and position-taking and others designated as marked to market.

- *Non-trading portfolios* include positions that primarily arise from the interest rate management of our retail and commercial banking assets and liabilities, financial investments designated as available for sale and held to maturity, and exposures arising from our insurance operations (see page 165).

Monitoring and limiting market risk exposures

Our objective is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with our status as one of the world s largest banking and financial services organisations.

We use a range of tools to monitor and limit market risk exposures, including:

- *sensitivity measures* are used to monitor the market risk positions within each risk type;

value at risk (VAR) is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence; and

in recognition of VAR s limitations we augment VAR with *stress testing* to evaluate the potential impact on portfolio values of more extreme, though plausible, events or movements in a set of financial variables. Examples of scenarios reflecting current market concerns are the US treasuries downgrade and the potential effects of a sovereign debt default, including its wider contagion effects.

The major contributor to the trading and non-trading VAR for the Group is Global Markets. Market risk arising in our insurance business is discussed in Risk management of insurance operations on page 171.

There were no material changes to our policies and practices for the management of market risk in 2011.

A summary of our current policies and practices regarding market risk is provided in the Appendix to Risk on page 188.

Market risk in 2011

(Audited)

Market risk in 2011 was managed against a backdrop of global economic slowdown, the fiscal deficit of the US and concerns over European sovereign debt and its contagion effects. Funding and capital concerns relating to financial institutions also dominated in Europe. All these factors triggered high levels of volatility in the financial markets. In addition, the transition to CRD III at the end of 2011, with its increased capital requirements for certain market risk exposures, also affected the environment in which market risk appetite was managed over the year. In response to these challenges, we managed down our market risk exposures within the eurozone and in our securitisation books. We proactively tested contingency plans intended to respond to potential adverse scenarios.

In 2011, our European Credit and Rates business reported significantly lower trading revenue as turmoil in eurozone sovereign debt markets escalated, particularly in the second half of the year. Increased risk aversion and limited client activity, led to a significant widening of credit spreads on certain eurozone sovereign and corporate bonds, resulting in trading losses and an increase in days of negative revenue.

Trading and non-trading portfolios

(Audited)

The following table provides an overview of the reporting of risks within this section:

	Portfolio	
	Trading	**Non-trading**
Risk type		
Foreign exchange and commodity	VAR	VAR[54]
Interest rate	VAR	VAR[55]
Equity	VAR	Sensitivity
Credit spread	VAR	VAR[56]

For footnotes, see page 185.

Report of the Directors: Operating and Financial Review (continued)

Value at risk of the trading and non-trading portfolios

Our Group VAR, both trading and non-trading, was as follows:

Value at risk

(Audited)

	2011 US$m	2010[57] US$m
At 31 December	**367.0**	371.6
Average	**301.6**	357.5
Minimum	**231.5**	205.3
Maximum	**404.3**	556.3

For footnote, see page 185.

Group total VAR was lower at the end of 2011 than at the end of 2010 despite an increase in volatility in the historical scenarios used in the VAR calculation. This was mainly driven by the reduction in sovereign, agency and bank eurozone

exposures. Further details are given in Exposures to countries in the eurozone on page 113.

We routinely validate the accuracy of our VAR models by back-testing the actual daily profit and loss results, adjusted to remove non-modelled items such as fees and commissions, against the corresponding VAR numbers. Statistically, we would expect to see losses in excess of VAR only 1% of the time over a one-year period. The actual number of excesses over this period can therefore be used to gauge how well the models are performing. In 2011, there was one loss exception at a Group level. This is consistent with what is statistically expected from the model.

The major contributor to Group trading and non-trading VAR was GB&M. Our Group daily VAR, both trading and non-trading, was as follows:

Daily VAR (trading and non-trading) (US$m)
(Unaudited)

Daily revenue
(Unaudited)

	2011 US$m	2010 US$m
Average daily revenue	**42.4**	49.3
Standard deviation[58]	**35.1**	37.8
Ranges of most frequent daily revenues	**30 to 40**	30 to 40
	days	days
daily occurrences	**42**	41

Days of negative revenue	**23**	9

Daily distribution of Global Markets trading, Balance Sheet Management and other trading revenues[59]

(Unaudited)

2011
Number of days

n Profit and loss frequency

2010
Number of days

n Profit and loss frequency

For footnotes, see page 185.

Report of the Directors: Operating and Financial Review (continued)

Trading portfolios

(Audited)

VAR by risk type for trading intent activities[60]

(Audited)

	Foreign exchange and commodity US$m	Interest rate US$m	Equity US$m	Credit spread US$m	Portfolio diversification[61] US$m	Total[62] US$m
At 31 December 2011	**18.6**	**49.4**	**7.4**	**75.2**	**(32.3)**	**118.3**
At 31 December 2010	24.9	49.5	13.0	39.1	(45.6)	80.8
Average						
2011	**16.8**	**54.2**	**8.0**	**57.3**	**(34.4)**	**101.8**
2010	27.2	51.6	9.2	62.0	(36.5)	113.4
Minimum						
2011	**7.6**	**30.1**	**2.5**	**34.7**		**62.2**
2010	8.0	34.7	2.9	33.7		55.0
Maximum						
2011	**31.9**	**80.2**	**17.2**	**103.2**		**143.9**
2010	62.9	88.9	21.6	102.5		212.2

For footnotes, see page 185.

The VAR for trading intent activity within Global Markets at 31 December 2011 was US$118.3m (2010: US$80.8m). The increase was mainly driven by the credit spread asset class, due to a rise in the volatilities in the historical scenarios used in the VAR calculation.

Credit spread risk

(Audited)

Credit spread risk also arises on credit derivative transactions entered into by Global Banking in order to manage the risk concentrations within our corporate loan portfolio and so enhance capital efficiency. At 31 December 2011, the credit VAR on these transactions was US$6.6m (2010: US$12.3m). The mark-to-market of these transactions is reflected in the income statement.

Gap risk

During 2011 gap risk continued to be managed down. We did not incur any material gap loss in 2011.

Non-trading portfolios

(Audited)

Available-for-sale debt securities

At 31 December 2011, the sensitivity of equity capital to the effect of movements in credit spreads on our available-for-sale debt securities, including the gross exposure for the SICs consolidated within our balance sheet, based on credit spread VAR, was US$389m (2010: US$299m). This sensitivity is calculated before taking into account losses which would have been absorbed by the capital note holders. Excluding the gross exposure for SICs consolidated in our balance sheet this exposure

reduced to US$325m (2010: US$264m). (Credit spread VAR for available-for-sale debt securities is included in the Group total VAR.)

At 31 December 2011, the capital note holders would absorb the first US$2.3bn (2010: US$2.2bn) of any losses incurred by the SICs before we incur any equity losses.

Equity securities classified as available for sale

Fair value of equity securities

(Audited)

	2011 **US$bn**	2010 US$bn
Private equity holdings[63]	**3.0**	2.8
Funds invested for short-term cash management	**0.2**	0.5
Investment to facilitate ongoing business[64]	**1.1**	1.0
Other strategic investments	**2.9**	3.7
	7.2	8.0

For footnotes, see page 185.

Potential new commitments are subject to risk appraisal to ensure that industry and geographical concentrations remain within acceptable levels for the portfolio. Regular reviews are performed to substantiate the valuation of the investments within the portfolio and investments held to facilitate ongoing business, such as holdings in government-sponsored enterprises and local stock exchanges.

The fair value of the constituents of equity securities classified as available for sale can fluctuate considerably. A 10% reduction in their value at 31 December 2011 would have reduced our equity by US$0.7bn (2010: US$0.8bn). For details of the impairment incurred on available-for-sale equity securities, see Securitisation exposures and other structured products on page 149.

Report of the Directors: Operating and Financial Review (continued)

Structural foreign exchange exposures

(Unaudited)

Our policies and procedures for managing structural foreign exchange exposures are described on page 201.

For details of structural foreign exchange exposures see Note 36 on the Financial Statements.

Sensitivity of net interest income

(Unaudited)

The table below sets out the effect on our future net

interest income of an incremental 25 basis points parallel rise or fall in all yield curves worldwide at the beginning of each quarter during the 12 months from 1 January 2012. Assuming no management actions, a sequence of such rises would increase planned net interest income for 2012 by US$1,571m (2011: US$882m), while a sequence of such falls would decrease planned net interest income by US$1,909m (2011: US$1,525m). These figures incorporate the effect of any option features in the underlying exposures.

Sensitivity of projected net interest income[65]

(Unaudited)

	US dollar bloc US$m	Rest of Americas bloc US$m	Hong Kong dollar bloc US$m	Rest of Asia bloc US$m	Sterling bloc US$m	Euro bloc US$m	Total US$m
Change in 2012 projected net interest income arising from a shift in yield curves of:							
+25 basis points at the beginning of each quarter	**209**	**62**	**263**	**232**	**729**	**76**	**1,571**
25 basis points at the beginning of each quarter	**(465)**	**(59)**	**(443)**	**(166)**	**(708)**	**(68)**	**(1,909)**
Change in 2011 projected net interest income arising from a shift in yield curves of:							
+25 basis points at the beginning of each quarter	164	72	191	245	292	(82)	882
25 basis points at the beginning of each quarter	(550)	(68)	(280)	(143)	(546)	62	(1,525)

For footnote, see page 185.

The interest rate sensitivities set out in the table above are illustrative only and are based on simplified scenarios. The limitations of this analysis are discussed in the Appendix to Risk on page 188.

The main drivers of the year-on-year changes in the sensitivity of the Group s net interest income to the change in rates shown in the table above were lower implied yield curves, the potential for wider margins in a rising interest rate scenario, and a reduction in the funding requirement of the HSBC Bank plc trading book. Net interest income and its associated sensitivity as reflected in the table above

include the expense of internally funding trading assets, while related revenue is reported in Net trading income .

We monitor the sensitivity of reported reserves to interest rate movements on a monthly basis by assessing the expected reduction in valuation of available-for-sale portfolios and cash flow hedges due to parallel movements of plus or minus 100 basis points in all yield curves. The table below describes the sensitivity of our reported reserves to these movements and the maximum and minimum month-end figures during the year:

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Sensitivity of reported reserves to interest rate movements

(Unaudited)

	US$m	Maximum impact US$m	Minimum impact US$m
At 31 December 2011			
+ 100 basis point parallel move in all yield curves	**(5,594)**	**(6,178)**	**(5,594)**
As a percentage of total shareholders equity	**(3.5%)**	**(3.9%)**	**(3.5%)**
100 basis point parallel move in all yield curves	**5,397**	**6,411**	**5,397**
As a percentage of total shareholders equity	**3.4%**	**4.0%**	**3.4%**
At 31 December 2010			
+ 100 basis point parallel move in all yield curves	(6,162)	(6,162)	(3,096)
As a percentage of total shareholders equity	(4.2%)	(4.2%)	(2.1%)
100 basis point parallel move in all yield curves	6,174	6,174	3,108
As a percentage of total shareholders equity	4.2%	4.2%	2.1%

The sensitivities above are illustrative only and are based on simplified scenarios. The table shows the potential sensitivity of reserves to valuation changes in available-for-sale portfolios and from cash flow hedges following the specified shifts in yield curves. These particular exposures form only a part of our overall interest rate exposures. The accounting treatment under IFRSs of our remaining interest rate exposures, while economically largely offsetting the exposures shown in the above table, does not require revaluation movements to go to reserves.

The year-on-year decrease in sensitivity of reserves is due to a decrease in government bonds held in Balance Sheet Management, which are accounted for on an available-for-sale basis.

Defined benefit pension schemes

(Audited)

Market risk arises within our defined benefit pension schemes to the extent that the obligations of the schemes are not fully matched by assets with determinable cash flows.

HSBC s defined benefit pension schemes

(Audited)

	2011 US$bn	2010 US$bn

Liabilities (present value)	**35.0 %**	32.6 %
Assets:		
Equities	**15**	20
Debt securities	**73**	66
Other (including property)	**12**	14
	100	100

For details of our defined benefit schemes, see Note 7 on the Financial Statements, and for pension risk management, see page 184.

Additional market risk measures applicable only to the parent company

(Audited)

The principal tools used in the management of market risk are VAR for foreign exchange rate risk, and the projected sensitivity of HSBC Holdings net interest income to future changes in yield curves and interest rate gap re-pricing tables for interest rate risk.

Foreign exchange risk

Total foreign exchange VAR arising within HSBC Holdings in 2011 was as follows:

HSBC Holdings foreign exchange VAR

(Audited)

	Foreign exchange	
	2011	2010
	US$m	US$m
At 31 December	**47.7**	40.4
Average	**43.3**	56.6
Minimum	**38.2**	40.2
Maximum	**48.3**	83.2

The foreign exchange risk largely arises from loans to subsidiaries of a capital nature that are not denominated in the functional currency of either the provider or the recipient and which are accounted for as financial assets. Changes in the carrying amount of these loans due to foreign exchange rate differences are taken directly to HSBC Holdings income statement. These loans, and the associated foreign exchange exposures, are eliminated on a Group consolidated basis.

HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Sensitivity of net interest income

(Audited)

HSBC Holdings monitors net interest income sensitivity over a 5-year time horizon reflecting the longer-term perspective on interest rate risk management appropriate to a financial services holding company. The table below sets out the effect on HSBC Holdings future net interest income over a 5-year time horizon of incremental 25 basis point parallel falls or rises in all yield curves worldwide at

the beginning of each quarter during the 12 months from 1 January 2012.

Assuming no management actions, a sequence of such rises would decrease planned net interest income for the next five years by US$269m (2011: increase of US$155m), while a sequence of such falls would increase planned net interest income by US$248m (2011: decrease of US$155m). These figures incorporate the effect of any option features in the underlying exposures.

Sensitivity of HSBC Holdings net interest income to interest rate movements[65]

(Audited)

	US dollar bloc US$m	Sterling bloc US$m	Euro bloc US$m	Total US$m
Change in projected net interest income as at 31 December arising from a shift in yield curves				
2011				
of + 25 basis points at the beginning of each quarter				
0-1 year	**(13)**	**11**	**4**	**2**
2-3 years	**(161)**	**33**	**33**	**(95)**
4-5 years	**(244)**	**21**	**47**	**(176)**
of 25 basis points at the beginning of each quarter				
0-1 year	**14**	**(11)**	**(4)**	**(1)**
2-3 years	**127**	**(27)**	**(27)**	**73**
4-5 years	**244**	**(21)**	**(47)**	**176**
2010				
of + 25 basis points at the beginning of each quarter				
0-1 year	(6)	19	11	24
2-3 years	(56)	75	62	81
4-5 years	(79)	71	58	50
of 25 basis points at the beginning of each quarter				

0-1 year	6	(19)	(11)	(24)
2-3 years	56	(75)	(62)	(81)
4-5 years	79	(71)	(58)	(50)

For footnote, see page 185.

The interest rate sensitivities tabulated above are illustrative only and are based on simplified scenarios. The figures represent hypothetical movements in net interest income based on our projected yield curve scenarios, HSBC Holdings current interest rate risk profile and assumed changes to that profile during the next five years. The main driver of the change in the US dollar projected net interest income sensitivity was a change in the assumptions for projected capital funding. Changes to assumptions concerning the risk profile over the next five years can have a significant impact on the net

interest income sensitivity for that period. However, the figures do not take into account the effect of actions that could be taken to mitigate this interest rate risk.

Interest rate repricing gap table

The interest rate risk on the fixed-rate securities issued by HSBC Holdings is not included within the Group VAR but is managed on a repricing gap basis. The interest rate repricing gap table below analyses the full-term structure of interest rate mismatches within HSBC Holdings balance sheet.

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Repricing gap analysis of HSBC Holdings

(Audited)

	Total US$m	Up to 1 year US$m	1 5 years US$m	5 10 years US$m	More than 10 years US$m	Non-interest bearing US$m
At 31 December 2011						
Cash at bank and in hand:						
balances with HSBC undertakings	**316**	**280**				**36**
Derivatives	**3,568**					**3,568**
Loans and advances to HSBC undertakings	**28,048**	**25,373**	**1,175**	**279**	**603**	**618**
Financial investments	**1,078**		**300**	**731**		**47**
Investments in subsidiaries	**90,621**	**232**	**875**			**89,514**
Other assets	**231**					**231**
Total assets	**123,862**	**25,885**	**2,350**	**1,010**	**603**	**94,014**
Amounts owed to HSBC undertakings	**(2,479)**	**(2,260)**				**(219)**
Financial liabilities designated at fair values	**(21,151)**	**(2,694)**	**(6,423)**	**(6,157)**	**(5,156)**	**(721)**
Derivatives	**(1,067)**					**(1,067)**
Debt securities in issue	**(2,613)**		**(1,617)**		**(1,006)**	**10**
Other liabilities	**(911)**					**(911)**
Subordinated liabilities	**(12,450)**	**(776)**	**(774)**	**(2,070)**	**(8,671)**	**(159)**
Total equity	**(82,183)**					**(82,183)**
Other non-interest bearing liabilities	**(1,008)**					**(1,008)**
Total liabilities and equity	**(123,862)**	**(5,730)**	**(8,814)**	**(8,227)**	**(14,833)**	**(86,258)**
Off-balance sheet items attracting interest rate sensitivity		**(17,945)**	**6,405**	**5,749**	**5,048**	**743**
Net interest rate risk gap		**2,210**	**(59)**	**(1,468)**	**(9,182)**	**8,499**
Cumulative interest rate gap		**2,210**	**2,151**	**683**	**(8,499)**	
At 31 December 2010						
Cash at bank and in hand:						
balances with HSBC undertakings	459	339				120
Derivatives	2,327					2,327
Loans and advances to HSBC undertakings	21,238	19,351		290	605	992
Financial investments	2,025		300	900	731	94
Investments in subsidiaries	92,899	1,785	875	1,164		89,075
Other assets	393					393
Total assets	119,341	21,475	1,175	2,354	1,336	93,001
Amounts owed to HSBC undertakings	(2,932)	(2,266)				(666)
Financial liabilities designated at fair values	(16,288)		(7,184)	(4,740)	(3,509)	(855)
Derivatives	(827)					(827)
Debt securities in issue	(2,668)		(1,664)		(1,004)	
Other liabilities	(1,232)					(1,232)

Subordinated liabilities	(13,313)	(750)	(1,579)	(2,140)	(8,680)	(164)
Total equity	(81,331)			(7,450)		(73,881)
Other non-interest bearing liabilities	(750)					(750)
Total liabilities and equity	(119,341)	(3,016)	(10,427)	(14,330)	(13,193)	(78,375)
Off-balance sheet items attracting interest rate sensitivity		(15,302)	7,221	4,403	3,409	269
Net interest rate risk gap		3,157	(2,031)	(7,573)	(8,448)	14,895
Cumulative interest rate gap		3,157	1,126	(6,447)	(14,895)	

Report of the Directors: Operating and Financial Review (continued)

Operational risk

(Unaudited)

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

HSBC has continued to enhance its operational risk management framework including the use of the risk and control assessment process that provides business areas and functions with a forward-looking view of operational risks and an assessment of the effectiveness of controls, and a tracking mechanism for action plans so that they can proactively manage operational risks within acceptable levels.

There were no material changes to our policies and procedures for the management of operational risk in 2011.

A summary of our current policies and practices regarding operational risk is provided in the Appendix to Risk on page 188.

Operational risk in 2011

During 2011, our top and emerging risk analysis included a number of risks which were of an operational nature:

- *challenges to achieving our strategy in a downturn*: businesses and geographical regions have prioritised strategy and annual operating plans to reflect current economic conditions. Performance against plan is monitored through a number of means including the use of balanced scorecards and by performance reporting at all relevant management committees;
- *internet crime and fraud*: increased monitoring and additional controls including internet banking controls have been implemented to enhance our defences against external attack and to reduce the level of losses in these areas;
- *social media risk*: compensating controls have been implemented by several Group companies to attempt to reduce our exposure to these risks, including:
  - an HSBC presence has been created in several of the larger social media networks in order to provide an official point of contact for HSBC customers and stakeholders; and
  - monitoring has been implemented in some entities to protect our brand identity and pro-active communication has been implemented in some geographies targeted at broadcasting to customers and media organisations;

- *level of change creating operational complexity*: Risk functions are engaged with business management in business transformation initiatives to ensure robust internal controls are maintained, including through participation in all relevant management committees; and

- *information security*: significant investment has already been made in enhancing controls including increased training to raise staff awareness of the requirements, enhanced controls around data access and heightened monitoring of information flows. This area will continue to be a focus of ongoing initiatives to strengthen the control environment.

Other operational risks are also monitored and managed through use of the operational risk management framework including investments made to further improve the resilience of our payments infrastructure.

There were no material losses relating to fraud and security during the year.

Further information on the nature of these risks is provided in 'Top and emerging risks' on page 99.

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Risk management of insurance operations

(Audited)

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The majority of the risk in our insurance business derives from manufacturing activities and can be categorised as insurance risk and financial risk. Insurance risk is the risk, other than financial risk, of loss transferred from the holder of the insurance contract to the issuer (HSBC). Financial risks include market risk, credit risk and liquidity risk.

There were no material changes to our policies and practices for the management of insurance risk, including the risks relating to different life and non-life products in 2011.

A summary of our policies and practices regarding insurance risk, and the main contracts we manufacture, is provided in the Appendix to Risk on page 188.

HSBC s bancassurance model

We operate a bancassurance model which provides insurance products for customers with whom we have a banking relationship. Insurance products are sold through all global businesses, mainly utilising retail branches, the internet and phone centres. RBWM customers attract the majority of sales and comprise the majority of policyholders.

Many of these insurance products are manufactured by our subsidiaries. Where we have scale, this allows us to retain the risks, within our appetite, and associated rewards with writing insurance contracts as both the underwriting profit and the commission paid by the manufacturer to the bank distribution channel are kept within the Group.

Where we do not have the risk appetite or operational scale to be effective, third parties are engaged to manufacture insurance products for sale through our banking network. We work with a limited number of market-leading partners to provide

the products. These arrangements earn us a commission.

Our bancassurance business operates in all six of our geographical regions with over 30 legal entities, the majority of which are subsidiaries of banking legal entities, manufacturing insurance products.

The insurance contracts we sell primarily relate to core underlying banking activities, such as savings and investment products, and credit life products.

Our manufacturing business concentrates on personal lines, e.g. contracts written for individuals. This focus on the higher volume, lower individual value personal lines contributes to diversifying risk.

Insurance risk in 2011

The principal risk we face is that, over time, the cost of acquiring and administering a contract, claims and benefits may exceed the aggregate amount of premiums received and investment income. The cost of claims and benefits can be influenced by many factors, including mortality and morbidity experience, lapse and surrender rates and, if the policy has a savings element, the performance of the assets held to support the liabilities.

In respect of financial risks, subsidiaries manufacturing products with guarantees are usually exposed to falls in market interest rates and equity prices to the extent that the market exposure cannot be managed by utilising any discretionary participation (or bonus) features (DPF) within the policy.

This section provides disclosures on the management of financial risks specific to insurance operations, including credit risk, liquidity risk and market risk. The assets of the insurance manufacturing subsidiaries are included within the consolidated Group credit risk disclosures. The consolidated Group liquidity and market risk management disclosures exclude insurance operations as these risks are managed within the insurance entities using methodologies and processes appropriate to these insurance activities, but remain subject to oversight at Group level. Risk management disclosures specific to the insurance manufacturing subsidiaries are provided below.

The following tables analyse our insurance risk exposures by geographical region and by type of business.

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Analysis of life insurance risk liabilities to policyholders[66]

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2011						
Life (non-linked)	**1,163**	**21,460**	**1,227**	**982**	**2,094**	**26,926**
Insurance contracts with DPF[67]	**335**	**20,109**	**338**			**20,782**
Credit life	**219**		**58**	**34**		**311**
Annuities	**517**		**78**	**741**	**1,546**	**2,882**
Term assurance and other long-term contracts	**92**	**1,351**	**753**	**207**	**548**	**2,951**
Life (linked)	**2,508**	**3,393**	**476**		**4,833**	**11,210**
Investment contracts with DPF[67,68]	**21,477**		**11**			**21,488**
Insurance liabilities to policyholders	**25,148**	**24,853**	**1,714**	**982**	**6,927**	**59,624**
At 31 December 2010						
Life (non-linked)	1,679	17,989	789	1,004	2,122	23,583
Insurance contracts with DPF[67]	327	17,203	278			17,808
Credit life	565		72	36	2	675
Annuities	471		31	760	1,622	2,884
Term assurance and other long-term contracts	316	786	408	208	498	2,216
Life (linked)	2,274	3,235	485		4,502	10,496
Investment contracts with DPF[67,68]	22,052		22			22,074
Insurance liabilities to policyholders	26,005	21,224	1,296	1,004	6,624	56,153

For footnotes, see page 185.

Our most significant life insurance products are investment contracts with DPF issued in France, insurance contracts with DPF issued in Hong Kong

and unit-linked contracts issued in Latin America, Hong Kong and the UK.

Analysis of non-life insurance risk net written insurance premiums[66,69]

(Audited)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	North America US$m	Latin America US$m	Total US$m
2011						
Accident and health	**23**	**186**	**8**		**39**	**256**
Motor		**17**	**25**		**328**	**370**
Fire and other damage	**5**	**29**	**13**	**30**	**29**	**106**
Liability	**1**	**16**	**5**		**1**	**23**
Credit (non-life)	**6**			**48**	**1**	**55**
Marine, aviation and transport		**10**	**3**		**25**	**38**
Other non-life insurance contracts	**7**	**39**	**1**	**7**	**91**	**145**
Total net written insurance premiums	**42**	**297**	**55**	**85**	**514**	**993**
Net insurance claims incurred and movement in liabilities to policyholders	**56**	**(127)**	**(26)**	**(22)**	**(231)**	**(350)**
2010						
Accident and health	78	174	8	3	37	300
Motor		15	28		267	310
Fire and other damage	38	29	11	16	22	116
Liability		20	4		2	26
Credit (non-life)	25			53	2	80
Marine, aviation and transport	3	10	4		18	35
Other non-life insurance contracts	20	39	1	9	84	153
Total net written insurance premiums	164	287	56	81	432	1,020
Net insurance claims incurred and movement in liabilities to policyholders	(169)	(117)	(25)	(13)	(201)	(525)

Report of the Directors: Operating and Financial Review (continued)

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	North America US$m	Latin America US$m	Total US$m
2009						
Accident and health	94	160	7	3	23	287
Motor	123	14	20		234	391
Fire and other damage	72	22	8	16	22	140
Liability		15	4		2	21
Credit (non-life)	35			86		121
Marine, aviation and transport	7	9	4		17	37
Other non-life insurance contracts	24	32	1	12	58	127
Total net written insurance premiums	355	252	44	117	356	1,124
Net insurance claims incurred and movement in liabilities to policyholders	(748)	(107)	(17)	(96)	(155)	(1,123)

For footnotes, see page 185.

(Audited)

Our motor business is written predominantly in Argentina. The UK motor book continued to run off and the business was sold in September 2011.

Our accident and health and fire and other damage to property contracts are written in all regions but mainly in Hong Kong.

Credit non-life insurance, which was historically originated in conjunction with the provision of loans, is concentrated in the US.

Balance sheet of insurance manufacturing subsidiaries

(Audited)

A principal tool we use to manage our exposure to insurance risk, in particular for life insurance contracts, is asset and liability matching.

The tables below show the composition of assets and liabilities by contract and by geographical region and demonstrate that there were sufficient assets to cover the liabilities to policyholders in each case at the end of 2011.

Balance sheet of insurance manufacturing subsidiaries by type of contract

(Audited)

	Insurance contracts					Investment contracts				
	With DPF US$m	Unit-linked US$m	Annuities US$m	Term assurance[70] US$m	Non-life US$m	With DPF[68] US$m	Unit-linked US$m	Other US$m	Other assets[71] US$m	Total US$m
At 31 December 2011										
Financial assets	20,520	10,355	2,531	3,398	1,656	20,745	7,843	4,103	7,219	78,370
trading assets			3		24					27
financial assets designated at fair value	1,730	10,101	426	594	206	5,491	7,191	1,515	1,616	28,870
derivatives	23	1				231	7	89	7	358
financial investments	15,523	1	1,778	2,540	791	13,732		1,913	4,008	40,286
other financial assets	3,244	252	324	264	635	1,291	645	586	1,588	8,829
Reinsurance assets	12	903	441	196	250				42	1,844
PVIF[72]									4,092	4,092
Other assets and investment properties	384	6	14	188	169	744	28	34	753	2,320
Total assets	20,916	11,264	2,986	3,782	2,075	21,489	7,871	4,137	12,106	86,626
Liabilities under investment contracts:										
designated at fair value							7,813	3,586		11,399
carried at amortised cost								435		435
Liabilities under insurance contracts	20,782	11,210	2,882	3,262	1,635	21,488				61,259
Deferred tax	15		21	6	1				931	974
Other liabilities									1,930	1,930
Total liabilities	20,797	11,210	2,903	3,268	1,636	21,488	7,813	4,021	2,861	75,997
Total equity									10,629	10,629
Total equity and liabilities[73]	20,797	11,210	2,903	3,268	1,636	21,488	7,813	4,021	13,490	86,626

Report of the Directors: Operating and Financial Review (continued)

Balance sheet of insurance manufacturing subsidiaries by type of contract (continued)

	Insurance contracts					Investment contracts				
	With DPF US$m	Unit-linked US$m	Annuities US$m	Term assurance[70] US$m	Non-life US$m	With DPF[68] US$m	Unit-linked US$m	Other US$m	Other assets[71] US$m	Total US$m
At 31 December 2010										
Financial assets	17,665	9,763	2,615	2,671	2,231	21,511	8,338	3,927	7,157	75,878
trading assets					11					11
financial assets designated at fair value	1,206	9,499	413	523	180	5,961	7,624	1,486	1,452	28,344
derivatives	53		1	6		229	7	1	4	301
financial investments	14,068		1,847	1,661	692	14,465		1,804	4,495	39,032
other financial assets	2,338	264	354	481	1,348	856	707	636	1,206	8,190
Reinsurance assets	10	760	400	263	432				79	1,944
PVIF[72]									3,440	3,440
Other assets and investment properties	189	6	21	398	213	565	14	56	712	2,174
Total assets	17,864	10,529	3,036	3,332	2,876	22,076	8,352	3,983	11,388	83,436
Liabilities under investment contracts:										
designated at fair value							8,321	3,379		11,700
carried at amortised cost								439		439
Liabilities under insurance contracts	17,808	10,496	2,884	2,891	2,456	22,074				58,609
Deferred tax	11		20	4	6			1	793	835
Other liabilities									2,075	2,075
Total liabilities	17,819	10,496	2,904	2,895	2,462	22,074	8,321	3,819	2,868	73,658
Total equity									9,778	9,778
Total equity and liabilities[73]	17,819	10,496	2,904	2,895	2,462	22,074	8,321	3,819	12,646	83,436

For footnotes, see page 185.

Balance sheet of insurance manufacturing subsidiaries by geographical region[66]

(Audited)

	Europe	**Hong Kong**	**Rest of Asia-Pacific**	**North America**	**Latin America**	**Total**

	US$m	US$m	US$m	US$m	US$m	US$m
At 31 December 2011						
Financial assets	**34,163**	**30,126**	**2,093**	**2,414**	**9,574**	**78,370**
trading assets					**27**	**27**
financial assets designated at fair value	**15,583**	**5,875**	**1,155**		**6,257**	**28,870**
derivatives	**244**	**114**				**358**
financial investments	**15,531**	**19,858**	**617**	**1,846**	**2,434**	**40,286**
other financial assets	**2,805**	**4,279**	**321**	**568**	**856**	**8,829**
Reinsurance assets	**746**	**912**	**39**	**19**	**128**	**1,844**
PVIF[72]	**1,097**	**2,322**	**282**	**65**	**326**	**4,092**
Other assets and investment properties	**909**	**946**	**31**	**24**	**410**	**2,320**
Total assets	**36,915**	**34,306**	**2,445**	**2,522**	**10,438**	**86,626**
Liabilities under investment contracts:						
designated at fair value	**6,961**	**4,405**	**33**			**11,399**
carried at amortised cost					**435**	**435**
Liabilities under insurance contracts	**25,795**	**25,160**	**1,802**	**1,079**	**7,423**	**61,259**
Deferred tax	**352**	**408**	**60**	**28**	**126**	**974**
Other liabilities	**1,200**	**269**	**69**	**13**	**379**	**1,930**
Total liabilities	**34,308**	**30,242**	**1,964**	**1,120**	**8,363**	**75,997**
Total equity	**2,607**	**4,064**	**481**	**1,402**	**2,075**	**10,629**
Total equity and liabilities[73]	**36,915**	**34,306**	**2,445**	**2,522**	**10,438**	**86,626**

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	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	North America US$m	Latin America US$m	Total US$m
At 31 December 2010						
Financial assets	36,233	26,278	1,651	2,548	9,168	75,878
trading assets					11	11
financial assets designated at fair value	16,133	5,550	1,106		5,555	28,344
derivatives	238	50	12		1	301
financial investments	16,758	17,299	247	2,006	2,722	39,032
other financial assets	3,104	3,379	286	542	879	8,190
Reinsurance assets	974	770	33	23	144	1,944
PVIF[72]	1,102	1,734	165	141	298	3,440
Other assets and investment properties	1,060	743	26	9	336	2,174
Total assets	39,369	29,525	1,875	2,721	9,946	83,436
Liabilities under investment contracts:						
designated at fair value	7,359	4,300	41			11,700
carried at amortised cost					439	439
Liabilities under insurance contracts	27,475	21,515	1,381	1,169	7,069	58,609
Deferred tax	375	298	39		123	835
Other liabilities	1,354	289	58	12	362	2,075
Total liabilities	36,563	26,402	1,519	1,181	7,993	73,658
Total equity	2,806	3,123	356	1,540	1,953	9,778
Total equity and liabilities[73]	39,369	29,525	1,875	2,721	9,946	83,436

For footnotes, see page 185.

Financial risks

(Audited)

The following table analyses the assets held in our insurance manufacturing subsidiaries at 31 December 2011 by type of contract, and provides a view of the exposure to financial risk. For linked

contracts, which pay benefits to policyholders which are determined by reference to the value of the investments supporting the policies, we typically designate assets at fair value; for non-linked contracts, the classification of the assets is driven by the nature of the underlying contract.

Financial assets held by insurance manufacturing subsidiaries

(Audited)

	Life linked contracts[74] US$m	Life non-linked contracts[75] US$m	Non-life insurance[76] US$m	Other assets[71] US$m	Total US$m
At 31 December 2011					
Trading assets					
Debt securities		3			3
Equity securities			24		24
Financial assets designated at fair value	17,292	9,756	206	1,616	28,870
Treasury bills	4	107			111
Debt securities	6,823	3,198	206	795	11,022
Equity securities	10,465	6,451		821	17,737
Financial investments					
Held-to-maturity: debt securities		17,506	175	1,300	18,981
Available-for-sale:	1	17,980	616	2,708	21,305
Treasury bills					
other eligible bills				50	50
debt securities		17,963	599	2,520	21,082
equity securities	1	17	17	138	173
Derivatives	8	343		7	358
Other financial assets[77]	897	5,709	635	1,588	8,829
Total financial assets[73]	18,198	51,297	1,656	7,219	78,370

Report of the Directors: Operating and Financial Review (continued)

Financial assets held by insurance manufacturing subsidiaries (continued)

	Life linked contracts[74] US$m	Life non-linked contracts[75] US$m	Non-life insurance[76] US$m	Other assets[71] US$m	Total US$m
At 31 December 2010					
Trading assets					
Debt securities			11		11
Equity securities					
Financial assets designated at fair value	17,123	9,589	180	1,452	28,344
Treasury bills	10	119		10	139
Debt securities	6,660	3,281	180	847	10,968
Equity securities	10,453	6,189		595	17,237
Financial investments					
Held-to-maturity: debt securities		16,015	152	908	17,075
Available-for-sale:		17,830	540	3,587	21,957
Treasury bills		10		31	41
other eligible bills		36	140	217	393
debt securities		17,776	391	3,210	21,377
equity securities		8	9	129	146
Derivatives	7	290		4	301
Other financial assets[77]	971	4,665	1,348	1,206	8,190
Total financial assets[73]	18,101	48,389	2,231	7,157	75,878

For footnotes, see page 185.

Approximately 65.2% of financial assets were invested in debt securities at 31 December 2011 (2010: 65.1%) with 22.9% (2010: 22.9%) invested in equity securities.

In life linked insurance, premium income less charges levied is invested in a portfolio of assets. We manage the financial risks of this product on behalf of the policyholders by holding appropriate assets in segregated funds or portfolios to which the liabilities are linked. These assets represented 23.2% (2010: 23.9%) of the total financial assets of our insurance manufacturing subsidiaries at the end of 2011.

Market risk

(Audited)

Market risk arises when mismatches occur between product liabilities and the investment assets which

back them. For example, mismatches between asset and liability yields and maturities give rise to interest rate risk.

Long-term insurance or investment products may incorporate benefits that are guaranteed. Where mismatches exist as a result of current yields falling below guaranteed levels for a prolonged period the risk that shareholder capital is required to meet liabilities to policyholders may increase. The table below shows, in respect of each category of guarantee, the total liabilities to policyholders established for guaranteed

products manufactured by our insurance subsidiaries. The table also shows the range of investment returns (net of operating costs) on the assets supporting these products and the implied investment returns that would enable the business to meet the guarantees.

Liabilities to policyholders[78]

(Audited)

	2011					**2010**				
	Amount of reserve US$m	**Investment returns implied by guarantee[73] %**		**Current yields %**		Amount of reserve US$m	Investment returns implied by guarantee[73] %		Current yields %	
Annuities in payment	**1,414**	**0.0**	**9.6**	**4.2**	**25.2**	1,491	0.0	8.5	1.5	16.2
Deferred annuities	**175**	**0.0**	**6.0**	**3.2**	**22.7**	642	0.0	6.0	2.1	16.8
Immediate annuities	**538**	**6.0**	**12.0**	**5.3**	**5.4**	532	6.0	12.0	5.5	5.5
Annual return	**20,465**	**0.0**	**2.5**	**0.0**	**6.9**	17,525	0.0	2.5	0.0	5.0
Annual return	**3,849**	**2.5**	**4.5**	**3.3**	**10.0**	2,455	2.5	4.5	1.8	5.9
Annual return	**163**	**4.5**	**6.0**	**6.4**	**6.5**	841	4.5	6.0	6.1	8.5
Capital	**17,400**			**2.3**	**7.8**	15,445			2.0	4.0

For footnotes, see page 185.

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The following table illustrates the effects of various interest rate, equity price, foreign exchange rate and credit spread scenarios on our profit for the year and total equity of our insurance manufacturing subsidiaries.

Where appropriate, we include the impact of the stress on the PVIF in the results of the sensitivity tests. The relationship between the values of certain

assets and liabilities and the risk factors may be non-linear and, therefore, the results disclosed cannot be extrapolated to measure sensitivities to different levels of stress. The sensitivities are stated before allowance for management actions which may mitigate the effect of changes in market rates, and for any factors such as policyholder behaviour that may change in response to changes in market risk.

Sensitivity of HSBC s insurance manufacturing subsidiaries to risk factors

(Audited)

	2011		2010	
	Effect on profit for the year US$m	**Effect on total equity US$m**	Effect on profit for the year US$m	Effect on total equity US$m
+ 100 basis points parallel shift in yield curves	**108**	**(178)**	72	(132)
100 basis points parallel shift in yield curves	**(115)**	**191**	(86)	131
10% increase in equity prices	**106**	**106**	76	76
10% decrease in equity prices	**(164)**	**(164)**	(76)	(76)
10% increase in US dollar exchange rate compared to all currencies	**31**	**31**	21	21
10% decrease in US dollar exchange rate compared to all currencies	**(31)**	**(31)**	(21)	(21)
Sensitivity to credit spread increases	**(30)**	**(75)**	(31)	(74)

Credit risk

(Audited)

Our exposure to credit risk products is included in the tables showing exposures to life and non-life insurance risk on pages 172 and 173.

Credit risk can give rise to losses through default and can lead to volatility in our income statement and balance sheet figures through movements in credit spreads, principally on the US$44.4bn (2010: US$43.3bn) non-linked bond portfolio.

As tabulated above, the sensitivity of the net profit after tax of our insurance subsidiaries to the effects of increases in credit spreads is similar to 2010. The balance and related movement are small because about 80% of the debt securities held by our insurance subsidiaries are classified as

either held to maturity or available for sale, and consequently any changes in the fair value of these financial investments, absent impairment, would have no effect on the profit after tax. We calculate the sensitivity using simplified assumptions based on a one-day movement in credit spreads over a two-year

period. A confidence level of 99%, consistent with our Group VAR, is applied. Credit spreads have generally widened from the levels observed at the end of 2010; however, the expected increase this would generally cause has been offset by a refinement made to the calculation to better reflect how the risk is shared with the policyholder. Consequently, the sensitivity reported is consistent with that seen in 2010.

Credit quality

(Audited)

The following table presents an analysis of treasury bills, other eligible bills and debt securities within our insurance business by measures of credit quality. The five credit quality classifications are defined in the Appendix to Risk on page 188. Only assets supporting liabilities under non-linked insurance and investment contracts and shareholders funds are included in the table as financial risk on assets supporting linked liabilities is predominantly borne by the policyholder. 86.6% (2010: 90.5%) of the assets included in the table are invested in investments rated as strong.

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HSBC HOLDINGS PLC

Report of the Directors: Operating and Financial Review (continued)

Treasury bills, other eligible bills and debt securities in HSBC s insurance manufacturing subsidiaries

(Audited)

	Neither past due nor impaired				
	Strong US$m	Good US$m	Satisfactory US$m	Sub-standard US$m	Total US$m
At 31 December 2011					
Supporting liabilities under non-linked insurance and investment contracts					
Trading assets debt securities	1		2		3
Financial assets designated at fair value	2,851	168	349	143	3,511
treasury and other eligible bills	107				107
debt securities	2,744	168	349	143	3,404
Financial investments	32,062	2,716	1,269	196	36,243
treasury and other similar bills					
other eligible bills					
debt securities	32,062	2,716	1,269	196	36,243
	34,914	2,884	1,620	339	39,757
Supporting shareholders funds[79]					
Financial assets designated at fair value	341	348	61	45	795
treasury and other eligible bills					
debt securities	341	348	61	45	795
Financial investments	3,198	560	83	29	3,870
treasury and other similar bills					
other eligible bills	50				50
debt securities	3,148	560	83	29	3,820
	3,539	908	144	74	4,665
Total[73]					