TEAM INC
Form 10-K
March 16, 2017
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2016

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission File Number 001-08604

TEAM, INC.
(Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	74-1765729 (I.R.S. Employer Identification No.)
13131 Dairy Ashford, Suite 600, Sugar Land, Texas (Address of Principal Executive Offices)	77478 (Zip Code)

(281) 331-6154
(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $0.30 par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes þ No ¨
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No þ
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, 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 þ No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

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

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

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The aggregate market value of the voting stock held by non-affiliates on June 30, 2016 was approximately $627 million, determined using the closing price of shares of common stock on the New York Stock Exchange on that date of $24.83.

For purposes for the foregoing calculation only, all directors, executive officers, the Team, Inc. Salary Deferral Plan and Trust and known 5% or greater beneficial owners have been deemed affiliates.

The Registrant had 29,800,837 shares of common stock, par value $0.30, outstanding as of March 10, 2017.

Documents Incorporated by Reference

Portions of our Definitive Proxy Statement for the 2017 Annual Meeting of Stockholders are incorporated by reference into Part III of this report.

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ANNUAL REPORT ON FORM 10-K INDEX

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Certain items required in Part III of this Annual Report on Form 10-K can be found in our 2017 Proxy Statement and are incorporated herein by reference. A copy of the 2017 Proxy Statement will be provided, without charge, to any person who receives a copy of this Annual Report on Form 10-K and submits a written request to Team, Inc., Attn: Corporate Secretary, 13131 Dairy Ashford, Suite 600, Sugar Land, Texas 77478.

PART I

ITEM 1. BUSINESS

General Information

Introduction. Unless otherwise indicated, the terms "Team, Inc.," "Team," "the Company," "we," "our" and "us" are used in th report to refer to Team, Inc., to one or more of our consolidated subsidiaries or to all of them taken as a whole. We are incorporated in the State of Delaware and our company website can be found at www.teaminc.com. Our corporate headquarters is located at 13131 Dairy Ashford, Suite 600, Sugar Land, Texas, 77478 and our telephone number is (281) 331-6154. Our stock is traded on the New York Stock Exchange ("NYSE") under the symbol "TISI." On November 10, 2015, we announced a change of our fiscal year end to December 31 of each calendar year from May 31.

We are a leading provider of standard to specialty industrial services, including inspection, engineering assessment and mechanical repair and remediation required in maintaining high temperature and high pressure piping systems and vessels that are utilized extensively in the refining, petrochemical, power, pipeline and other heavy industries. We conduct operations in three segments: TeamQualspec Group ("TeamQualspec") (formerly the Inspection and Heat Treating Services Group), TeamFurmanite Group ("TeamFurmanite") (formerly the Mechanical Services Group) and Quest Integrity ("Quest Integrity"). Through the capabilities and resources in these three segments, we believe that Team is uniquely qualified to provide integrated solutions involving in their most basic form, inspection to assess condition, engineering assessment to determine fitness for purpose in the context of industry standards and regulatory codes and mechanical services to repair, rerate or replace based upon the client's election. In addition, our Company is capable of escalating with the client's needs—as dictated by the severity of the damage found and the related operating conditions—from standard services to some of the most advanced services and expertise available in the industry.

TeamQualspec provides standard and advanced non-destructive testing ("NDT") services for the process, pipeline and power sectors, pipeline integrity management services, field heat treating services, as well as associated engineering and assessment services. These services can be offered while facilities are running (on-stream), during facility turnarounds or during new construction or expansion activities.

TeamFurmanite, our mechanical services segment, provides turnaround and on-stream services. Turnaround services are project-related and demand is a function of the number and scope of scheduled and unscheduled facility turnarounds as well as new industrial facility construction or expansion activities. The turnaround services TeamFurmanite provides include field machining, technical bolting, field valve repair, heat exchanger repair, and isolation test plugging services. On-stream services offered by TeamFurmanite represent the services offered while plants are operating and under pressure. These services include leak repair, fugitive emissions control and hot tapping.

Quest Integrity provides integrity and reliability management solutions for the process, pipeline and power sectors. These solutions encompass two broadly-defined disciplines: (1) highly specialized in-line inspection services for unpiggable process piping and pipelines using proprietary in-line inspection tools and analytical software; and (2) advanced condition assessment services through a multi-disciplined engineering team.

We offer these services globally through over 220 locations in 20 countries throughout the world with more than 7,400 employees. We market our services to companies in a diverse array of heavy industries which include the petrochemical, refining, power, pipeline, steel, pulp and paper industries, as well as municipalities, shipbuilding, original equipment manufacturers ("OEMs"), distributors, and some of the world's largest engineering and construction firms.

Narrative Description of Business

TeamQualspec Group:

TeamQualspec offers standard to specialty inspection services as well as heat treating services. Heat treating services are generally associated with turnaround or project activities. A description of these services is as follows:

Non-Destructive Evaluation and Testing Services. Machined parts and industrial structures can be complex systems that experience extreme loads and fatigue during their lifetime. Our Non-Destructive Evaluation ("NDE"), or Non-Destructive

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Testing (“NDT”), enables the inspection of these components without permanently altering the equipment. It is a highly valuable technique that is often used to validate the integrity of materials, detect instabilities, discover performance outside of tolerances, identify failed components, or highlight an inadequate control system. Inspection services frequently require industry recognized training and certification processes. We maintain training and certification programs, which are designed to meet or exceed industry standards. As assets continue to age and compliance regulations advance, inspection techniques are playing a critical role in fit-for-life service assessments.

Radiographic Testing. Radiographic Testing (“RT”) is used to detect discontinuities in ferrous and nonferrous castings, welds or forgings using X-ray or gamma ray radiation. RT reveals both external and internal defects, internal assembly details and changes in thickness. Our licensed technicians utilize conventional, computed and real-time radiography testing techniques depending upon the complexity and needs of our customers.

Ultrasonic Testing. Ultrasonic Testing (“UT”) uses high frequency ultrasonic waves to detect surface breaking and internal imperfections, measure material thickness and determine acceptance or rejection of a test object based on a reference code or standard. We offer ten different types of UT methods, including traditional scans as well as automated and high speed ultrasonic Electro Magnet Acoustic Transducer testing. Each method is utilized to meet a specific material or process application requirement.

Magnetic Particle Inspection. Magnetic Particle Inspection is an NDT process for detecting surface and slightly subsurface discontinuities in ferroelectric materials such as iron, nickel, cobalt, and some of their alloys. The process puts a magnetic field into the test object. When the part is magnetized, flaws perpendicular to the magnetic field direction cause flux leakage. If a lapse or a crack is present, the magnetic particles will be attracted to the flawed area, providing our technician with what is called an indication. Our technician will then evaluate the indication to assess the location, size, shape and extent of these imperfections.

Liquid Penetrant Inspection. Liquid Penetrant Inspection is one of the most widely used NDE/ NDT methods. Its popularity can be attributed to two main factors: its relative ease of use and its flexibility. Liquid Penetrant Inspection can be used to inspect almost any material. At Team, we utilize Liquid Penetrant Inspection to detect surface discontinuities in both ferromagnetic and non-ferromagnetic materials. In castings and forgings, there may be cracks or leaks in new products or fatigue cracks in in-service components.

Positive Material Identification. Positive Material Identification (“PMI”) quickly and accurately identifies the composition of more than 100 different engineering alloys onsite. Team can perform PMI on virtually any size or shape of pipe, plate, weld, welding materials, machined parts or castings.

Electromagnetic Testing. Electromagnetic Testing applies to a family of test methods that use magnetism and electricity to detect or measure cracks, flaws, corrosion or heat damage in conductive materials. Magnetic properties and geometric analysis are used to determine the best technique to identify defects. Our electromagnetic services enable our technicians to evaluate small cracks, pits, dents and general thinning in tubing with small diameters, large steel surfaces such as storage tank floors, and everything in between.

Alternating Current Field Measurement. Originally developed for inspection of fatigue cracking, our Alternating Current Field Measurement (“ACFM”) is an advanced technique for detecting surface cracks and pinpointing the location, length and depth of the defect. Our ACFM works through paint and coatings and in a wide range of temperatures. Results are automatically recorded and accepted by certification authorities.

Eddy Current Testing. Eddy Current Testing (“ET”) is ideal for nonferrous materials such as heat exchanger tubes, condensers, boilers, tubing and aircraft surfaces. Team’s ET uses electromagnetic induction to detect flaws in conductive materials, displaying the presence of very small cracks, pits, dents and general thinning.

Long-Range Guided Ultrasonics. Guided wave inspection is a method of ultrasonic testing that enables the detection and location of pipe defects above and below ground without disruption of service. This technique only requires a small area of excavation to perform the testing where applicable. Guided ultrasonics sends a bilateral signal over hundreds of feet allowing long ranges of piping to be inspected at one time.

Phased Array Ultrasonic Testing. Phased Array Ultrasonics (“PAUT”) provides sharper detection capability for off-angle cracks and is capable of displaying multiple presentations simultaneously. PAUT applies computer-controlled excitation to individual elements in a multi-element probe. By varying the timing of the excitation, the sound beam can be swept through a range of angles. The shape of the beam may also be modified to a specific focal distance or spot.

Tank Inspection and Management Programs. Our wholly-owned subsidiary, TCI Services, Inc. ("TCI"), is a storage tank management company that performs inspections, engineering and repair services across the U.S. for above ground storage tanks. Backed by Team's in-house engineering, documentation and certification services – including API 653

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evaluations – TCI's on-site tank inspections, repair and maintenance services help keep customers' tanks fully operational and compliant with stringent industry standards.

Rope Access. We provide a range of innovative and cost-effective solutions to suit the customer's individual requirements for inspection and maintenance services to the energy and industrial markets. Our rope access solutions allow for work to be carried out more quickly than traditional methods using scaffolding, keeping costs and job duration to a minimum. We provide these services under full accreditation by the Industrial Rope Access Trade Association, whose guidelines are recognized by the industry as the safest method of working at height.

Mechanical Integrity Services. Maintaining the integrity of equipment is more than simply performing inspections. A well-implemented Mechanical Integrity ("MI") program involves multiple components that improve the safety and reliability of a facility's equipment. Our MI programs ensure the continued integrity and fitness for service of piping systems, pressure vessels, tanks and related components. Our mechanical integrity engineers are well versed in pertinent codes and standards of the Occupational Safety and Health Administration's process safety management and U.S. Environmental Protection Agency's ("EPA") risk management program regulations.

Field Heat Treating Services. Field Heat Treating Services include electric resistance and gas-fired combustion, primarily utilized by industrial customers to enhance the metallurgical properties of their process piping and equipment. Electric resistance heating is the transfer of high energy power sources through attached heaters to the plant component to preheat weld joints, to remove contaminants and moisture prior to welding, post-weld heat treatments and to relieve metal thermal stresses induced by the welding process. Specialty heat treating processes are performed using gas-fired combustion on large pressure vessels for stress relieving to bake specialty paint coatings and controlled drying of abrasion and temperature resistant refractories. Special high frequency heating, commonly called induction heating, is used for expanding metal parts for assembly or disassembly, expanding large bolting for industrial turbines and stress relieving projects which is cost prohibitive for electric resistance or gas-fired combustion.

TeamFurmanite Group:

TeamFurmanite offers standard to specialty services as follows within both on-stream and turnaround/project-related environments as follows:

Leak Repair Services. Our leak repair services consist of on-stream repairs of leaks in pipes, valves, flanges and other parts of piping systems and related equipment. Our on-stream repairs utilize composite repair, drill and tap repair, and both standard and custom-designed clamps and enclosures for piping systems. We use specially developed techniques, sealants and equipment for repairs. Many of our repairs are furnished as interim measures which allow plant systems to continue operating until more permanent repairs can be made during plant shut downs. Our leak repair services involve inspection of the leak by our field crew who records pertinent information about the faulty part of the system and transmits the information to our engineering department for determination of appropriate repair techniques. Repair materials such as clamps and enclosures are custom designed and manufactured at our ISO-9001 certified manufacturing centers and delivered to the job site. We maintain an inventory of raw materials and semi-finished clamps and enclosures to reduce the time required to manufacture the finished product.

Fugitive Emissions Control Services. We provide fugitive volatile organic compound ("VOC") emission leak detection services that include identification, monitoring, data management and reporting primarily for the chemical, refining and natural gas processing industries. These services are designed to monitor and record VOC emissions from specific process equipment and piping components as required by environmental regulations and customer requests, typically assisting the customer in enhancing an ongoing maintenance program and/or complying with present and/or future environmental regulations. We provide specialty trained technicians in the use of portable organic chemical analyzers and data loggers to measure potential leaks at designated plant components maintained in customer or our proprietary databases. The measured data is used to prepare standard reports in compliance with the EPA and local regulatory requirements. We also provide enhanced custom-designed reports to customer specifications.

Hot Tapping Services. Our hot tapping services consist of a full range of hot tapping, Line-stop™ and Freeze-stop™ services with capabilities for up to 48" diameter pipelines. Hot tapping services involve utilizing special equipment to cut a hole in a pressurized pipeline so that a new branch pipe can be connected onto the existing pipeline without interrupting operations. Line-stop™ services permit the line to be depressurized downstream so that maintenance work can be performed on the piping system. We typically perform these services by mechanically cutting into the pipeline similar to a hot tap and installing a special plugging device to stop the process flow. The Hi-stop™ is a proprietary procedure that allows stopping of the process flow in extreme pressures and temperatures. In some cases, we may use a line freezing procedure by injecting liquid nitrogen into installed special external chambers around the pipe to stop the process flow. Inflatable bag stops are used

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when a pipe is out of round or inside surface conditions of the pipe prevent a standard line stop. It can also be used to back up a line stop. A small hot tap is made into a pipe and an inflatable pipe plug is inserted into the pipe to allow the plug to stop the flow in the pipe. Additionally, we provide innovative line stop applications for unique service applications to meet customers' needs.

Field Machining Services and Technical Bolting Services. We use portable machining equipment to repair or modify machinery, equipment, vessels and piping systems not easily removed from a permanent location. As opposed to conventional machining processes where the work piece rotates and the cutting tool is fixed, in field machining, the work piece remains fixed in position and the cutting tool rotates. Other common descriptions for this service are on-site or in-place machining. Field machining services include flange facing, pipe cutting, line boring, journal turning, drilling and milling. We provide customers technical bolting as a complementary service to field machining during plant shut downs or maintenance activities. These services involve the use of hydraulic or pneumatic equipment with industry standard bolt tightening techniques to achieve reliable and leak-free connections following plant maintenance or expansion projects. Additional services include bolt disassembly and hot bolting, which is a technique to remove and replace a bolt while in service and hot.

Valve Repair Services. We perform on-site repairs to manual and control valves and pressure and safety relief valves as well as specialty valve actuator diagnostics and repair. We are certified and authorized to perform testing and repairs to pressure and safety relief valves by The National Board of Boiler and Pressure Vessel Inspectors. This certification requires specific procedures, testing and documentation to maintain the safe operation of these essential plant valves. We provide special transportable trailers to the plant site which contain specialty machines to manufacture valve components without removing the valve from the piping system. In addition, we provide preventive maintenance programs for VOC specific valves and valve data management programs.

Field Welding. We perform certified manual, semi-automatic and fully automated machine welding services in a variety of specialty industrial applications. All Team welders are certified to applicable American Society of Mechanical Engineers ("ASME") code and we are authorized by the National Board of Boiler and Pressure Vessel Inspectors for the repair of nuclear components, boilers and other pressure-containing components.

Heat Exchanger and Maintenance Services. We provide turnkey heat exchanger services that allow for blind to blind disassembly and re-assembly. Utilizing our expanding fleet of bundle extractors that allow us to pull and push the tube bundles, as well as field machining and bolting equipment, we can make complete repairs to minimize downtime by using one contractor. A complete service allows us to unbolt the exchanger heads and remove the tube bundle for inspection and repair. Team is certified by The National Board of Boiler and Pressure Vessel Inspectors to make welded code repairs when necessary to the many components that make up the assembly. Based on the inspection, the bundle tubes can be replaced or plugged. Assembly of the exchanger is documented by our rigid quality control process providing documented procedures and final "as assembled" bolted values.

Isolation and Test Plug Services. We install isolation plugs to provide a mechanical block of flammable atmosphere to allow for pipe cutting and welding without having to purge the entire piping system. The plugs are mechanically expanded to seal on the inside pipe surface and provide a venting system to prevent pressure from building up in the piping system while the system is opened. Test plugs are used to verify the integrity of welded joints by providing sealing surfaces on both sides of the weld and pressuring the void cavity in between. The test plugs allow the customer to comply with the ASME hydrostatic test requirements for welded joints without having to pressurize the whole system which may result in shutdown of other systems or environmental issues with the test medium.

Valve Insertion Services. We offer professional installation services for our patented InsertValve™. The valve installs under pressure, eliminating the need for line shut downs in the event of planned or emergency valve cut-ins. Designed for a wide range of line sizes and types, the InsertValve™ wedge gate sits on the valve body, not the pipe bottom. This unique feature prevents the seat from coming into contact with the cut pipe edges to significantly extend valve life. If a repair is ever needed, we believe it is the only valve on the market that can be repaired under pressure.

Quest Integrity:

Quest Integrity offers integrity management solutions to the energy industry in the form of advanced quantitative inspection and engineering assessment services and products. Quest Integrity's advanced quantitative inspection services utilize proprietary non-destructive testing and examination (NDT/NDE) instrumentation to provide technology-enabled in-line inspections of fired heaters, piping systems and steam reformers, primarily to the process, pipeline and power industries. Additionally, Quest Integrity offers engineering assessment services enabled by proprietary software and a variety of analytical models. Effective July 1, 2013, Quest Integrity became a stand-alone reportable segment of Team.

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Quest Integrity's major service offerings are described as follows:
Furnace Tube Inspection System. Furnace Tube Inspection System ("FTIS™") in-line inspection service provides an untethered 360-degree 100% coverage ultrasonic inspection of the internal and external surfaces of serpentine coils of fired heaters, which are found in refineries. FTIS™ allows us to detect and quantify internal/external pipe/tube wall loss, deformation and fouling and thereby identify weak points in such heaters in order to provide customers with timely, actionable information to better manage their infrastructure.
InVista™. Our proprietary InVista™ in-line inspection service provides an untethered 360-degree 100% coverage ultrasonic inspection of the internal and external surfaces of pipelines that are considered "unpiggable" or too challenging to inspect by traditional inspection methods, due to a number of factors. InVista™ allows us to detect and quantify pipe/tube internal/external wall loss, deformation, pitting and fouling in such pipelines. Our InVista™ service also provides an integrated fitness-for-service report which forecasts remaining life of the pipeline and displays the information in a highly intuitive format, providing an integrated solution set for pipeline customers.
Pipeline Integrity Management. We offer turn-key Pipeline Integrity Management services, including project management, integrity engineering and integrity management development services, in-line inspection support, land surveying, and materials equipment selection and procurement. We offer these resources on an integrated basis with our InVista™ and HYDRA™ in-line inspection services and engineering assessment capabilities, or individually as applicable.
Engineering Assessment Services. Using proprietary software and a variety of analytical models, we offer a variety of advanced engineering assessment services to customers in the process, power, pipeline, and petrochemical industries including fitness-for-service, computational mechanics, failure analysis, pipeline analysis, risk-based asset management, and materials consulting.
Acquisitions
In June 2016, we acquired a mechanical furnace and pipe cleaning business in Europe, Turbinate International B.V. ("Turbinate") for approximately $8 million. Recognized as a service leader in the European market, Turbinate specializes in de-coking and cleaning of fired heaters and unpiggable refinery assets as well as mechanical cleaning of furnaces and pipes from two to 18 inches by means of pigging, endoscopy and ultra sound inspection services. Turbinate is located in Vianen, the Netherlands. Turbinate is reported in the Quest Integrity segment.
In April 2016, we acquired two related businesses in Europe: Quality Inspection Services ("QIS") and TiaT Europe ("TiaT") for a total of approximately $9 million. QIS is an NDT inspection company and TiaT is an NDT training school and consultancy and engineering company recognized as a specialist in aerospace inspections. Both companies are located in Roosendaal, the Netherlands. The businesses add about 65 employees to our organization in Europe and serve steel construction, ship repair, off-shore and storage tank customers, as well as the aerospace industry. QIS is the fourth largest NDT inspection company in the Netherlands and represents Team's first inspection operation outside of North America. QIS and TiaT are reported in the TeamQualspec segment.
In November 2015, Team and Furmanite Corporation ("Furmanite") entered into an Agreement and Plan of Merger (the "Merger Agreement") under which we acquired all the outstanding shares of Furmanite in a stock transaction. Under the terms of the Merger Agreement, Furmanite shareholders received 0.215 shares of Team common stock for each share of Furmanite common stock they owned. The merger was completed on February 29, 2016 at a value of approximately $282.3 million which included the payoff, immediately prior to closing, of approximately $70.8 million in Furmanite debt. The combination doubled the size of Team's mechanical services capabilities and established a deeper, broader talent and resource pool that better supports customers across standard and specialty mechanical services. In addition, our expanded capability and capacity offers an enhanced single-point of accountability and flexibility in addressing some of the most critical needs of clients; whether as individual services or as part of an integrated specialty industrial services solution. The purchase price allocation included net working capital of $143.9 million, $63.3 million in fixed assets, $89.0 million in intangibles, $91.4 million of non-current deferred tax liabilities, $13.5 million of defined benefit pension liabilities with $89.6 million allocated to goodwill. Our consolidated results include the activity of Furmanite beginning on the acquisition date of February 29, 2016. Included in the Furmanite acquisition was a process management inspection services business serving contractors and operators participating primarily in the midstream oil and gas market in the United States. Upon acquisition, we determined that this business

was not a strategic fit for Team and shortly thereafter began marketing the business to prospective buyers. We completed the sale of this operation in December 2016. The operating results of this business are reported as discontinued operations in our consolidated financial statements.

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In July 2015, we acquired 100% of the membership interests in Qualspec Group LLC ("Qualspec") for total cash consideration of $255.5 million. Qualspec is a leading provider of non-destructive testing NDT services in the United States, with significant operations in the West Coast, Gulf Coast and Mid-Western areas of the country. Qualspec adds strength to our resident refinery inspection programs with major customer relationships across the U.S., and to add to our already strong capabilities in advanced inspection services, rope access services and the delivery of innovative technologies to our customers. The purchase of Qualspec was financed through borrowings under our banking credit facility. The purchase price allocation included net working capital of $16.3 million, $15.5 million in fixed assets, $78.1 million in intangibles, $3.0 million of non-current deferred tax liability, with $148.5 million allocated to goodwill. Our consolidated results include the activity of Qualspec beginning on the acquisition date of July 7, 2015 in the TeamQualspec segment.

In June 2015, we purchased DK Amans Valve, an advanced valve leader located in Long Beach, California, with a portfolio of projects from various sectors including oil and gas refining, pipelines and power generation for a total consideration of $12.3 million, net of cash acquired of $0.1 million. The purchase price included net working capital of $3.0 million, $0.6 million in fixed assets and $8.8 million in intangibles that includes $2.5 million allocated to goodwill. The purchase price allocation included contingent consideration valued at $1.8 million. The contingent consideration is based upon the achievement of certain performance targets over a three-year period for an additional amount of up to $4.0 million. DK Amans Valve is reported in the TeamFurmanite segment.

In August 2014, we purchased a valve repair company in the U.K. for total consideration of $3.1 million, net of cash acquired of $0.2 million, including estimated contingent consideration of $0.3 million. Our purchase price allocation resulted in $2.1 million being allocated to fixed assets and net working capital and $1.0 million being applied to goodwill and intangible assets.

In July 2013, we purchased a leading provider of industrial rope access services, for total consideration of approximately $12.9 million including net working capital of $1.3 million and $11.6 million allocated to goodwill and intangible assets. We estimate $9.2 million of the goodwill recognized to be deductible for tax purposes. The purchase price allocation included contingent consideration valued at $1.9 million. The contingent consideration is based upon the achievement of operating earnings thresholds over a six-year period for an amount of up to $4.0 million.

Marketing and Customers

Our industrial services are marketed principally by personnel based at our service locations. We believe that these service locations are situated to facilitate timely responses to customer needs with on-call expertise, which is an important feature of selling and providing our services. Our array of integrated services also allows us to benefit from the procurement trends of many of our customers who are seeking reductions in the number of contractors and vendors in their facilities. No single customer accounted for 10% or more of consolidated revenues during the year ended December 31, 2016, the seven months ended December 31, 2015 or in either of the years ended May 31, 2015 and 2014.

Generally, customers are billed on a time and materials basis, although some work may be performed pursuant to a fixed-price bid. Services are usually performed pursuant to purchase orders issued under written customer agreements. While most purchase orders provide for the performance of a single job, some provide for services to be performed on a run and maintain basis. Substantially all our agreements and contracts may be terminated by either party on short notice. The agreements generally specify the range of services to be performed and the hourly rates for labor. While many contracts cover specific plants or locations, we also enter into multiple-site regional or national contracts which cover multiple plants or locations.

Geographic Areas

For a discussion and breakdown of revenues by geographic area, see Note 14 to the consolidated financial statements.

Seasonality

We experience some seasonal fluctuations. Historically, the refining industry has scheduled plant shutdowns (commonly referred to as "turnarounds") for the fall and spring seasons. The timing of large turnarounds can significantly impact our revenues.

Employees

At December 31, 2016, we had approximately 7,400 employees in our worldwide operations. Our employees in the U.S. are predominantly non-unionized. Most of our Canadian employees and certain employees outside of North America, primarily

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Europe, are unionized. There have been no employee work stoppages to date and we believe our relations with our employees and their representative organizations are fair and productive.

Regulation

A significant portion of our business activities are subject to foreign, federal, state and local laws and regulations. These regulations are administered by various foreign, federal, state and local health and safety and environmental agencies and authorities, including the Occupational Safety and Health Administration of the U.S. Department of Labor and the EPA. Failure to comply with these laws and regulations may involve civil and criminal liability. From time to time, we are also subject to a wide range of reporting requirements, certifications and compliance as prescribed by various federal and state governmental agencies that include, but are not limited to, the EPA, the Nuclear Regulatory Commission, the Chemical Safety Board, the Department of Transportation and the Federal Aviation Administration. Expenditures relating to such regulations are made in the normal course of our business and are neither material nor place us at any competitive disadvantage. We do not currently expect that compliance with such laws and regulations will require us to make material expenditures.

From time to time, during the operation of our environmental consulting and engineering services, the assets of which were sold in 1996, we handled small quantities of certain hazardous wastes or other substances generated by our customers. Under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (the “Superfund Act”), the EPA is authorized to take administrative and judicial action to either cause parties who are responsible under the Superfund Act for cleaning up any unauthorized release of hazardous substances to do so, or to clean up such hazardous substances and to seek reimbursement of the costs thereof from the responsible parties, who are jointly and severally liable for such costs under the Superfund Act. The EPA may also bring suit for treble damages from responsible parties who unreasonably refuse to voluntarily participate in such a clean-up or funding thereof. Responsible parties include anyone who owns or operates the facility where the release occurred (either currently and/or at the time such hazardous substances were disposed of), or who by contract arranges for disposal, treatment, transportation for disposal or treatment of a hazardous substance, or who accepts hazardous substances for transport to disposal or treatment facilities selected by such person from which there is a release. We believe that our risk of liability is minimized since our handling consisted solely of maintaining and storing small samples of materials for laboratory analysis that are classified as hazardous. Due to its prohibitive costs, we accordingly do not currently carry insurance to cover liabilities which we may incur under the Superfund Act or similar environmental statutes.

Intellectual Property

We hold various patents, trademarks, trade secrets and licenses, which have not historically been material to our consolidated business operations. However, Quest Integrity has significant trade secrets and intellectual property pertaining to its in-line inspection tool technologies. This subsidiary was acquired in the fiscal year ended 2011 and a significant amount of the purchase price was allocated to these intangible assets.

Competition

In general, competition stems from a large number of other outside service contractors. More than 100 different competitors are currently active in our markets. We believe we have a competitive advantage over most service contractors due to the quality, training and experience of our technicians, our nationwide and increasingly international service capability, our broad range of services, and our technical support and manufacturing capabilities supporting the service network. However, there are other competitors that may offer a similar range of coverage or services and include, but are not limited to, Acuren Group, Inc., Guardian Compliance, Mistras Group, Inc. and T.D. Williamson, Inc.

Available Information

As a public company, we are required to file periodic reports with the Securities and Exchange Commission (the “SEC”) within established deadlines. Any document we file with the SEC may be viewed or copied at the SEC’s Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Additional information regarding the Public Reference Room can be obtained by calling the SEC at (800) SEC-0330. Our SEC filings are also available to the public through the SEC’s website located at www.sec.gov. Our internet website address is www.teaminc.com. Information contained on our website is not part of this Annual Report on Form 10-K. Our annual reports on Form 10-K, quarterly reports on Form 10-Q, Proxy Statements and current reports on Form 8-K filed with (or furnished to) the SEC are available on our website, free of charge, as soon as reasonably practicable after we file or furnish such material. We also post our code of ethical conduct, our governance principles, our social responsibility policy and the charters of our Board of Directors' (the "Board") committees on our website. Our governance documents are available in print to any stockholder that submits a written request to Team, Inc., Attn: Corporate Secretary, 13131 Dairy Ashford, Suite 600, Sugar Land, Texas 77478.

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ITEM 1A. RISK FACTORS

Our business, financial condition or results of operations could be materially adversely affected by any of the risks and uncertainties described below.

The economic environment may affect our customers' demand for our services. Future economic uncertainty may reduce the availability of liquidity and credit and, in many cases, reduce demand for our customers' products. Disruption of the credit markets could also adversely affect our customers' ability to finance on-going maintenance and new projects, resulting in contract cancellations or suspensions, and project delays. An extended or deep recession may result in plant closures or other contractions in our customer base. These factors may also adversely affect our ability to collect payment for work we have previously performed. Furthermore, our ability to expand our business could be limited if, in the future, we are unable to increase our credit capacity under favorable terms or at all. Such disruptions, should they occur, could materially impact our results of operations, financial position or cash flows.

Our revenues are heavily dependent on certain industries. Sales of our services are dependent on customers in certain industries, particularly the refining and petrochemical industries. As experienced in the past, and as expected to occur in the future, downturns characterized by diminished demand for services in these industries could have a material impact on our results of operations, financial position or cash flows. Certain of our customers have employees represented by unions and could be subject to temporary work stoppage which could impact our activity level.

We sell our services in highly competitive markets, which places pressure on our profit margins and limits our ability to maintain or increase the market share of our services. Our competition generally stems from other outside service contractors, many of whom offer a similar range of services. Future economic uncertainty could generally reduce demand for industrial services and thus create a more competitive bidding environment for new and existing work. No assurances can be made that we will continue to maintain our pricing model and our profit margins or increase our market share.

No assurances can be made that we will be successful in maintaining or renewing our contracts with our customers. A significant portion of our contracts and agreements with customers may be terminated by either party on short notice. Although we actively pursue the renewal of our contracts, we cannot assure that we will be able to renew these contracts or that the terms of the renewed contracts will be as favorable as the existing contracts. If we are unable to renew or replace these contracts, or if we renew on less favorable terms, we may suffer a material reduction in revenue and earnings.

No assurances can be made that we will be successful in hiring or retaining members of a skilled technical workforce. We have a skilled technical workforce and an industry recognized technician training program for each of our service lines that prepares new employees as well as further trains our existing employees. The competition for these individuals is intense. The loss of the services of a number of these individuals, or failure to attract new employees, could adversely affect our ability to perform our obligations on our customers' projects or maintenance and consequently could negatively impact the demand for our products and services.

Unsatisfactory safety performance can affect customer relationships, result in higher operating costs and negatively impact our ability to hire and retain a skilled technical workforce. Our workers are subject to the normal hazards associated with providing services at industrial facilities. Even with proper safety precautions, these hazards can lead to personal injury, loss of life, destruction of property, plant and equipment, lower employee morale and environmental damage. We are intensely focused on maintaining a strong safety environment and reducing the risk of accidents to the lowest possible level. Poor safety performance may limit or eliminate potential revenue streams from many of our largest customers and may materially increase our future insurance and other operating costs. Although we maintain insurance coverage, such coverage may be inadequate to protect us from all expenses related to these risks.

We are subject to risks associated with indebtedness under our banking credit facility, including the risk of failure to maintain compliance with financial covenants, the risk of being unable to make interest and principal payments when due and the risk of rising interest rates. Under our credit agreement, which we renewed in July 2015 (the "Credit Facility"), we are required to maintain compliance with certain financial covenants, as discussed in "Liquidity and Capital Resources" in Part II, Item 7 of this Form 10-K. As of December 31, 2016, we are in compliance with these covenants. With respect to the covenant not to exceed a maximum ratio of consolidated funded debt to consolidated

EBITDA (the “Total Leverage Ratio”, as defined in our Credit Facility agreement), our ratio stood at 4.19 to 1.00 as of December 31, 2016, compared to the maximum permitted ratio as of such date of 4.50 to 1.00. Under the Credit Facility, the maximum permitted ratio decreases to 4.25 to 1.00 as of March 31, 2017 and June 30, 2017, 3.75 to 1.00 as of September 30, 2017 and thereafter decreases by 0.25 to 1.00 every quarter until it reaches 3.00 to 1.00. While we are in compliance with our financial covenants as of December 31, 2016, management continues to execute various initiatives designed to reduce the Company’s obligations outstanding under the

Credit Facility and improve operating cash flows. However, there can be no assurance that these actions will be successful or that we will be able to maintain compliance with the financial covenants as of any future date. Our future compliance is dependent upon our future operating performance and future financial condition, both of which are subject to various risks and uncertainties, such as those risks and uncertainties described in this Item 1A.

We rely primarily on cash flows from our operations to make required interest and principal payments on our debt under the Credit Facility. If we are unable to generate sufficient cash flows from our operations, we may be unable to pay interest and principal obligations on our debt when they become due. Failure to comply with these obligations or failure to comply with the financial covenants discussed above could result in an event of default, which would permit our lenders to accelerate the repayment of the debt. If our lenders accelerate the repayment of debt, there is no assurance that we could refinance such debt on terms favorable to us or at all. Also, our debt under the Credit Facility bears interest at variable rates and therefore we are exposed to the risk of rising market interest rates, which could adversely impact our cash flows and increase our interest expense. Further, our Credit Facility restricts our ability to, among other items, incur additional indebtedness, engage in mergers, acquisitions and dispositions and alter the business conducted by the Company and its subsidiaries. These restrictions could adversely affect our ability to operate our businesses and may limit our ability to take advantage of potential business opportunities as they arise.

An impairment of our goodwill and intangible assets could have a material adverse impact on our results of operations and financial condition. As a result of past acquisitions, goodwill and intangible assets comprise a substantial portion of our total assets. As of December 31, 2016, our goodwill and intangible assets totaled $355.8 million and $176.1 million, respectively. We assess or test goodwill and intangible assets for impairment at least annually in accordance with Generally Accepted Accounting Principles in the U.S. (“GAAP”). A decrease in our market capitalization or profitability or unfavorable changes in market, economic and industry conditions all would increase the risk of impairment. If we determine an impairment exists, we may be required to recognize significant impairment charges, which could materially and adversely impact our results of operations and financial condition.

The implementation of a new enterprise resource planning (“ERP”) system may disrupt the Company’s operations or its system of internal controls. At the end of 2013, we initiated the design and implementation of a new ERP system, which is expected to be substantially installed by the end of 2017. As this system continues to be deployed throughout the Company, delays or difficulties may be encountered in effectively and efficiently processing transactions and conducting business operations until personnel are familiar with all appropriate aspects and capabilities of the upgraded systems.

The Company’s operations and information systems are subject to cybersecurity risks. Team continues to increase its dependence on digital technologies to conduct its operations. Many of the Company’s files are digitized and more employees are working in almost paperless and remote environments. We have also outsourced certain information technology development, maintenance and support functions. As a result, the Company may be exposed to potentially severe cyber incidents at both its internal locations and outside vendor locations that could result in a theft of intellectual property and/or disruption of its operations for an extended period of time resulting in the loss of critical data and in higher costs to correct and remedy the effects of such incidents, although no such material incidents have occurred to date to the Company’s knowledge.

Our operations and properties are subject to extensive governmental regulation under environmental laws. Environmental laws and regulations can impose substantial sanctions for violations or operational changes that may limit our services. We must conform our operations to applicable regulatory requirements and adapt to changes in such requirements in all locations in which we operate. These actions may increase the overall costs of providing our services. Some of our services involve handling or monitoring highly regulated materials, including VOCs or hazardous wastes. Environmental laws and regulations generally impose limitations and standards for regulated materials and require us to obtain permits and comply with various other requirements. The improper characterization, handling, disposal or monitoring of regulated materials or any other failure by us to comply with increasingly complex and strictly enforced federal, state and local environmental laws and regulations or associated environmental permits could subject us to the assessment of administrative, civil and criminal penalties, the imposition of investigatory or remedial obligations, or the issuance of injunctions that could restrict or prevent our ability to operate our business and complete contracted services. A defect in our services or faulty workmanship could result in an environmental liability if, as a result of the defect or faulty workmanship, a contaminate is released into the environment.

We currently maintain liability insurance to limit any potential loss, but there can be no assurance that our insurance will fully protect us against a claim or loss. We perform services in hazardous environments on or around high-pressure, high temperature systems and our employees are exposed to a number of hazards, including exposure to hazardous materials, explosion hazards and fire hazards. Incidents that occur at these large industrial facilities or systems, regardless of fault, may be catastrophic and adversely impact our employees and third parties by causing serious personal injury, loss of life, damage to

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property or the environment, and interruption of operations. Our contracts typically require us to indemnify our customers for injury, damage or loss arising out of our presence at our customers' location, regardless of fault, or the performance of our services and provide for warranties for materials and workmanship. We may also be required to name the customer as an additional insured under our insurance policies. We maintain insurance coverage against these and other risks associated with our business. Due to the high cost of general liability coverage, we maintain insurance with a self-insured retention of $3.0 million per occurrence. This insurance may not protect us against liability for certain events, including events involving pollution, product or professional liability, losses resulting from business interruption or acts of terrorism or damages from breach of contract by the Company. We cannot assure you that our insurance will be adequate in risk coverage or policy limits to cover all losses or liabilities that we may incur. Moreover, in the future, we cannot assure that we will be able to maintain insurance at levels of risk coverage or policy limits that we deem adequate. Any future damages caused by our products or services that are not covered by insurance or are in excess of policy limits could have a material adverse effect on our results of operations, financial position or cash flows.
We are involved and are likely to continue to be involved in legal proceedings, which will increase our costs and, if adversely determined, could have a material effect on our results of operations, financial position or cash flows. We are currently a defendant in legal proceedings arising from the operation of our business and it is reasonable to expect that we will be named in future actions. Most of the legal proceedings against us arise out of the normal course of performing services at customer facilities, and include claims for workers' compensation, personal injury and property damage. Legal proceedings can be expensive to defend and can divert the attention of management and other personnel for significant periods of time, regardless of the ultimate outcome. An unsuccessful defense of a liability claim could have an adverse effect on our business, results of operations, financial position or cash flows.
Economic, political and other risks associated with international operations could adversely affect our business. A portion of our operations are conducted and located outside the United States, and accordingly, our business is subject to risks associated with doing business internationally, including changes in foreign currency exchange rates, instability in political or economic conditions, difficulty in repatriating cash proceeds, differing employee relations, differing regulatory environments, trade protection measures, and difficulty in administering and enforcing corporate policies which may be different than the normal business practices of local cultures. In many foreign countries, particularly in those with developing economies, it is common to engage in business practices that are prohibited by U.S. and foreign anti-corruption regulations applicable to us such as the U.S. Foreign Corrupt Practices Act and the United Kingdom Bribery Act. Our international business operations may include projects in countries where corruption is prevalent. Although we have, and continue to, implement policies and procedures designed to ensure compliance with these laws, there can be no assurance that all of our employees, contractors or agents, including those representing us in countries where practices which violate such anti-corruption laws may be customary, will not take actions in violation of our policies and procedures. Any violation of foreign or U.S. laws by our employees, contractors or agents, even if such violation is prohibited by our policies and procedures, could have a material adverse effect on our results of operations, financial position or cash flows.
Our growth strategy entails risk for investors. We intend to continue to pursue acquisitions in, or complementary to, the specialty maintenance and construction services industry to complement and diversify our existing business. We may not be able to continue to expand our market presence through acquisitions, and any future acquisitions may present unforeseen integration difficulties or costs. From time to time, we make acquisitions of other businesses that enhance our services or geographic scope. No assurances can be made that we will realize the cost savings, synergies or revenue enhancements that we may anticipate from any acquisition, or that we will realize such benefits within the time frame that we expect. If we are not able to address the challenges associated with acquisitions and successfully integrate acquired businesses, or if our integrated product and service offerings fail to achieve market acceptance, our business could be adversely affected. The consideration paid in connection with an acquisition may also affect our share price or future financial results depending on the structure of such consideration. To the extent we issue stock or other rights to purchase stock, including options or other rights, existing shareholders may be diluted and earnings per share may decrease. In addition, acquisitions may result in the incurrence of additional debt.

The price of our outstanding securities may be volatile. It is possible that in some future quarter (or quarters) our revenues, operating results or other measures of financial performance will not meet the expectations of public stock market analysts or investors, which could cause the price of our outstanding securities to decline or be volatile. Historically, our quarterly and annual sales and operating results have fluctuated. We expect fluctuations to continue in the future. In addition to general economic and political conditions, the following factors may affect our sales and operating results: the timing of significant customer orders, the timing of planned maintenance projects at customer facilities, changes in competitive pricing, wide variations in profitability by product line, variations in operating expenses, rapid increases in raw material and labor costs, the timing of announcements or introductions of new products or services by us, our competitors or our respective customers, the acceptance of those services, our ability to adequately meet staffing requirements with qualified personnel, relative

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variations in manufacturing efficiencies and costs, and the relative strength or weakness of international markets. Since our quarterly and annual revenues and operating results vary, we believe that period-to-period comparisons are not necessarily meaningful and should not be relied upon as indicators of our future performance.

Our business may be adversely impacted by work stoppages, staffing shortages and other labor matters. At December 31, 2016, we had approximately 7,400 employees, approximately 950 of whom were located in Canada and Europe where employees predominantly are represented by unions. Although we believe that our relations with our employees are good and we have had no strikes or work stoppages, no assurances can be made that we will not experience these and other types of conflicts with labor unions, works councils, other groups representing employees, or our employees in general, or that any future negotiations with our labor unions will not result in significant increases in the cost of labor.

Climate change legislation or regulations restricting emissions of “greenhouse gases” could result in reduced demand for our services and products. Scientific studies have suggested that emissions of certain gases, commonly referred to as “greenhouse gases” may be contributing to warming of the earth’s atmosphere. As a result, there have been a variety of regulatory developments, proposals or requirements and legislative initiatives that have been introduced in the United States (and other parts of the world) that are focused on restricting the emission of carbon dioxide, methane and other greenhouse gases. The adoption and implementation of any regulations which impose limiting emissions of carbon dioxide and other greenhouse gases from customers for whom we provide repair and maintenance services could affect demand for our products and services.

Interruptions in the proper functioning of our information systems could disrupt operations and cause increases in costs and/or decreases in revenues. The proper functioning of our information systems is critical to the successful operation of our business. Although our information systems are protected through physical and software safeguards, our information systems are still vulnerable to natural disasters, power losses, telecommunication failures and other problems. If critical information systems fail or are otherwise unavailable, our business operations could be adversely affected.

Regulations related to conflict-free minerals may cause us to incur additional expenses. The SEC has established annual disclosure and reporting requirements for those companies who use “conflict” minerals sourced from the Democratic Republic of Congo and adjoining countries in their products. These requirements could limit the pool of suppliers who can provide conflict-free minerals and as a result, we cannot ensure that we will be able to obtain these minerals at competitive prices. Compliance with these new requirements may also increase our costs. In addition, we may face challenges with our customers if we are unable to sufficiently verify the origins of the minerals used in our products.

Other risk factors. Other risk factors may include interruption of our operations, or the operations of our customers due to fire, hurricanes, earthquakes, power loss, telecommunications failure, terrorist attacks, labor disruptions, health epidemics and other events beyond our control.

Any one of these factors, or a combination of these factors, could materially affect our future results of operations, financial position or cash flows and whether any forward-looking statements in this Annual Report on Form 10-K ultimately prove to be accurate.

ITEM 1B. UNRESOLVED STAFF COMMENTS

NONE

ITEM 2. PROPERTIES

There are several materially important physical properties used in our operations. Our 120,000 square foot facility in Alvin, Texas consists of our primary training facility, equipment center and ISO-9001 certified manufacturing facility for clamps, enclosures, and sealants. Additionally, we own a 39,000 square foot manufacturing facility in Houston, Texas. We lease approximately 60,000 square feet of office space utilized as our corporate headquarters in Sugar Land, Texas. The following is a list of owned and leased branch service locations considered materially important physical properties:

- Beaumont, Texas
- Pasadena, Texas (2 locations)

- Pearland, Texas
- Hammond, Indiana
- Cincinnati, Ohio

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- Gonzales, Louisiana
- Wood River, Illinois
- Long Beach, California
- Columbus, Ohio
- Vlissingen, Netherlands
- Kendal, Cumbria, United Kingdom

We believe that our property and equipment are adequate for our current needs, although additional investments are expected to be made for expansion of property and equipment, replacement of assets at the end of their useful lives will occur in connection with corporate development activities.

ITEM 3. LEGAL PROCEEDINGS

Con Ed Matter—We have, from time to time, provided temporary leak repair services for the steam operations of Consolidated Edison Company of New York ("Con Ed") located in New York City. In July 2007, a Con Ed steam main located in midtown Manhattan ruptured causing one death and other injuries and property damage. As of December 31, 2016, ninety-two lawsuits are currently pending against Con Ed, the City of New York and Team in the Supreme Courts of New York located in Kings, New York and Bronx County, alleging that our temporary leak repair services may have contributed to the cause of the rupture. The lawsuits seek generally unspecified compensatory damages for personal injury, property damage and business interruption. Additionally, on March 31, 2008, we received a letter from Con Ed alleging that our contract with Con Ed requires us to indemnify and defend Con Ed for additional claims filed against Con Ed as a result of the rupture. Con Ed filed an action to join Team and the City of New York as defendants in all lawsuits filed against Con Ed that did not include Team and the City of New York as direct defendants. We are vigorously defending the lawsuits and Con Ed's claim for indemnification. We filed a motion to dismiss in December 2016. Based upon the current briefing schedule, a ruling on the motion is anticipated in the fall of 2017. We are unable to estimate the amount of liability to us, if any, associated with these lawsuits and the claim for indemnification. We maintain insurance coverage, subject to a deductible limit of $250,000, which we believe should cover these claims. We have not accrued any liability in excess of the deductible limit for the lawsuits. We do not believe the ultimate outcome of these matters will have a material adverse effect on our financial position, results of operations, or cash flows. We anticipate a trial on the merits during the first half of 2018.

Patent Infringement Matters—In December 2014, our subsidiary, Quest Integrity, filed three patent infringement lawsuits against three different defendants, two in the U.S. District of Delaware (the "Delaware Cases") and one in the U.S. District of Western Washington ("Washington Case"). Quest Integrity alleges that the three defendants infringed Quest Integrity's patent, entitled "2D and 3D Display System and Method for Furnace Tube Inspection". This Quest Integrity patent generally teaches a system and method for displaying inspection data collected during the inspection of furnace tubes in petroleum and petro-chemical refineries. The subject patent litigation is specific to the visual display of the collected data and does not relate to Quest Integrity's underlying advanced inspection technology. In these lawsuits Quest Integrity is seeking temporary and permanent injunctive relief, as well as monetary damages. Defendants have denied they infringe any valid claim of Quest Integrity's patent, and have asserted declaratory judgment counterclaims that the patent at issue is invalid and/or unenforceable, and not infringed. In June 2015, the U.S. District of Delaware denied our motions for preliminary injunctive relief in the Delaware Cases (that is, our request that the defendants stop using our patented systems and methods during the pendency of the actions). The Delaware Cases are expected to proceed to trial in the second quarter of 2017. The Washington Case does not have a trial date scheduled.

We are involved in various other lawsuits and are subject to various claims and proceedings encountered in the normal conduct of business. In our opinion, any uninsured losses that might arise from these lawsuits and proceedings will not have a materially adverse effect on our consolidated financial statements.

ITEM 4. MINE SAFETY DISCLOSURES

NOT APPLICABLE

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our stock is traded on the NYSE under the symbol "TISI". The table below reflects the high and low sales prices of our common stock by quarter for the year ended December 31, 2016, the seven-month transition period from June 1, 2015 to December 31, 2015 and the year ended May 31, 2015.

	Sales Price	
	High	Low
2016		
Quarter ended:		
March 31, 2016	$31.86	$21.75
June 30, 2016	$32.49	$23.53
September 30, 2016	$33.71	$24.10
December 31, 2016	$39.60	$28.00
2015		
Transition period:		
June 1, 2015 - December 31, 2015	$47.55	$30.81
Quarter ended:		
August 31, 2014	$43.53	$36.09
November 30, 2014	$44.36	$35.18
February 28, 2015	$41.42	$35.44
May 31, 2015	$41.22	$35.60

Holders

There were 579 holders of record of our common stock as of March 10, 2017, excluding beneficial owners of stock held in street name.

Dividends

No cash dividends were declared or paid during the year ended December 31, 2016, the seven months ended December 31, 2015 or the year ended May 31, 2015. We are limited in our ability to pay cash dividends without the consent of our bank syndicate. Accordingly, we have no present intention to pay cash dividends in the foreseeable future. Additionally, any future dividend payments will continue to depend on our financial condition, market conditions and other matters deemed relevant by the Board.

Securities Authorized for Issuance Under Equity Compensation Plans

This information has been omitted from this Annual Report on Form 10-K as we intend to file such information in our Definitive Proxy Statement no later than 120 days following the close of our fiscal year ended December 31, 2016. The information required regarding equity compensation plans is hereby incorporated by reference.

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Performance Graph

The following performance graph compares the performance of our common stock to the NYSE Composite Index and a Peer Group Index. The comparison assumes $100 was invested on May 31, 2011 in our common stock, the NYSE Composite Index and a Peer Group Index. The values of each investment are based on share price appreciation, with reinvestment of all dividends, assuming any were paid. For each graph, the investments are assumed to have occurred at the beginning of each period presented. The following companies are included in our Peer Group Index used in the graph: Matrix Service Company, Englobal Corporation and Mistras Group, Inc.

* $100 invested on 5/31/11 in stock or index, including reinvestment of dividends. Years ended May 31, 2012, 2013, 2014 and 2015; seven-month transition period ended December 31, 2015; and year ended December 31, 2016.

	5/11	5/12	5/13	5/14	5/15	12/15	12/16
Team, Inc.	100.00	116.00	156.83	182.26	173.04	138.96	170.65
NYSE Composite	100.00	90.38	116.26	136.99	144.14	134.13	150.14
Peer Group	100.00	100.50	110.43	166.73	105.39	115.66	145.13

Notes: The above information was provided by Research Data Group, Inc.

ITEM 6. SELECTED FINANCIAL DATA

We have included selected financial data for the year ended December 31, 2016, the seven months ended December 31, 2015 and for the years ended May 31, 2012 through 2015 under “Five Year Comparison,” in the financial information that is included in this report in Part II, Item 8, “Financial Statements and Supplementary Data.” This information is incorporated herein by reference.

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ITEM 7. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The Management’s Discussion and Analysis of Financial Condition and Results of Operations listed in the Financial Table of Contents included in this report is incorporated herein by reference.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have included a discussion about market risks under “Market Risk” in the Management’s Analysis that is included in this report in Part II, Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” This information is incorporated herein by reference.

ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our Consolidated Financial Statements, the Notes to Consolidated Financial Statements, the reports of our Independent Registered Public Accounting Firm and the information under “Quarterly Results” listed in this report are incorporated herein by reference. All other schedules for which provision is made in the applicable accounting regulation of the SEC are not required under the related instructions or are inapplicable, and therefore, have been omitted.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

There have been no disagreements concerning accounting and financial disclosures with our independent accountants during any of the periods presented.

ITEM 9A. CONTROLS AND PROCEDURES

Limitations on effectiveness of control. Our management, including the principal executive and financial officer, does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent or detect all errors and all fraud. A control system, no matter how well designed or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. The design of our control system reflects the fact that there are resource constraints and the benefits of such controls must be considered relative to their costs. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control failures and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts, by collusion of two or more people, or by management override of the controls. The design of any system of controls is also based in part on certain assumptions about the likelihood of future events and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Projections of management’s assessments of the current effectiveness of our disclosure controls and procedures and its internal control over financial reporting are subject to risks. However, our disclosure controls and procedures are designed to provide reasonable assurance that the objectives of our control system are met.

Evaluation of disclosure controls and procedures. As of the end of the period covered by this report, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer (“CEO”) and our Chief Financial Officer (“CFO”), of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (“Exchange Act”)). This evaluation included consideration of the various processes carried out under the direction of our disclosure committee in an effort to ensure that information required to be disclosed in our SEC reports is recorded, processed, summarized and reported within the time periods specified by the SEC. This evaluation also considered the work completed related to our compliance with Section 404 of the Sarbanes-Oxley Act of 2002. Based on this evaluation, our CEO and CFO concluded that, as of December 31, 2016, our disclosure controls and procedures were operating effectively to ensure that the information required to be disclosed in our SEC reports is recorded, processed, summarized and reported within the requisite time periods and that such information is appropriately accumulated and communicated to management, including our CEO and CFO, as appropriate, to allow timely decisions regarding required disclosure.

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Management’s Annual Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Exchange Act Rule 13a-15(f). Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of our consolidated financial statements for external purposes in accordance with GAAP.

Internal control over financial reporting cannot provide absolute assurance of achieving financial objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting can also be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

We have used the framework set forth in the report entitled Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013) to evaluate the effectiveness of our internal control over financial reporting. We have concluded that our internal control over financial reporting was effective as of December 31, 2016.

Management’s annual assessment of the effectiveness of our internal control over financial reporting as of December 31, 2016 excluded the internal control over financial reporting of Furmanite, representing total assets of approximately $215 million and total revenues of approximately $216 million included in the financial statements of Team, Inc. and subsidiaries as of and for the year ended December 31, 2016.

Attestation report of the registered public accounting firm. The attestation report of KPMG LLP, the Company’s independent registered public accounting firm, on the Company’s internal control over financial reporting is set forth in this Annual Report on Form 10-K on page 35.

Changes in internal control over financial reporting. There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Securities Exchange Act) that have materially affected or are reasonably likely to materially affect our internal control over financial reporting during the fourth quarter of our fiscal year ended December 31, 2016.

ITEM 9B. OTHER INFORMATION

NONE

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PART III

The information for the following items of Part III has been omitted from this Annual Report on Form 10-K since we will file, not later than 120 days following the close of our fiscal year ended December 31, 2016, our Definitive Proxy Statement. The information required by Part III will be included in that proxy statement and such information is hereby incorporated by reference, with the exception of the information under the headings “Compensation Committee Report” and “Audit Committee Report.”

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

ITEM 11. EXECUTIVE COMPENSATION

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) 1) Consolidated Financial Statements filed as part of this report are listed in the Financial Table of Contents included in this report and incorporated by reference in this report in Part II, Item 7 " Management's Discussion and Analysis of Financial Condition and Results of Operations" and Item 8, "Consolidated Financial Statements and Supplementary Data."

2) All schedules for which provision is made in the applicable accounting regulations of the SEC are listed in this report in Part II, Item 8, "Consolidated Financial Statements and Supplementary Data."

3) Reference is made to the Exhibit Index beginning on page 20 hereof.

(b) Exhibits

Reference is made to the Exhibit Index beginning on page 20 hereof.

ITEM 16. FORM 10-K SUMMARY

NONE

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized March 15, 2017.

TEAM, INC.

/S/ TED W. OWEN
Ted W. Owen
President and Chief Executive Officer
(Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacity and on the dates indicated.

/S/ TED W. OWEN (Ted W. Owen)	President and Chief Executive Officer and Director (Principal Executive Officer)	March 15, 2017
/S/ GREG L. BOANE (Greg L. Boane)	Executive Vice President, Chief Financial Officer and Treasurer (Principal Financial Officer and Principal Accounting Officer)	March 15, 2017
/S/ JEFFERY G. DAVIS (Jeffery G. Davis)	Director	March 15, 2017
/S/ VINCENT D. FOSTER (Vincent D. Foster)	Director	March 15, 2017
/S/ PHILIP J. HAWK (Philip J. Hawk)	Chairman of the Board	March 15, 2017
/S/ SYLVIA J. KERRIGAN (Sylvia J. Kerrigan)	Director	March 15, 2017
/S/ EMMETT J. LESCROART (Emmett J. Lescroart)	Director	March 15, 2017
/S/ MICHAEL A. LUCAS (Michael A. Lucas)	Director	March 15, 2017
/S/ LOUIS A. WATERS (Louis A. Waters)	Director	March 15, 2017

/s/ GARY G. YESAVAGE (Gary G. Yesavage)	Director	March 15, 2017

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EXHIBIT INDEX

Exhibit Number	Description
3.1	Amended and Restated Articles of Incorporation of the Company (filed as Exhibit 3.1 to the Company's Current Report on Form 8-K filed on December 2, 2011, incorporated by reference herein).
3.2	Certificate of Amendment of Amended and Restated Certificate of Incorporation of the Company, dated October 24, 2013 (filed as Exhibit 3.1 to the Company's Current Report on Form 8-K filed on October 25, 2013, incorporated by reference herein).
3.3	Amended and Restated Bylaws of the Company (filed as Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q filed on April 4, 2014, incorporated by reference herein).
4.1	Certificate representing shares of common stock of Company (filed as Exhibit 4(1) to the Company's Registration Statement on Form S-1, File No. 2-68928, incorporated by reference herein).
10.1†	Team, Inc. 2004 Restricted Stock Option and Award Plan dated June 24, 2004 (filed as Exhibit 10.21 to the Company's Annual Report on Form 10-K for the year ended May 31, 2004, incorporated by reference herein).
10.2†	Team, Inc. 2006 Stock Incentive Plan (as Amended and Restated August 1, 2009) (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed on September 30, 2009, incorporated by reference herein).
10.3†	Form of Stock Unit Agreement (filed as Exhibit 10.2 to the Company's Current Report on Form 8-K filed on October 17, 2008, incorporated by reference herein).
10.4†	Form of Performance-Based Stock Unit Agreement (filed as Exhibit 10.3 to the Company's Current Report on Form 8-K filed on October 17, 2008, incorporated by reference herein).
10.5†	Form of Performance Share Award Agreement (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed November 4, 2014, incorporated by reference herein).
10.6	Third Amended and Restated Credit Agreement dated as of July 7, 2015 among Team, Inc., Bank of America, N.A. as Administrative Agent, Swingline Lender and L/C Issuer, JPMorgan Chase Bank, N.A., as Syndication Agent, Compass Bank, as Documentation Agent and the other Lenders party thereto (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed on July 9, 2015, incorporated by reference herein).
10.7†	Furmanite Corporation 1994 Stock Incentive Plan, Amendment and Restatement effective May 9, 2013 (filed as Exhibit 4.4 to the Company's Registration Statement on Form S-8, File No. 333-209871, filed on March 1, 2016, incorporated by reference herein).
10.8	Second Amendment and Commitment Increase to Credit Agreement, dated February 24, 2016, among Team Inc., certain Team Inc. Subsidiary Guarantors, Bank of America, N.A., as Administrative Agent, Swing Line Lender and L/C Issuer, and other Lenders party thereto (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K filed on March 1, 2016, incorporated by reference herein).

10.9†	Team, Inc. 2016 Equity Incentive Plan (incorporated by reference to Annex A of the Company’s Definitive Proxy on Schedule 14A, as filed with the SEC on April 12, 2016, incorporated by reference herein).
10.10†	Non-Disclosure, Non-Competition and Non-Solicitation Agreement between Philip J. Hawk, Team Industrial Services, Inc., Team, Inc. and their affiliated entities, effective as of August 8, 2016 (filed as Exhibit 10.1 to the Company’s Quarterly Report on Form 10-Q filed on August 9, 2016, incorporated herein by reference).
10.11	Third Amendment to Credit Agreement, dated August 17, 2016, among Team, Inc., certain Team, Inc. Subsidiary Guarantors, Bank of America, N.A., as Administrative Agent, Swing Line Lender and L/C Issuer, and other Lenders party thereto (filed as Exhibit 10.1 to the Company’s Current Report on Form 8-K filed on August 23, 2016, incorporated by reference herein).
10.12	Fourth Amendment and Limited Waiver to Credit Agreement, dated December 19, 2016, among Team, Inc., certain Team, Inc. Subsidiary Guarantors, Bank of America, N.A., as Administrative Agent, Swing Line Lender and L/C Issuer, and other Lenders party thereto.
10.13	ATM Equity Offering^{SM} Sales Agreement, dated as of November 28, 2016, by and among Team, Inc., Merrill Lynch, Pierce, Fenner & Smith Incorporated, Raymond James & Associates, Inc. and SunTrust Robinson Humphrey, Inc. (filed as Exhibit 1.1 to the Company’s Current Report on Form 8-K filed on November 28, 2016, incorporated by reference herein).
10.14†	Form of Performance Award Agreement.

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Exhibit Number	Description
21	Subsidiaries of the Company.
23.1	Consent of Independent Registered Public Accounting Firm—KPMG LLP.
31.1	Certifications pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certifications pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certifications pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certifications pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS	XBRL Instance Document.
101.SCH	XBRL Taxonomy Schema Document.
101.CAL	XBRL Calculation Linkbase Document.
101.DEF	XBRL Definition Linkbase Document.
101.LAB	XBRL Label Linkbase Document.
101.PRE	XBRL Presentation Linkbase Document.

† Management contract or compensation plan or arrangement.

Note: Unless otherwise indicated, documents incorporated by reference are located under SEC file number 001-08604.

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MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following review of our results of operations and financial condition should be read in conjunction with Item 1 “Business,” Item 1A “Risk Factors,” Item 2 “Properties,” and Item 8 “Consolidated Financial Statements and Supplementary Data,” included in this Annual Report on Form 10-K.

CAUTIONARY STATEMENT FOR THE PURPOSE OF
SAFE HARBOR PROVISIONS OF THE
PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This report includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. In addition, other written or oral statements that constitute forward-looking statements may be made by us or on behalf of the Company in other materials we release to the public including all statements, other than statements of historical facts, included or incorporated by reference in this Annual Report on Form 10-K, that address activities, events or developments which we expect or anticipate will or may occur in the future. You can generally identify our forward-looking statements by the words “anticipate,” “believe,” “expect,” “plan,” “intend,” “estimate,” “project,” “projection,” “predict,” “budget,” “forecast,” “goal,” “guidance,” “target,” “w “may” and similar expressions.

We based our forward-looking statements on our reasonable beliefs and assumptions, and our current expectations, estimates and projections about ourselves and our industry. We caution that these statements are not guarantees of future performance and involve risks, uncertainties and assumptions that we cannot predict. In addition, we based many of these forward-looking statements on assumptions about future events that may prove to be inaccurate. We wish to ensure that such statements are accompanied by meaningful cautionary statements, so as to obtain the protections of the safe harbor established in the Private Securities Litigation Reform Act of 1995. New risk factors emerge from time to time and it is not possible for us to predict all such risk factors, nor can we assess the impact of all such risk factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. Accordingly, forward-looking statements cannot be relied upon as a guarantee of future results and involve a number of risks and uncertainties that could cause actual results to differ materially from those projected in the statements, including, but not limited to the statements under “Risk Factors.” We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

This Management’s Discussion and Analysis of Financial Condition and Results of Operations is provided as a supplement to the accompanying consolidated financial statements and notes to help provide an understanding of our financial condition, changes in financial condition, and results of operations.

General Information

We are a leading provider of standard to specialty industrial services, including inspection, engineering assessment and mechanical repair and remediation required in maintaining high temperature and high pressure piping systems and vessels that are utilized extensively in the refining, petrochemical, power, pipeline and other heavy industries. We conduct operations in three segments: TeamQualspec, TeamFurmanite and Quest Integrity. Through the capabilities and resources in these three segments, we believe that Team is uniquely qualified to provide integrated solutions involving in their most basic form, inspection to assess condition, engineering assessment to determine fitness for purpose in the context of industry standards and regulatory codes and mechanical services to repair, rerate or replace based upon the client’s election. In addition, our Company is capable of escalating with the client’s needs—as dictated by the severity of the damage found and the related operating conditions—from standard services to some of the most advanced services and expertise available in the industry.

TeamQualspec provides standard and advanced NDT services for the process, pipeline and power sectors, pipeline integrity management services, field heat treating services, as well as associated engineering and assessment services. These services can be offered while facilities are running (on-stream), during facility turnarounds or during new construction or expansion activities.

TeamFurmanite, our mechanical services segment, provides turnaround and on-stream services. Turnaround services are project-related and demand is a function of the number and scope of scheduled and unscheduled facility turnarounds as well as new industrial facility construction or expansion activities. The turnaround services TeamFurmanite provides include field machining, technical bolting, field valve repair, heat exchanger repair, and isolation test plugging services. On-stream services

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offered by TeamFurmanite represent the services offered while plants are operating and under pressure. These services include leak repair, fugitive emissions control and hot tapping.

Quest Integrity provides integrity and reliability management solutions for the process, pipeline and power sectors. These solutions encompass two broadly-defined disciplines: (1) highly specialized in-line inspection services for unpiggable process piping and pipelines using proprietary in-line inspection tools and analytical software; and (2) advanced condition assessment services through a multi-disciplined engineering team.

We offer these services globally through over 220 locations in 20 countries throughout the world with more than 7,400 employees. We market our services to companies in a diverse array of heavy industries which include the petrochemical, refining, power, pipeline, steel, pulp and paper industries, as well as municipalities, shipbuilding, OEMs, distributors, and some of the world's largest engineering and construction firms.

Results of Operations

In November 2015, we announced we would change our fiscal year end to December 31 of each calendar year from May 31. In connection with this change, we previously filed a Transition Report on Form 10-K to report the results of the seven-month transition period from June 1, 2015 to December 31, 2015. In this report, the periods presented are the year ended December 31, 2016, the seven-month transition period from June 1, 2015 to December 31, 2015 and the years ended May 31, 2015 and 2014. For comparison purposes, we have also included unaudited data for the year ended December 31, 2015 and for the seven months ended December 31, 2014.

Year Ended December 31, 2016 Compared to Year Ended December 31, 2015

The following table sets forth the components of revenue and operating income (loss) from our operations for years ended December 31, 2016 and 2015 (in thousands):

	Year Ended December 31,		Increase (Decrease)	
	2016	2015 (unaudited)	$	%
Revenues by business segment:				
TeamQualspec	$589,478	$549,307	$40,171	7.3 %
TeamFurmanite	539,627	302,581	237,046	78.3 %
Quest Integrity	67,591	74,468	(6,877)	(9.2)%
Total	$1,196,696	$926,356	$270,340	29.2 %
Operating income (loss):				
TeamQualspec	$43,367	$56,001	$(12,634)	(22.6)%
TeamFurmanite	27,283	26,164	1,119	4.3 %
Quest Integrity	4,780	11,497	(6,717)	(58.4)%
Corporate and shared support services	(78,548)	(46,371)	(32,177)	69.4 %
Total	$(3,118)	$47,291	$(50,409)	(106.6)%

Revenues. Total revenues grew $270.3 million or 29.2% from the same period in the prior year, primarily due to the Furmanite and Qualspec acquisitions, completed in February 2016 and July 2015, respectively, partially offset by lower Quest Integrity revenues and an adverse impact of $6.6 million due to changes in foreign exchange rates. Due to the integration of both Furmanite and Qualspec into our existing operations during 2016, it is not practicable to specifically quantify the year-over-year revenue impact of these acquisitions. On a pro forma basis, assuming that the Furmanite and Qualspec acquisitions has occurred at the beginning of 2015, total revenues declined $120.8 million, or 8.9%. Market softness, which began in the second half of 2015, continued throughout 2016 across all three business segments. The weak market conditions led to a combination of project deferrals, scope reductions and maintenance deferrals, which, among other impacts, resulted in approximately 29% lower sales volumes in heat treating services, typically associated with large, more complex turnaround projects, within our TeamQualspec segment. Additionally, our TeamFurmanite and TeamQualspec segments were adversely affected by wildfires in the Canadian oil sands area near Fort McMurray in the second quarter of 2016 as well as severe

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flooding in Louisiana in the third quarter of 2016. In the fall of 2016, what appeared to be the first signs of more normalized market activity did not ultimately develop into sustained increases as we saw demand weaken again in the latter part of the year. In spite of the soft demand in 2016, we continue to be optimistic that end markets could begin to improve during 2017.

Operating income (loss). Overall operating loss was $3.1 million, compared to operating income of $47.3 million in the prior year. The current year includes non-routine expenses totaling $34.6 million consisting of $14.5 million in professional fees and other costs associated with mergers and acquisitions activity and change in fiscal year end, $7.6 million in costs related to the implementation of our new ERP system, $5.5 million in exit costs and other related charges primarily associated with severance costs related to the closure of certain acquired Furmanite locations in Western Europe, $3.0 million in legal fees associated with a legal defense of Quest Integrity intellectual property and $4.0 million in other non-routine items. The non-routine items were attributed to our operating segments as follows: $0.9 million in TeamQualspec, $8.9 million in TeamFurmanite, $3.1 million in Quest Integrity and $21.7 million in corporate and shared support services. Approximately $5.2 million of the merger and acquisition-related costs were attributable to Furmanite obligations, primarily for change of control and severance payments. The prior year included $14.2 million of non-routine expenses resulting from $7.7 million in professional fees and other costs associated with mergers and acquisitions activity and a change in fiscal year end, $2.7 million in legal fees associated with a legal defense of Quest Integrity intellectual property, $2.9 million in costs related to the implementation of our new ERP system and $0.9 million of other non-routine items. The non-routine items were attributed to our operating segments as follows: $0.5 million in TeamQualspec, $0.4 million in TeamFurmanite, $2.7 million in Quest Integrity and $10.6 million in corporate and shared support services. Excluding the impact of these non-routine items, operating income (loss) changed unfavorably by $30.0 million as the effect of acquisition-related growth was more than offset by the adverse effects of the current market softness and reduced customer spending described above. Additionally, we experienced lower average gross margins in the current year as the market softness resulted in an unfavorable service mix shift away from higher margin advanced and specialty services normally tied to large turnaround projects. Further, operating income (loss) was affected by an increase in corporate and shared support services of $21.1 million, which includes the addition of Furmanite’s ongoing corporate-related costs and higher share-based compensation expense.

Interest expense. Interest expense increased from $5.8 million in the prior year to $12.7 million in the current year. The increase is due primarily to additional debt financing used to fund acquisitions, including the July 2015 acquisition of Qualspec and a portion of the February 2016 acquisition of Furmanite.

Venezuelan Impairment Loss. During the year ended December 31, 2015, we began reporting the results of our Venezuelan operations using the cost method of accounting. This change resulted in a one-time pre-tax charge of $1.2 million, which is included in other expense (income), net. This decision was made given the other-than-temporary lack of exchangeability in the Venezuelan currency combined with other recent Venezuelan regulations that negatively impacted our ability to control operations and maintain normal service levels. We disposed of our Venezuelan operations in June 2015.

Foreign currency gain (loss). Foreign currency gains were $0.1 million for the year ended December 31, 2016 compared to foreign currency losses of $1.1 million in the same period last year. Foreign currency gains and losses in both periods reflect the effects of fluctuations in the U.S. Dollar relative to the currencies we have exposure to, including but not limited to, the Australian Dollar, Brazilian Real, British Pound, Canadian Dollar, Euro, Malaysian Ringgit and Mexican Peso.

Taxes. The benefit for income tax was $3.1 million on the pre-tax loss from continuing operations of $15.7 million in the current year compared to the provision for income tax of $13.7 million on pre-tax income from continuing operations of $39.2 million in the prior year. The effective tax rate was 19.8% for the year ended December 31, 2016 and 35.1% for the year ended December 31, 2015. The decrease in the effective tax rate was primarily driven by the effects of discrete items such as the settlement of prior years with the Internal Revenue Service and changes in valuation allowances as well as permanent differences that had significant impacts due to the size and direction of pre-tax income (loss) from continuing operations in both periods.

Discontinued operations. Loss from discontinued operations, net of income tax, was $0.1 million for the year ended December 31, 2016 and relates to the operating results and disposal of an acquired Furmanite business that we sold in December 2016.

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Seven Months Ended December 31, 2015 Compared to Seven Months Ended December 31, 2014

The following table sets forth the components of revenue and operating income from our operations for the seven months ended December 31, 2015 and 2014 (in thousands):

	Seven Months Ended December 31,		Increase (Decrease)	
	2015	2014 (unaudited)	$	%
Revenues by business segment:				
TeamQualspec	$351,949	$269,742	$82,207	30.5 %
TeamFurmanite	178,238	176,112	2,126	1.2 %
Quest Integrity	41,531	41,554	(23)	(0.1)%
Total	$571,718	$487,408	$84,310	17.3 %
Operating income:				
TeamQualspec	$31,175	$35,696	$(4,521)	(12.7)%
TeamFurmanite	14,335	16,838	(2,503)	(14.9)%
Quest Integrity	5,491	7,194	(1,703)	(23.7)%
Corporate and shared support services	(31,839)	(19,645)	(12,194)	62.1 %
Total	$19,162	$40,083	$(20,921)	(52.2)%

Revenues. Total revenues grew $84.3 million or 17.3% from the same period in 2014. Of this amount, approximately $85.8 million represents revenues from acquisitions completed during 2015. Excluding the impacts of acquisitions and an adverse impact of $16.3 million due to foreign exchange rates, total revenues increased by $14.8 million, TeamQualspec revenues increased by $11.6 million, TeamFurmanite revenues increased by $2.3 million and Quest revenues increased by $0.9 million. While activity levels were up slightly in the seven months ended December 31, 2015, the fall turnaround season was softer than expected as our refining and petrochemical customers deferred many of their planned capital and maintenance projects.

Operating income. Overall operating income declined by $20.9 million or 52.2% from the same period in 2014. The seven months ended December 31, 2015 includes non-routine expenses totaling $11.1 million related to $7.1 million in professional fees related to costs associated with mergers and acquisitions activity and a change in fiscal year end, $0.5 million in contingent consideration revaluation, $1.2 million in intellectual property defense legal costs and $2.3 million in costs related to the implementation of our ERP system (all included in Corporate and shared support services). The seven months ended December 31, 2014 included $0.2 million of professional fees related to mergers and acquisitions activity. Additionally, adverse foreign exchange rates reduced operating income by $1.1 million. Excluding the impact of these non-routine items, operating income decreased by $8.7 million or 21.7% as a result of weaker than expected revenue generation mentioned above coupled with an increase in corporate and shared support services of $2.8 million.

Interest expense. Interest expense increased from $1.3 million for the seven months ended December 31, 2014 to $4.9 million for the seven months ended December 31, 2015. The increase is due primarily to additional debt financing used to fund the July 2015 acquisition of Qualspec.

Foreign currency loss. Foreign currency losses decreased from $1.2 million in the seven months ended December 31, 2014 to $0.8 million in the seven months ended December 31, 2015. The seven-month period ended December 31, 2015 reflected the effects of a strengthening U.S. Dollar relative to the currencies we have exposure to, including but not limited to, the Euro, Australian Dollar, Brazilian Real, Canadian Dollar, Malaysian Ringgit and Mexican Peso.

Taxes. The provision for income tax was $4.6 million on pre-tax income of $13.5 million for the seven months ended December 31, 2015 compared to the provision for income tax of $13.6 million on pre-tax income of $37.6 million for the same period in 2014. The effective tax rate was 34% for the seven months ended December 31, 2015 and 36% for the seven months ended December 31, 2014. The reduction in the effective tax rate was primarily the result of foreign exchange rate changes to certain deferred tax liability accounts.

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Year Ended May 31, 2015 Compared to Year Ended May 31, 2014

The following table sets forth the components of revenue and operating income from our operations for years ended May 31, 2015 and 2014 (in thousands):

	Year Ended May 31,		Increase (Decrease)	
	2015	2014	$	%
Revenues by business segment:				
TeamQualspec	$467,099	$408,259	$58,840	14.4%
TeamFurmanite	300,456	275,322	25,134	9.1 %
Quest Integrity	74,492	65,946	8,546	13.0%
Total	$842,047	$749,527	$92,520	12.3%
Operating income:				
TeamQualspec	$60,198	$47,787	$12,411	26.0%
TeamFurmanite	28,713	26,177	2,536	9.7 %
Quest Integrity	13,196	9,260	3,936	42.5%
Corporate and shared support services	(33,642)	(29,803)	(3,839)	12.9%
Total	$68,465	$53,421	$15,044	28.2%

Revenues. Total revenues increased 12.3% or $92.5 million in 2015 versus 2014, with TeamQualspec revenues growing $58.8 million, TeamFurmanite revenues growing $25.1 million and Quest Integrity revenues growing $8.5 million. The TeamQualspec business is comprised of both traditional and advanced NDE services, as well as Heat Treating services. The TeamQualspec NDE services were $364.3 million in 2015, up $44.3 million or 14% from 2014. Overall favorable market conditions across most of our regions, coupled with growth in tank inspection and rope access services, all contributed to the increase in TeamQualspec revenues. Advanced inspection services, such as Phased Array Ultrasonics also experienced increased demand in 2015. TeamQualspec Heat Treating services, which are fundamentally performed in turnarounds or projects, were $102.8 million, up $12.8 million or 14% from 2014 due to favorable market conditions, increased large project activity levels, and successful deployment of our mobile smart rigs and smart heat consoles. Unfavorable foreign currency exchange rate fluctuations in Canada negatively impacted TeamQualspec's revenue by approximately $8.0 million when compared to 2014.

TeamFurmanite includes both on-stream and turnaround/project services. On-stream services were $158.7 million in 2015, consistent with 2014 results. Turnaround services within TeamFurmanite were $141.8 million, up $25.8 million or 22% from 2014. Overall market conditions were favorable as TeamFurmanite experienced revenue growth across most regions and service offerings. Turnaround project levels were strong during the year and favorably impacted by several large projects. Offsetting these market growth factors, TeamFurmanite was negatively impacted by unfavorable foreign currency exchange rate fluctuations during 2015 relating primarily to the Euro and Canadian dollar. We estimate an unfavorable foreign currency impact of approximately $6.0 million.

Quest Integrity revenues increased $8.5 million or 13% in 2015 from 2014 as Quest Integrity's pipeline inspection business was up significantly in 2015. However, this was partially offset by a generally weak process inspection market, resulting from lower crude oil prices, which led to some turnaround project deferrals.

Operating Income. Total operating income was $68.5 million in 2015 compared to $53.4 million in 2014, an increase of $15.0 million or 28%. Changes in operating income within business groups were driven primarily by increased revenues from higher activity levels. Gross margins improved by one point and four points in 2015 for TeamQualspec and Quest Integrity, respectively, while gross margin for TeamFurmanite was unchanged in comparison to the prior year. Operating income in 2015 was negatively impacted by $3.2 million in non-routine costs consisting of acquisition-related fees, legal fees surrounding the defense of intellectual property associated with Quest Integrity, ERP system implementation costs, and a fixed asset write down. Non-routine items benefitted operating income in 2014 by $1.4 million consisting of a revaluation of contingent consideration, partially offset by severance costs.

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Earnings from Unconsolidated Affiliates. The earnings from unconsolidated affiliates in the 2014 results represented our interest in a joint venture providing inspection services in Alaska. The joint venture was dissolved in December 2013 and the operations that were formerly conducted in the joint venture are now conducted directly by the TeamQualspec business unit.

Venezuelan Impairment Loss. During the year ended May 31, 2015, Team began reporting the results of its Venezuelan operations using the cost method of accounting. This change resulted in a one-time pre-tax charge of $1.2 million. This decision was made given the other-than-temporary lack of exchangeability in the Venezuelan currency combined with other recent Venezuelan regulations that negatively impacted our ability to control operations and maintain normal service levels. We disposed of our Venezuelan operations in June 2015.

Foreign Currency Loss. Non-operating results include $1.5 million foreign currency transaction losses for the year ended May 31, 2015 compared to losses of $4.2 million for the year ended May 31, 2014. Currency transaction losses in the year ended May 31, 2015 were driven primarily by a weakening of the Euro, Canadian Dollar and Mexican Peso against the U.S. Dollar. Currency transaction losses in the year ended May 31, 2014 were primarily due to fluctuations between the Venezuelan Bolivar and the U.S. Dollar. We accounted for Venezuela as a highly-inflationary economy and accordingly, all currency fluctuations between the Bolivar and the U.S. Dollar were recorded in our statement of operations. Due to the devaluations of the Bolivar in 2014, we recorded a $4.0 million foreign currency loss during the year ended May 31, 2014.

Taxes. The provision for income tax was $22.8 million on pre-tax income of $63.3 million for the year ended May 31, 2015 compared to the provision for income tax of $16.2 million on pre-tax income of $46.4 million for the year ended May 31, 2014. The effective tax rate was 36% for the year ended May 31, 2015 and 35% for the year ended May 31, 2014. The increase in the effective tax rate was primarily due to changes in deferred tax liabilities related to the differences between the financial reporting basis and U.S. tax basis of investments in certain foreign subsidiaries.

Liquidity and Capital Resources

Financing for our operations consists primarily of vendor financing and leasing arrangements, our banking credit facility and cash flows attributable to our operations, which we believe are sufficient to fund our business needs.

In July 2015, we renewed our banking credit facility. In accordance with the second amendment to the Credit Facility, which was signed in February 2016, the Credit Facility has borrowing capacity of up to $600 million and consists of a $400 million, five-year revolving loan facility and a $200 million five-year term loan facility, the proceeds of which were used to fund, in part, the Company's acquisition of Qualspec. The swing line facility is $35 million. The Credit Facility matures in July 2020, bears interest based on a variable Eurodollar rate option (LIBOR plus 2.25% margin at December 31, 2016) and has commitment fees on unused borrowing capacity (0.40% at December 31, 2016). The Credit Facility limits our ability to pay cash dividends without the consent of our bank syndicate. The Credit Facility also contains financial covenants, which were amended in August 2016 pursuant to the third amendment to the Credit Agreement. The covenants, as amended, require the Company to maintain as of the end of each fiscal quarter (i) a maximum ratio of consolidated funded debt to consolidated EBITDA (the "Total Leverage Ratio", as defined in the Credit Facility agreement) of not more than 4.50 to 1.00 as of December 31, 2016, not more than 4.25 to 1.00 as of March 31, 2017 and June 30, 2017, not more than 3.75 to 1.00 as of September 30, 2017 and thereafter the maximum ratio decreases by 0.25 to 1.00 every quarter until it reaches 3.00 to 1.00, (ii) a maximum ratio of senior secured debt to consolidated EBITDA of not more than 3.00 to 1.00 and (iii) an interest coverage ratio of less than 3.00 to 1.00. As of December 31, 2016, we are in compliance with these covenants. With respect to the Total Leverage Ratio, our ratio stood at 4.19 to 1.00 as of December 31, 2016. At December 31, 2016, we had $46.2 million of cash on hand and approximately $29 million of available borrowing capacity through our Credit Facility. In connection with the renewal of our Credit Facility, we are amortizing $3.0 million of associated debt issuance costs over the life of the Credit Facility. While we are in compliance with our financial covenants as of December 31, 2016, management continues to execute various initiatives designed to reduce the Company's obligations outstanding under the Credit Facility and improve operating cash flows. However, there can be no assurance that these actions will be successful or that we will be able to maintain compliance with the financial covenants as of any future date.

At the end of 2013, we initiated the design and implementation of a new ERP system, which is expected to be substantially installed by the end of 2017. Through December 31, 2016, we have capitalized $44.9 million associated

with the project which includes $1.4 million of capitalized interest.
On October 1, 2013, our Board approved an initial $25 million stock repurchase plan, superseding and replacing our previous stock repurchase plan. During the second quarter ended November 30, 2013, we repurchased 369,900 shares for a total cost of $13.3 million. These shares, along with 89,569 shares purchased under a previous plan in a prior period at a cost of $1.3 million, were retired and are not included in common stock issued and outstanding as of May 31, 2014. The retirement of

the shares purchased resulted in a reduction in common stock of $0.1 million, a reduction of $2.2 million to additional paid-in capital, and a $12.3 million reduction in retained earnings.
On June 23, 2014, our Board authorized an increase in the stock repurchase plan limit to repurchase Team common stock up to $50 million (net of the $13.3 million repurchased in the quarter ended November 30, 2013). During the quarter ended February 28, 2015, we repurchased 546,977 shares for a total cost of $21.1 million. During the year ended December 31, 2016, we repurchased 274,110 shares for a total cost of $7.6 million. In the fourth quarter of 2016, these 821,087 shares were retired and are not included in common stock issued and outstanding as of December 31, 2016. The retirement of the shares resulted in a reduction in common stock of $0.2 million, a reduction of $9.1 million to additional paid-in capital and a $19.4 million reduction to retained earnings. At December 31, 2016, $7.9 million remained available to repurchase shares under the stock repurchase plan.

On October 11, 2016, we filed a universal shelf registration statement on Form S-3 with the SEC (the "Shelf Registration Statement"). The Shelf Registration Statement allows us to issue common stock, preferred stock, debt securities, warrants and units from time to time in one or more offerings. Issuances of securities pursuant to the Shelf Registration Statement require the filing of a prospectus supplement with the SEC identifying the amount and terms of the securities to be issued.
On November 28, 2016, we filed a prospectus supplement to the Shelf Registration Statement under which we may sell up to $150.0 million of our common stock through an "at-the-market" equity offering program (the "ATM Program"). Through December 31, 2016, we sold 167,931 shares of common stock under the ATM Program. The net proceeds from such sales were $6.0 million after deducting the aggregate commissions paid of approximately $0.1 million and were used to reduce outstanding indebtedness. The Company intends to use the net proceeds from any future sales under the ATM Program primarily to reduce outstanding indebtedness, which may include amounts outstanding under the Company's Credit Facility, and for general corporate purposes. The timing of any additional sales of common stock made pursuant to the ATM Program will depend on a variety of factors to be determined by the Company. In connection with the filing of the Shelf Registration Statement and the commencement of the ATM program, we capitalized costs totaling $0.7 million, which are being allocated as issuance costs as sales of securities occur.
Restrictions on cash. Included in our cash and cash equivalents at December 31, 2016 is $14.0 million of cash in certain foreign subsidiaries (located primarily in Europe and Canada) where earnings are considered by the Company to be permanently reinvested. In the event that some or all of this cash were to be repatriated, we would be required to accrue and pay additional taxes. While not legally restricted from repatriating this cash, we consider all undistributed earnings of these foreign subsidiaries to be indefinitely reinvested and access to cash to be limited. At December 31, 2015, we had $5.0 million in restricted cash on our balance sheet to reflect the amount held in escrow for contingent consideration as stipulated by the Qualspec purchase agreement. Based on Qualspec's results through December 31, 2015, the contingent consideration did not become due and, accordingly, this cash became unrestricted in 2016.
Cash flows attributable to our operating activities. For the year ended December 31, 2016, net cash provided by operating activities was $79.6 million. Although we incurred a net loss of $12.7 million, the effect of depreciation and amortization of $48.7 million, a decrease in working capital of $31.2 million and non-cash compensation cost of $7.3 million resulted in positive operating cash flow.
For the seven months ended December 31, 2015, net cash provided by operating activities was $17.3 million. Positive operating cash flow was primarily attributable to net income of $8.9 million, depreciation and amortization of $19.4 million, and non-cash compensation cost of $3.5 million offset by a increase in working capital of $20.4 million.
For the year ended May 31, 2015, net cash provided by operating activities was $43.5 million. Positive operating cash flow was primarily attributable to net income of $40.5 million, depreciation and amortization of $22.8 million, and non-cash compensation cost of $4.8 million offset by a $27.7 million increase in working capital.
For the year ended May 31, 2014, net cash provided by operating activities was $52.9 million. Positive operating cash flow was primarily attributable to net income of $30.1 million, depreciation and amortization of $21.5 million, and non-cash compensation cost of $4.2 million offset by a $5.6 million increase in working capital.
Cash flows attributable to our investing activities. For the year ended December 31, 2016, net cash used in investing activities was $70.8 million, consisting primarily of $48.4 million for business acquisitions, $45.8 million of capital

expenditures and $13.3 million in net proceeds from the sale of discontinued operations. Capital expenditures included $19.3 million in costs related to our ERP project. Capital expenditures can vary depending upon specific customer needs that may

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arise unexpectedly. Discontinued operations relates to a pipeline inspection business that we acquired as part of the acquisition of Furmanite. This operation was sold in December 2016.

For the seven months ended December 31, 2015, net cash used in investing activities was $287.8 million, consisting primarily of $262.1 million for business acquisitions and $25.8 million of capital expenditures. Capital expenditures included $11.1 million in costs related to our ERP project. Capital expenditures can vary depending upon specific customer needs that may arise unexpectedly.

For the year ended May 31, 2015, net cash used in investing activities was $31.8 million, consisting primarily of $28.8 million of capital expenditures and $3.1 million related to business acquisitions. Capital expenditures included $10.0 million in costs related to our ERP project.

For the year ended May 31, 2014, net cash used in investing activities was $40.6 million, consisting primarily of $33.0 million of capital expenditures and $10.2 million related to business acquisitions. Capital expenditures included $4.7 million in costs related to our ERP project.

Cash flows attributable to our financing activities. For the year ended December 31, 2016, net cash used in financing activities was $6.0 million, consisting primarily of $7.6 million of cash related to the purchase of stock pursuant to our stock repurchase plan, $4.0 million of net cash used for debt repayments and $2.5 million of contingent and deferred consideration payments, partially offset by $11.1 million of net cash generated from the issuance of common stock and exercise of stock options.

For the seven months ended December 31, 2015, net cash provided by financing activities was $283.7 million consisting primarily of $293.0 million of net borrowings related to our Credit Facility principally to fund the Qualspec acquisition and $2.1 million from the issuance of common stock from share-based payment arrangements. These amounts were partially offset by $5.9 million for the acquisition of the noncontrolling interest in Quest Integrity, $2.3 million in deferred consideration payments and $2.0 million related to debt issuance costs.

For the year ended May 31, 2015, net cash used in financing activities was $10.1 million, consisting primarily of $21.1 million of cash related to the purchase of stock pursuant to our stock repurchase plan partially offset by $8.0 million of borrowings.

For the year ended May 31, 2014, net cash used in financing activities was $9.6 million, consisting primarily of $13.3 million of cash related to the purchase of stock pursuant to our stock repurchase plan partially offset by $5.3 million provided by the issuance of common stock from share-based payment arrangements.

Effect of exchange rate changes on cash. For the year ended December 31, 2016, the effect of foreign exchange rate changes on cash was a negative impact of $1.3 million. The negative impact in the current period is primarily attributable to changes in U.S. Dollar exchange rates with the British Pound.

For the seven months ended December 31, 2015, the effect of foreign exchange rate changes on cash was a negative impact of $1.6 million. The negative impact in the current period is primarily attributable to changes in U.S. Dollar exchange rates with Canada, Europe and Malaysia.

For the years ended May 31, 2015 and 2014, the effect of foreign exchange rate changes on cash was a negative impact of $3.1 million and $2.2 million, respectively. The negative impact in 2015 was primarily attributable to changes in U.S. Dollar exchange rates with Canada and Europe. The negative impact in 2014 was primarily due to changes in U.S. Dollar exchange rates with Canada and Venezuela.

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Contractual Obligations

A summary of contractual obligations as of December 31, 2016 is as follows (in thousands):

	Less than 1 year	1-3 years	3-5 years	More than 5 years	Total
Long-term debt obligations	$ 20,000	$40,000	$306,911	$ —	$366,911
Operating lease obligations	32,418	42,647	18,766	16,295	110,126
Defined benefit pension plan contribution obligations	1,481	3,088	3,265	9,009	16,843
Total	$ 53,899	$85,735	$328,942	$ 25,304	$493,880

The table above excludes interest on our Credit Facility. We cannot predict with any certainty the amount of interest due to the expected variability of interest rates and principal amounts outstanding. If we assume interest payment amounts are calculated using the outstanding principal balances and interest rates as of December 31, 2016, the estimated interest payments on our Credit Facility would be approximately $10 million for 2017 and 2018, approximately $9 million for 2019 and approximately $4 million for 2020 for a total of approximately $33 million over the remaining contractual period.

A summary of long-term debt and other long-term obligations as of December 31, 2016 and 2015 is as follows (in thousands):

	December 31, 2016	December 31, 2015
Credit facility	$ 366,911	$ 371,383
Current maturities	(20,000)	(20,000)
Long-term debt, excluding current maturities	$ 346,911	$ 351,383
Outstanding letters of credit	$ 21,600	$ 13,218
Leasing arrangements	$ 110,126	$ 81,437
Defined benefit pension liability	$ 21,239	$ —
Other long-term liabilities	$ 2,592	$ —

Critical Accounting Policies

The process of preparing financial statements in accordance with GAAP requires our management to make estimates and judgments. It is possible that materially different amounts could be recorded if these estimates and judgments change or if actual results differ from these estimates and judgments. We have identified the following six critical accounting policies that require a significant amount of estimation and judgment and are considered to be important to the portrayal of our financial position and results of operations:

- Revenue Recognition
- Goodwill and Intangible Assets
- Income Taxes
- Workers' Compensation, Auto, Medical and General Liability Accruals
- Allowance for Doubtful Accounts
- Estimated Useful Lives

Revenue recognition. Most of our projects are short-term in nature and we predominantly derive revenues by providing a variety of industrial services on a time and material basis. For all of these services, our revenues are recognized when services are rendered or when product is shipped to the job site and risk of ownership passes to the customer. However, due to various contractual terms with our customers, at the end of any reporting period, there may be earned but unbilled revenue that is accrued to properly match revenues with related costs. At December 31, 2016 and December 31, 2015, the amount of earned but unbilled revenue included in accounts receivable was $39.7 million, $47.1 million, respectively.

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Goodwill and intangible assets. We allocate the purchase price of acquired businesses to their identifiable tangible assets and liabilities, such as accounts receivable, inventory, property, plant and equipment, accounts payable and accrued liabilities. We also allocate a portion of the purchase price to identifiable intangible assets, such as non-compete agreements, trademarks, trade names, patents, technology and customer relationships. Allocations are based on estimated fair values of assets and liabilities. We use all available information to estimate fair values including quoted market prices, the carrying value of acquired assets, and widely accepted valuation techniques such as discounted cash flows. Certain estimates and judgments are required in the application of the fair value techniques, including estimates of future cash flows, selling prices, replacement costs, economic lives and the selection of a discount rate, and it involves using of Level 3 measurements as defined in Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 820 Fair Value Measurements and Disclosure ("ASC 820"). Deferred taxes are recorded for any differences between the assigned values and tax bases of assets and liabilities. Estimated deferred taxes are based on available information concerning the tax bases of assets acquired and liabilities assumed and loss carryforwards at the acquisition date, although such estimates may change in the future as additional information becomes known. Any remaining excess of cost over allocated fair values is recorded as goodwill. We typically engage third-party valuation experts to assist in determining the fair values for both the identifiable tangible and intangible assets. The judgments made in determining the estimated fair value assigned to each class of assets acquired and liabilities assumed, as well as asset lives, could materially impact our results of operations.

Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but are instead tested for impairment at least annually in accordance with the provisions of the ASC 350, Intangibles—Goodwill and Other ("ASC 350"). Intangible assets with estimated useful lives are amortized over their respective estimated useful lives up to their estimated residual values and reviewed for impairment in accordance with ASC 350. We assess goodwill for impairment at the reporting unit level, which we have determined to be the same as our operating segments. Each reporting unit has goodwill relating to past acquisitions.

The test for impairment was performed at the reporting unit level which is deemed to be at the operating segment level. The test was a two-step process that involved comparing the estimated fair value of each reporting unit to the reporting unit's carrying value, including goodwill. If the fair value of a reporting unit exceeded its carrying amount, the goodwill of the reporting unit was not considered impaired; therefore, the second step of the impairment test would not be deemed necessary. If the carrying amount of the reporting unit exceeded its fair value, we would then perform a second step to the goodwill impairment test to measure the amount of goodwill impairment loss to be recorded. With the change in our fiscal year end to December 31 of each calendar year, our goodwill annual test date is now December 1, effective December 1, 2015. We performed our impairment testing as of December 1, 2016 and 2015 and concluded that there was no impairment.

The fair values of the reporting units at December 1, 2016 and 2015 were determined using a method based on discounted cash flow models with estimated cash flows based on internal forecasts of revenue and expenses over a five-year period plus a terminal value period (the income approach). The income approach estimated fair value by discounting each reporting unit's estimated future cash flows using a discount rate that approximated our weighted-average cost of capital. Major assumptions applied in an income approach include forecasted growth rates as well as forecasted profitability by reporting unit. The fair value derived from the income approach, in the aggregate, approximated our market capitalization. At December 1, 2016, our market capitalization exceeded the carrying value of our consolidated net assets by approximately $437 million or 80%, and the fair value of each reporting unit significantly exceeded its respective carrying amount as of that date. At December 1, 2015, our market capitalization exceeded the carrying value of our consolidated net assets by approximately $482 million or 141%, and the fair value of each reporting unit significantly exceeded its respective carrying amount as of that date.

There was $355.8 million and $256.7 million of goodwill at December 31, 2016, December 31, 2015, respectively. A summary of goodwill is as follows (in thousands):

Twelve Months Ended
December 31, 2016

	TeamQualspec	TeamFurmanite	Quest Integrity	Total
Balance at beginning of year	$207,497	$ 19,874	$ 29,283	$256,654
Acquisitions	5,955	89,646	4,137	99,738
Foreign currency adjustments	23	(461)	(168)	(606)
Balance at end of year	$213,475	$ 109,059	$ 33,252	$355,786

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	Seven Months Ended December 31, 2015			
	TeamQualspec	TeamFurmanite	Quest Integrity	Total
Balance at beginning of period	$60,737	$ 17,466	$ 29,570	$107,773
Acquisitions	148,482	2,483	—	150,965
Foreign currency adjustments	(1,722)	(75)	(287)	(2,084)
Balance at end of period	$207,497	$ 19,874	$ 29,283	$256,654

Income taxes. We follow the guidance of ASC 740, Income Taxes ("ASC 740") which requires that we use the asset and liability method of accounting for deferred income taxes and provide deferred income taxes for all significant temporary differences. As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax payable and related tax expense together with assessing temporary differences resulting from differing treatment of certain items, such as depreciation, for tax and accounting purposes. These differences can result in deferred tax assets and liabilities, which are included within our consolidated balance sheets.

In accordance with ASC 740, we are required to assess the likelihood that our deferred tax assets will be realized and, to the extent we believe that it is more likely than not (a likelihood of more than 50%) that some portion or all of the deferred tax assets will not be realized, we must establish a valuation allowance. We consider all available evidence to determine whether, based on the weight of the evidence, a valuation allowance is needed. Evidence used includes information about our current financial position and our results of operations for the current and preceding years, as well as all currently available information about future years, including our anticipated future performance, the reversal of existing taxable temporary differences and tax planning strategies.

Management believes future sources of taxable income, reversing temporary differences and other tax planning strategies will be sufficient to realize assets for which no reserve has been established. While we have considered these factors in assessing the need for a valuation allowance, there is no assurance that a valuation allowance would not need to be established in the future if information about future years change. Any change in the valuation allowance would impact our income tax provision and net income (loss) in the period in which such a determination is made. As of December 31, 2016, we believe that it is more likely than not that we will have sufficient reversals of temporary differences and future taxable income to allow us to realize the benefits of the net deferred tax assets except for those primarily related to net operating loss carry forwards of certain foreign subsidiaries in the amount $41.0 million. Our belief is based upon our record of historical earnings levels in recent years and projections of future taxable income over the periods in which the future deductible temporary differences become deductible. As of December 31, 2016, our deferred tax assets were $67.7 million, less a valuation allowance of $13.2 million. As of December 31, 2016, our deferred tax liabilities were $125.1 million.

Significant judgment is required in assessing the timing and amounts of deductible and taxable items for tax purposes. In accordance with ASC 740-10, we establish reserves for uncertain tax positions when, despite our belief that our tax return positions are supportable, we believe that it is not more likely than not that the position will be sustained upon challenge. When facts and circumstances change, we adjust these reserves through our provision for income taxes. To the extent interest and penalties may be assessed by taxing authorities on any related underpayment of income tax, such amounts have been accrued and are classified as a component of income tax provision (benefit) in our consolidated statements of operations. As of December 31, 2016, our unrecognized tax benefits related to uncertain tax positions were $0.9 million.

Workers' compensation, auto, medical and general liability accruals. In accordance with ASC 450, Contingencies ("ASC 450"), we record a loss contingency when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. We review our loss contingencies on an ongoing basis to ensure that we have appropriate reserves recorded on our balance sheet. These reserves are based on historical experience with claims incurred but not received, estimates and judgments made by management, applicable insurance coverage for litigation matters, and are adjusted as circumstances warrant. For workers' compensation, our self-insured retention is $1.0 million and our automobile liability self-insured retention is currently $500,000 per occurrence. For general liability claims we have an effective self-insured retention of $3.0 million per occurrence. For medical claims, our self-insured retention is $350,000 per individual claimant determined on an annual basis. For environmental liability claims, our self-insured retention is $1.0 million per occurrence. We maintain insurance for claims that exceed such self-retention limits. The insurance is subject to terms, conditions, limitations and exclusions that may not fully compensate us for all losses. Furmanite was incorporated into our existing insurance coverage during 2016, but for certain items it maintained separate insurance policies during portions of 2016 and accordingly maintained separate self-insurance retention amounts, with such self-retention amounts generally below the levels noted above. Our estimates and judgments could change based on new information, changes in laws or regulations, changes in management's

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plans or intentions, or the outcome of legal proceedings, settlements or other factors. If different estimates and judgments were applied with respect to these matters, it is likely that reserves would be recorded for different amounts.

Allowance for doubtful accounts. In the ordinary course of business, a portion of our accounts receivable are not collected due to billing disputes, customer bankruptcies, dissatisfaction with the services we performed and other various reasons. We establish an allowance to account for those accounts receivable that we estimate will eventually be deemed uncollectible. The allowance for doubtful accounts is based on a combination of our historical experience and management’s review of long outstanding accounts receivable.

Estimated useful lives. The estimated useful lives of our long-lived assets are used to compute depreciation expense, future asset retirement obligations and are also used in impairment testing. Estimated useful lives are based, among other things, on the assumption that we provide an appropriate level of associated capital expenditures and maintenance while the assets are still in operation. Without these continued associated capital expenditures and maintenance, the useful lives of these assets could decrease significantly. Estimated useful lives could be impacted by such factors as future energy prices, environmental regulations, various legal factors and competition. If the useful lives of these assets were found to be shorter than originally estimated, depreciation expense may increase, liabilities for future asset retirement obligations may be insufficient and impairments in carrying values of tangible and intangible assets may result.

New Accounting Principles

For information about newly adopted accounting principles as well as information about new accounting principles pending adoption, see Note 1 to the consolidated financial statements.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have operations in foreign countries with a functional currency that is not the U.S. Dollar. We are exposed to market risk, primarily related to foreign currency fluctuations related to these operations. Subsidiaries with asset and liability balances denominated in currencies other than their functional currency are remeasured in the preparation of their financial statements using a combination of current and historical exchange rates, with any resulting remeasurement adjustments included in net income (loss) for the period. Net foreign currency transaction gains for the year ended December 31, 2016 were $0.1 million. The foreign currency transaction gains realized in the year ended December 31, 2016 reflect the effects of fluctuations in the U.S. Dollar relative to the currencies we have exposure to, including but not limited to, the Australian Dollar, Brazilian Real, British Pound, Canadian Dollar, Euro, Malaysian Ringgit and Mexican Peso.

In 2015, we initiated a foreign currency hedging program to mitigate the foreign currency risk in countries where we have significant assets and liabilities denominated in currencies other than the functional currency. We utilize monthly foreign currency swap contracts to reduce exposures to changes in foreign currency exchange rates related to our largest exposures including, but not limited to the Australian Dollar, Canadian Dollar, Brazilian Real, British Pound, Euro, Malaysian Ringgit and Mexican Peso. The impact from these swap contracts was not material as of and for the year ended December 31, 2016, as of and for the seven months ended December 31, 2015 nor for the year ended May 31, 2015.

Translation adjustments for the assets and liability accounts are included as a separate component of accumulated other comprehensive loss in shareholders’ equity. Foreign currency translation losses recognized in other comprehensive loss were $3.8 million for the year ended December 31, 2016.

For the year ended December 31, 2016, we had foreign currency-based revenues and operating income of $306.7 million and $15.0 million, respectively, a hypothetical 10% adverse change in all applicable foreign currencies would result in an annual change in revenues and operating income of $30.7 million and $1.5 million, respectively.

We carry Euro based debt to serve as a hedge of our net investment in our European operations as fluctuations in the fair value of the borrowing attributable to the U.S. Dollar/Euro spot rate will offset translation gains or losses attributable to our investment in our European operations. We are exposed to market risk, primarily related to foreign currency fluctuations related to the unhedged portion of our investment in our European operations.

We hold certain floating-rate obligations. We are exposed to market risk primarily related to potential increases in interest rates related to our debt.

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Report of Independent Registered Public Accounting Firm
The Board of Directors and Shareholders
Team, Inc.:

We have audited Team, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Team, Inc. acquired Furmanite Corporation (Furmanite) in February 2016, and management excluded from its assessment of the effectiveness of Team, Inc.'s internal control over financial reporting as of December 31, 2016, Furmanite's internal control over financial reporting associated with total assets of $215 million and total revenues of $216 million included in the consolidated financial statements of Team, Inc. and subsidiaries as of and for the year ended December 31, 2016. Our audit of internal control over financial reporting of Team, Inc. also excluded an evaluation of the internal control over financial reporting of Furmanite.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Team, Inc. and subsidiaries as of December 31, 2016 and 2015, and the related consolidated statements of operations, comprehensive income (loss), shareholders' equity, and cash flows for the year ended December 31, 2016, the seven months ended December 31, 2015 and each of the years in the two-year period ended May 31, 2015, and our report dated March 15, 2017 expressed an unqualified opinion on those

consolidated financial statements.
(signed) KPMG LLP
Houston, Texas
March 15, 2017

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Team, Inc.:

We have audited the accompanying consolidated balance sheets of Team, Inc. and subsidiaries as of December 31, 2016 and 2015, and the related consolidated statements of operations, comprehensive income (loss), shareholders' equity, and cash flows for the year ended December 31, 2016, the seven months ended December 31, 2015 and each of the years in the two-year period ended May 31, 2015. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Team, Inc. and subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for the year ended December 31, 2016, the seven months ended December 31, 2015 and each of the years in the two-year period ended May 31, 2015, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Team, Inc.'s internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 15, 2017 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

(signed) KPMG LLP
Houston, Texas
March 15, 2017

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TEAM, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(in thousands, except share and per share data)

	December 31, 2016	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$46,216	$44,825
Restricted cash	—	5,000
Receivables, net of allowance of $7,835 and $3,548	262,773	214,324
Inventory	49,571	27,936
Income tax receivable	512	3,893
Deferred income taxes	16,521	6,917
Prepaid expenses and other current assets	25,764	11,664
Total current assets	401,357	314,559
Property, plant and equipment, net	203,130	124,983
Intangible assets, net of accumulated amortization of $37,309 and $21,161	176,104	99,119
Goodwill	355,786	256,654
Other assets, net	4,826	2,421
Deferred income taxes	6,215	1,255
Total assets	$1,147,418	$798,991
LIABILITIES AND EQUITY		
Current liabilities:		
Current-portion of long term debt	$20,000	$20,000
Accounts payable	47,817	22,364
Other accrued liabilities	79,904	49,796
Total current liabilities	147,721	92,160
Deferred income taxes	93,318	17,302
Long-term debt	346,911	351,383
Defined benefit pension liability	21,239	—
Other long-term liabilities	2,592	—
Total liabilities	611,781	460,845
Commitments and contingencies		
Equity:		
Preferred stock, 500,000 shares authorized, none issued	—	—
Common stock, par value $0.30 per share, 60,000,000 shares authorized; 29,784,734 and 21,836,694 shares issued	8,934	6,552
Additional paid-in capital	336,756	120,126
Retained earnings	218,947	250,980
Accumulated other comprehensive loss	(29,000)	(18,374)
Treasury stock at cost, 0 and 546,977 shares	—	(21,138)
Total equity	535,637	338,146
Total liabilities and equity	$1,147,418	$798,991

See accompanying notes to consolidated financial statements.

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TEAM, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Twelve Months Ended December 31, 2016	Seven Months Ended December 31, 2015	Twelve Months Ended May 31, 2015	2014
Revenues	$1,196,696	$571,718	$842,047	$749,527
Operating expenses	868,144	409,391	584,054	527,611
Gross margin	328,552	162,327	257,993	221,916
Selling, general and administrative expenses	323,973	142,643	189,528	171,455
Exit costs and other related charges	5,513	—	—	—
Loss (gain) on revaluation of contingent consideration	2,184	522	—	(2,138)
Earnings from unconsolidated affiliates	—	—	—	822
Operating income (loss)	(3,118)	19,162	68,465	53,421
Interest expense, net	12,667	4,898	2,489	2,851
Loss on investment in Venezuela	—	—	1,177	—
Foreign currency (gain) loss	(93)	813	1,509	4,185
Other expense (income), net	(34)	—	—	—
Earnings (loss) from continuing operations before income taxes	(15,658)	13,451	63,290	46,385
Less: Provision (benefit) for income taxes (see Note 8)	(3,093)	4,573	22,793	16,236
Income (loss) from continuing operations	(12,565)	8,878	40,497	30,149
Loss from discontinued operations, net of income tax	(111)	—	—	—
Net income (loss)	(12,676)	8,878	40,497	30,149
Less: Income attributable to noncontrolling interest	—	—	427	294
Net income (loss) available to Team shareholders	$(12,676)	$8,878	$40,070	$29,855
Basic earnings (loss) per share:				
Continuing operations	$(0.45)	$0.43	$1.95	$1.46
Discontinued operations	—	—	—	—
Net income (loss)	$(0.45)	$0.43	$1.95	$1.46
Diluted earnings (loss) per share:				
Continuing operations	$(0.45)	$0.41	$1.85	$1.40
Discontinued operations	—	—	—	—
Net income (loss)	$(0.45)	$0.41	$1.85	$1.40
Amounts attributable to Team shareholders:				
Income (loss) from continuing operations, net of income tax	$(12,565)	$8,878	$40,070	$29,855
Loss from discontinued operations, net of income tax	(111)	—	—	—
Net income (loss)	$(12,676)	$8,878	$40,070	$29,855

See accompanying notes to consolidated financial statements.

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TEAM, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(in thousands)

	Twelve Months Ended December 31,	Seven Months Ended December 31,	Twelve Months Ended May 31,	
	2016	2015	2015	2014
Net income (loss)	$(12,676)	$ 8,878	$40,497	$30,149
Foreign currency translation adjustment	(3,849)	(7,228)	(15,822)	(1,613)
Foreign currency hedge	481	101	3,237	(775)
Net actuarial loss on defined benefit pension plans	(10,518)	—	—	—
Tax benefit attributable to other comprehensive loss	3,260	2,291	1,655	1,498
Total comprehensive income (loss)	(23,302)	4,042	29,567	29,259
Less: Total comprehensive income attributable to noncontrolling interest	—	—	356	294
Total comprehensive income (loss) available to Team shareholders	$(23,302)	$ 4,042	$29,211	$28,965

See accompanying notes to consolidated financial statements.

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TEAM, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(in thousands)

	Common Shares	Treasury Shares	Common Stock	Treasury Stock	Additional Paid in Capital	Noncontrolling Interest	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at June 1, 2013	20,588	(90)	$6,176	$(1,344)	$99,278	$5,384	$184,485	$(1,789)	$292,190
Net income	—	—	—	—	—	—	30,149	—	30,149
Foreign currency translation adjustment, net of tax	—	—	—	—	—	—	—	(400)	(400)
Foreign currency hedge, net of tax	—	—	—	—	—	—	—	(490)	(490)
Comprehensive income attributable to noncontrolling interest	—	—	—	—	—	294	(294)	—	—
Non-cash compensation	—	—	—	—	4,239	—	—	—	4,239
Vesting of stock awards	117	—	34	—	(1,744)	—	—	—	(1,710)
Tax effect of share-based payment arrangements	—	—	—	—	1,131	—	—	—	1,131
Exercise of stock options	232	—	70	—	5,200	—	—	—	5,270
Purchase of treasury stock	—	(369)	—	(13,334)	—	—	—	—	(13,334)
Retirement of treasury stock	(459)	459	(138)	14,678	(2,232)	—	(12,308)	—	—
Balance at May 31, 2014	20,478	—	6,142	—	105,872	5,678	202,032	(2,679)	317,045
Net income	—	—	—	—	—	—	40,497	—	40,497
Foreign currency translation adjustment, net of tax	—	—	—	—	—	—	—	(13,263)	(13,263)
Foreign currency hedge, net of tax	—	—	—	—	—	—	—	2,333	2,333
Comprehensive income attributable to noncontrolling interest	—	—	—	—	—	356	(427)	71	—

Non-cash compensation	—	—	—	—	4,838	—	—	—	4,838
Vesting of stock awards	106	—	33	—	(1,808)	—	—	—	(1,775)
Tax effect of share-based payment arrangements	—	—	—	—	3,034	—	—	—	3,034
Exercise of stock options	325	—	98	—	3,706	—	—	—	3,804
Purchase of treasury stock	—	(547)	—	(21,138)	—	—	—	—	(21,138)
Balance at May 31, 2015	20,909	(547)	6,273	(21,138)	115,642	6,034	242,102	(13,538)	335,375
Net income	—	—	—	—	—	—	8,878	—	8,878
Foreign currency translation adjustment, net of tax	—	—	—	—	—	—	—	(4,898)	(4,898)
Foreign currency hedge, net of tax	—	—	—	—	—	—	—	62	62
Purchase of noncontrolling interest	728	—	218	—	(118)	(6,034)	—	—	(5,934)
Non-cash compensation	—	—	—	—	3,522	—	—	—	3,522
Vesting of stock awards	89	—	27	—	(1,402)	—	—	—	(1,375)
Tax effect of share-based payment arrangements	—	—	—	—	374	—	—	—	374
Exercise of stock options	111	—	34	—	2,108	—	—	—	2,142
Balance at December 31, 2015	21,837	(547)	6,552	(21,138)	120,126	—	250,980	(18,374)	338,146
Net loss	—	—	—	—	—	—	(12,676)	—	(12,676)
Foreign currency translation adjustment, net of tax	—	—	—	—	—	—	—	(2,498)	(2,498)
Foreign currency hedge, net of tax	—	—	—	—	—	—	—	300	300
Change in defined benefit pension plan net actuarial loss, net of tax	—	—	—	—	—	—	—	(8,428)	(8,428)
Non-cash compensation	—	—	—	—	7,313	—	—	—	7,313
Vesting of stock awards	142	—	40	—	(1,749)	—	—	—	(1,709)

Tax effect of share-based payment arrangements	—	—	—	—	(535)	—	—	—	(535)
Issuance of common stock in Furmanite acquisition and conversion of Furmanite share-based awards	8,208	—	2,462	—	209,068	—	—	—	211,530
Exercise of stock options	251	—	75	—	5,828	—	—	—	5,903
Issuance of common stock	168	—	50	—	5,884	—	—	—	5,934
Purchase of treasury stock	—	(274)	—	(7,593)	—	—	—	—	(7,593)
Retirement of treasury stock	(821)	821	(245)	28,731	(9,129)	—	(19,357)	—	—
Other		—	—	—	(50)	—	—	—	(50)
Balance at December 31, 2016	29,785	—	$ 8,934	$—	$ 336,756	$ —	$ 218,947	$ (29,000)	$ 535,637

See accompanying notes to consolidated financial statements.

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TEAM, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Twelve Months Ended December 31, 2016	Seven Months Ended December 31, 2015	Twelve Months Ended May 31, 2015	2014
Cash flows from operating activities:				
Net income (loss)	$(12,676)	$8,878	$40,497	$30,149
Adjustments to reconcile net income (loss) to net cash provided by operating activities:				
Earnings from unconsolidated affiliates	—	—	—	(822)
Depreciation and amortization	48,673	19,426	22,787	21,468
Loss on asset impairment and disposals	1,540	51	617	78
Amortization of deferred loan costs	541	256	223	223
Provision for doubtful accounts	6,336	1,819	233	2,140
Loss on investment in Venezuela	—	—	1,177	—
Foreign currency (gain) loss	(93)	813	1,509	4,185
Deferred income taxes	(4,236)	2,411	(729)	(1,040)
Loss (gain) on contingent consideration revaluation	2,184	522	—	(2,138)
Non-cash compensation cost	7,313	3,469	4,838	4,239
Other, net	(1,182)	—	—	—
(Increase) decrease, net of the effects of acquisitions:				
Receivables	16,518	15,231	(43,425)	(8,952)
Inventory	2,119	372	(925)	822
Prepaid expenses and other current assets	(163)	(111)	(2,525)	(17)
Increase (decrease), net of the effects of acquisitions:				
Accounts payable	8,361	(13,365)	10,789	(295)
Other accrued liabilities	(2,346)	(14,426)	9,377	(1,208)
Income taxes	6,675	(8,085)	(972)	4,029
Net cash provided by operating activities	79,564	17,261	43,471	52,861
Cash flows from investing activities:				
Capital expenditures	(45,812)	(25,802)	(28,769)	(33,016)
Proceeds from sale of assets	4,232	5,227	133	357
Net proceeds from sale of discontinued operations	13,295	—	—	—
Business acquisitions, net of cash acquired	(48,382)	(262,100)	(3,075)	(10,175)
Change in restricted cash	5,000	(5,000)	—	—
Change related to Venezuelan operations	—	—	(620)	—
Distributions from joint venture	—	—	—	2,223
(Increase) decrease in other assets, net	827	(105)	550	2
Net cash used in investing activities	(70,840)	(287,780)	(31,781)	(40,609)
Cash flows from financing activities:				
Net debt borrowings	15,996	103,000	8,000	—
Net (payments) borrowings under term loan	(20,000)	190,000	—	—
Deferred consideration payments	(694)	(2,307)	(1,000)	(1,000)
Contingent consideration payments	(1,816)	(230)	(1,000)	—

Purchase of noncontrolling interest	—	(5,934)	—	—
Debt issuance costs	(801)	(1,950)	—	—
Payments related to withholding tax for share-based payment arrangements	(1,709)	(1,375)	(1,775)	(1,710)
Corporate tax effect from share-based payment arrangements	(535)	374	3,034	1,131
Exercise of stock options	5,903	2,142	3,804	5,270
Issuance of common stock, net of issuance costs	5,243	—	—	—
Purchase of treasury stock	(7,593)	—	(21,138)	(13,334)
Net cash provided by (used in) financing activities	(6,006)	283,720	(10,075)	(9,643)
Effect of exchange rate changes on cash	(1,327)	(1,587)	(3,060)	(2,154)
Net increase (decrease) in cash and cash equivalents	1,391	11,614	(1,445)	455
Cash and cash equivalents at beginning of period	44,825	33,211	34,656	34,201
Cash and cash equivalents at end of period	$46,216	$44,825	$33,211	$34,656
Supplemental disclosure of cash flow information:				
Cash paid (refunded) during the year for:				
Interest	$12,207	$3,907	$2,028	$2,728
Income taxes	(2,741)	10,252	21,491	12,111

See accompanying notes to consolidated financial statements.

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TEAM, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND PRACTICES

Description of Business. Unless otherwise indicated, the terms “Team, Inc.,” “Team,” “the Company,” “we,” “our” and “us” ar used in this report to refer to Team, Inc., to one or more of our consolidated subsidiaries or to all of them taken as a whole. We are a leading provider of standard to specialty industrial services, including inspection, engineering assessment and mechanical repair and remediation required in maintaining high temperature and high pressure piping systems and vessels that are utilized extensively in the refining, petrochemical, power, pipeline and other heavy industries. We conduct operations in three segments: TeamQualspec Group (“TeamQualspec”) (formerly the Inspection and Heat Treating Services Group), TeamFurmanite Group (“TeamFurmanite”) (formerly the Mechanical Services Group) and Quest Integrity (“Quest Integrity”). Through the capabilities and resources in these three segments, we believe that Team is uniquely qualified to provide integrated solutions involving in their most basic form, inspection to assess condition, engineering assessment to determine fitness for purpose in the context of industry standards and regulatory codes and mechanical services to repair, rerate or replace based upon the client’s election. In addition, our Company is capable of escalating with the client’s needs—as dictated by the severity of the damage found and the related operating conditions—from standard services to some of the most advanced services and expertise available in the industry.

TeamQualspec provides standard and advanced non-destructive testing (“NDT”) services for the process, pipeline and power sectors, pipeline integrity management services, field heat treating services, as well as associated engineering and assessment services. These services can be offered while facilities are running (on-stream), during facility turnarounds or during new construction or expansion activities.

TeamFurmanite, our mechanical services segment, provides turnaround and on-stream services. Turnaround services are project-related and demand is a function of the number and scope of scheduled and unscheduled facility turnarounds as well as new industrial facility construction or expansion activities. The turnaround services TeamFurmanite provides include field machining, technical bolting, field valve repair, heat exchanger repair, and isolation test plugging services. On-stream services offered by TeamFurmanite represent the services offered while plants are operating and under pressure. These services include leak repair, fugitive emissions control and hot tapping.

Quest Integrity provides integrity and reliability management solutions for the process, pipeline and power sectors. These solutions encompass two broadly-defined disciplines: (1) highly specialized in-line inspection services for unpiggable process piping and pipelines using proprietary in-line inspection tools and analytical software; and (2) advanced condition assessment services through a multi-disciplined engineering team.

We offer these services globally through over 220 locations in 20 countries throughout the world with more than 7,400 employees. We market our services to companies in a diverse array of heavy industries which include the petrochemical, refining, power, pipeline, steel, pulp and paper industries, as well as municipalities, shipbuilding, OEMs, distributors, and some of the world’s largest engineering and construction firms.

Our stock is traded on the New York Stock Exchange under the symbol “TISI”.

In November 2015, we announced we would change our fiscal year end to December 31 of each calendar year from May 31. In connection with this change, we previously filed a Transition Report on Form 10-K to report the results of the seven-month transition period from June 1, 2015 to December 31, 2015. In this report, the periods presented are the year ended December 31, 2016, the seven-month transition period from June 1, 2015 to December 31, 2015 and for the years ended May 31, 2015 and 2014. For comparison purposes, we have also included unaudited data for the year ended December 31, 2015 and for the seven months ended December 31, 2014 (see Note 20).

Consolidation. The consolidated financial statements include the accounts of Team, Inc. and our majority-owned subsidiaries where we have control over operating and financial policies. Investments in affiliates in which we have the ability to exert significant influence over operating and financial policies, but where we do not control the operating and financial policies, are accounted for using the equity method. All material intercompany accounts and transactions have been eliminated in consolidation. Effective February 1, 2015, we began reporting the results of our Venezuelan operations using the cost method of accounting (see Note 17).

Use of estimates. Our accounting policies conform to Generally Accepted Accounting Principles in the U.S. (“GAAP”). Our most significant accounting policies are described below. The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and judgments that affect our reported financial position and results of operations. We review significant estimates and judgments affecting our consolidated financial statements on a recurring basis and record the effect of any necessary adjustments prior to their publication. Estimates and judgments are based on information available at the time such estimates and judgments are made. Adjustments made with respect to the use of these estimates and judgments often relate to information not previously available. Uncertainties with respect to such estimates and judgments are inherent in the preparation of financial statements. Estimates and judgments are used in, among other things, (1) aspects of revenue recognition, (2) valuation of acquisition related tangible and intangible assets and assessments of all long lived assets for possible impairment, (3) estimating various factors used to accrue liabilities for workers' compensation, auto, medical and general liability, (4) establishing an allowance for uncollectible accounts receivable, (5) estimating the useful lives of our assets, (6) assessing future tax exposure and the realization of tax assets, (7) estimating the value associated with contingent consideration payment arrangements and (8) selecting assumptions used in the measurement of costs and liabilities associated with defined benefit pension plans.

Fair value of financial instruments. Our financial instruments consist primarily of cash, cash equivalents, accounts receivable, accounts payable and debt obligations. The carrying amount of cash, cash equivalents, trade accounts receivable and trade accounts payable are representative of their respective fair values due to the short-term maturity of these instruments. The fair value of our banking facility is representative of the carrying value based upon the variable terms and management's opinion that the current rates available to us with the same maturity and security structure are equivalent to that of the banking facility.

Cash and cash equivalents. Cash and cash equivalents consist of all demand deposits and funds invested in highly liquid short-term investments with original maturities of three months or less. Included in our cash and cash equivalents at December 31, 2016 is $14.0 million of cash in certain foreign subsidiaries (located primarily in Europe and Canada) where earnings are considered by the Company to be permanently reinvested. In the event that some or all of this cash were to be repatriated, we would be required to accrue and pay additional taxes. While not legally restricted from repatriating this cash, we consider all undistributed earnings of these foreign subsidiaries to be indefinitely reinvested and access to cash to be limited.

Restricted cash. At December 31, 2015, we had $5.0 million in restricted cash on our balance sheet to reflect the amount held in escrow for contingent consideration as stipulated by the Qualspec Group LLC ("Qualspec") purchase agreement. Based on Qualspec's results through December 31, 2015, the contingent consideration did not become due and, accordingly, this cash became unrestricted in 2016.

Inventory. We use the first-in, first-out method to determine inventory cost, except that inventory cost of Furmanite Corporation ("Furmanite") and its subsidiaries, which we acquired on February 29, 2016 (see Note 2), is determined based on weighted-average cost. Inventory includes material, labor and certain fixed overhead costs. Inventory is stated at the lower of cost or market. Inventory quantities on hand are reviewed periodically and carrying cost is reduced to net realizable value for inventories for which their cost exceeds their utility. The cost of inventories consumed or products sold are included in operating expenses.

Property, plant and equipment. Property, plant and equipment are stated at cost less accumulated depreciation and amortization. Leasehold improvements are amortized over the shorter of their respective useful life or the lease term. Depreciation and amortization of assets are computed by the straight-line method over the following estimated useful lives of the assets:

Classification	Useful Life
Buildings	20-40 years
Leasehold improvements	2-15 years
Machinery and equipment	2-12 years
Furniture and fixtures	2-10 years
Computers and computer software	2-5 years
Automobiles	2-5 years

Revenue recognition. Most of our projects are short-term in nature and we predominantly derive revenues by providing a variety of industrial services on a time and material basis. For all of these services our revenues are recognized when services are rendered or when product is shipped to the job site and risk of ownership passes to the customer. However, due to various contractual terms with our customers, at the end of any reporting period, there may be earned but unbilled revenue that is accrued to properly match revenues with related costs. At December 31, 2016 and December 31, 2015, the amount of earned but unbilled revenue included in accounts receivable was $39.7 million and $47.1 million, respectively.

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Goodwill and intangible assets. We allocate the purchase price of acquired businesses to their identifiable tangible assets and liabilities, such as accounts receivable, inventory, property, plant and equipment, accounts payable and accrued liabilities. We also allocate a portion of the purchase price to identifiable intangible assets, such as non-compete agreements, trademarks, trade names, patents, technology and customer relationships. Allocations are based on estimated fair values of assets and liabilities. We use all available information to estimate fair values including quoted market prices, the carrying value of acquired assets, and widely accepted valuation techniques such as discounted cash flows. Certain estimates and judgments are required in the application of the fair value techniques, including estimates of future cash flows, selling prices, replacement costs, economic lives and the selection of a discount rate, and it involves using of Level 3 measurements as defined in Financial Accounting Standards Board (“FASB”) FASB Accounting Standards Codification (“ASC”) 820 Fair Value Measurements and Disclosure (“ASC 820”). Deferred taxes are recorded for any differences between the assigned values and tax bases of assets and liabilities. Estimated deferred taxes are based on available information concerning the tax bases of assets acquired and liabilities assumed and loss carryforwards at the acquisition date, although such estimates may change in the future as additional information becomes known. Any remaining excess of cost over allocated fair values is recorded as goodwill. We typically engage third-party valuation experts to assist in determining the fair values for both the identifiable tangible and intangible assets. The judgments made in determining the estimated fair value assigned to each class of assets acquired and liabilities assumed, as well as asset lives, could materially impact our results of operations.

Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but are instead tested for impairment at least annually in accordance with the provisions of the ASC 350 Intangibles—Goodwill and Other (“ASC 350”). Intangible assets with estimated useful lives are amortized over their respective estimated useful lives to their estimated residual values and reviewed for impairment in accordance with ASC 350. We assess goodwill for impairment at the reporting unit level, which we have determined to be the same as our operating segments. Each reporting unit has goodwill relating to past acquisitions.

The test for impairment is performed at the reporting unit level which is deemed to be at the operating segment level. The test was a two-step process that involved comparing the estimated fair value of each reporting unit to the reporting unit’s carrying value, including goodwill. If the fair value of a reporting unit exceeded its carrying amount, the goodwill of the reporting unit was not considered impaired; therefore, the second step of the impairment test would not be deemed necessary. If the carrying amount of the reporting unit exceeded its fair value, we would then perform a second step to the goodwill impairment test to measure the amount of goodwill impairment loss to be recorded. With the change in our fiscal year end to December 31 of each calendar year, our goodwill annual test date is now December 1, effective December 1, 2015. We performed our impairment testing as of December 1, 2016 and 2015 and concluded that there was no impairment.

The fair values of the reporting units at December 1, 2016 and 2015 were determined using a method based on discounted cash flow models with estimated cash flows based on internal forecasts of revenue and expenses over a five-year period plus a terminal value period (the income approach). The income approach estimated fair value by discounting each reporting unit’s estimated future cash flows using a discount rate that approximated our weighted-average cost of capital. Major assumptions applied in an income approach include forecasted growth rates as well as forecasted profitability by reporting unit. The fair value derived from the income approach, in the aggregate, approximated our market capitalization. At December 1, 2016, our market capitalization exceeded the carrying value of our consolidated net assets by approximately $437 million or 80%, and the fair value of each reporting unit significantly exceeded its respective carrying amount as of that date. At December 1, 2015, our market capitalization exceeded the carrying value of our consolidated net assets by approximately $482 million or 141%, and the fair value of each reporting unit significantly exceeded its respective carrying amount as of that date.

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There was $355.8 million and $256.7 million of goodwill at December 31, 2016 and 2015, respectively. A summary of goodwill is as follows (in thousands):

	Twelve Months Ended December 31, 2016			
	TeamQualspec	TeamFurmanite	Quest Integrity	Total
Balance at beginning of period	$207,497	$ 19,874	$ 29,283	$256,654
Acquisitions	5,955	89,646	4,137	99,738
Foreign currency adjustments	23	(461)	(168)	(606)
Balance at end of period	$213,475	$ 109,059	$ 33,252	$355,786

	Seven Months Ended December 31, 2015			
	TeamQualspec	TeamFurmanite	Quest Integrity	Total
Balance at beginning of year	$60,737	$ 17,466	$ 29,570	$107,773
Acquisitions	148,482	2,483	—	150,965
Foreign currency adjustments	(1,722)	(75)	(287)	(2,084)
Balance at end of year	$207,497	$ 19,874	$ 29,283	$256,654

Income taxes. We follow the guidance of ASC 740 Income Taxes (“ASC 740”), which requires that we use the asset and liability method of accounting for deferred income taxes and provide deferred income taxes for all significant temporary differences. As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax payable and related tax expense together with assessing temporary differences resulting from differing treatment of certain items, such as depreciation, for tax and accounting purposes. These differences can result in deferred tax assets and liabilities, which are included within our consolidated balance sheets.

In accordance with ASC 740, we are required to assess the likelihood that our deferred tax assets will be realized and, to the extent we believe that it is more likely than not (a likelihood of more than 50%) that some portion or all of the deferred tax assets will not be realized, we must establish a valuation allowance. We consider all available evidence to determine whether, based on the weight of the evidence, a valuation allowance is needed. Evidence used includes information about our current financial position and our results of operations for the current and preceding years, as well as all currently available information about future years, including our anticipated future performance, the reversal of existing taxable temporary differences and tax planning strategies.

Management believes future sources of taxable income, reversing temporary differences and other tax planning strategies will be sufficient to realize assets for which no reserve has been established. While we have considered these factors in assessing the need for a valuation allowance, there is no assurance that a valuation allowance would not need to be established in the future if information about future years change. Any change in the valuation allowance would impact our income tax provision and net income (loss) in the period in which such a determination is made. As of December 31, 2016, we believe that it is more likely than not that we will have sufficient reversals of temporary differences and future taxable income to allow us to realize the benefits of the net deferred tax assets except for those related to net operating loss carry forwards of certain foreign subsidiaries in the amount $41.0 million. Our belief is based upon our record of historical earnings levels in recent years and projections of future taxable income over the periods in which the future deductible temporary differences become deductible. As of December 31, 2016, our deferred tax assets were $67.7 million, less a valuation allowance of $13.2 million. As of December 31, 2016, our deferred tax liabilities were $125.1 million.

Significant judgment is required in assessing the timing and amounts of deductible and taxable items for tax purposes. In accordance with ASC 740-10, we establish reserves for uncertain tax positions when, despite our belief that our tax return positions are supportable, we believe that it is not more likely than not that the position will be sustained upon challenge. When facts and circumstances change, we adjust these reserves through our provision for income taxes. To the extent interest and penalties may be assessed by taxing authorities on any related underpayment of income tax, such amounts have been accrued

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and are classified as a component of income tax provision (benefit) in our consolidated statements of operations. As of December 31, 2016, our unrecognized tax benefits related to uncertain tax positions were $0.9 million.

Workers' compensation, auto, medical and general liability accruals. In accordance with ASC 450 Contingencies ("ASC 450"), we record a loss contingency when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. We review our loss contingencies on an ongoing basis to ensure that we have appropriate reserves recorded on our balance sheet. These reserves are based on historical experience with claims incurred but not received, estimates and judgments made by management, applicable insurance coverage for litigation matters, and are adjusted as circumstances warrant. For workers' compensation, our self-insured retention is $1.0 million and our automobile liability self-insured retention is currently $500,000 per occurrence. For general liability claims, we have an effective self-insured retention of $3.0 million per occurrence. For medical claims, our self-insured retention is $350,000 per individual claimant determined on an annual basis. For environmental liability claims, our self-insured retention is $1.0 million per occurrence. We maintain insurance for claims that exceed such self-retention limits. The insurance is subject to terms, conditions, limitations and exclusions that may not fully compensate us for all losses. Furmanite was incorporated into our existing insurance coverage during 2016, but for certain items it maintained separate insurance policies during portions of 2016 and accordingly maintained separate self-insurance retention amounts, with such self-retention amounts generally below the levels noted above. Our estimates and judgments could change based on new information, changes in laws or regulations, changes in management's plans or intentions, or the outcome of legal proceedings, settlements or other factors. If different estimates and judgments were applied with respect to these matters, it is likely that reserves would be recorded for different amounts.

Allowance for doubtful accounts. In the ordinary course of business, a portion of our accounts receivable are not collected due to billing disputes, customer bankruptcies, dissatisfaction with the services we performed and other various reasons. We establish an allowance to account for those accounts receivable that we estimate will eventually be deemed uncollectible. The allowance for doubtful accounts is based on a combination of our historical experience and management's review of long outstanding accounts receivable.

Concentration of credit risk. No single customer accounts for more than 10% of consolidated revenues.

Earnings (loss) per share. Basic earnings (loss) per share is computed by dividing income (loss) from continuing operations, income (loss) from discontinued operations or net income (loss) available to Team shareholders by the weighted-average number of shares of common stock outstanding during the year. Diluted earnings per share is computed by dividing income (loss) from continuing operations, income (loss) from discontinued operations or net income (loss) available to Team shareholders, less income or loss for the period attributable to the noncontrolling interest, by the sum of (1) the weighted-average number of shares of common stock, outstanding during the period, (2) the dilutive effect of the assumed exercise of share-based compensation using the treasury stock method and (3) the dilutive effect of the assumed conversion of our noncontrolling interest to our common stock prior to the acquisition of that interest.

Amounts used in basic and diluted earnings (loss) per share, for all periods presented, are as follows (in thousands):

	Twelve Months Ended December 31,	Seven Months Ended December 31,	Twelve Months Ended May 31,	
	2016	2015	2015	2014
Weighted-average number of basic shares outstanding	28,095	20,852	20,500	20,439
Stock options, stock units and performance awards	—	260	419	633
Conversion of noncontrolling interest	—	313	732	213
Total shares and dilutive securities	28,095	21,425	21,651	21,285

For the year ended December 31, 2016, all outstanding share-based compensation awards were excluded from the calculation of diluted earnings (loss) per share because their inclusion would be antidilutive due to the loss from

continuing operations for the period. There were no share-based awards outstanding during the seven months ended December 31, 2015 and the twelve months ended May 31, 2015 and 2014, that were excluded from the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of common shares during the periods.
Foreign currency. For subsidiaries whose functional currency is not the U.S. Dollar, assets and liabilities are translated at period ending rates of exchange and revenues and expenses are translated at period average exchange rates. Translation

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adjustments for the asset and liability accounts are included as a separate component of accumulated other comprehensive loss in shareholders' equity. Foreign currency transaction gains and losses are included in our statements of operations. Effective December 1, 2009, we began to account for Venezuela as a highly-inflationary economy and the effect of all subsequent currency fluctuations between the Bolivar and the U.S. Dollar are recorded in our statements of operations. Subsequently, effective February 1, 2015, we began reporting the results of our Venezuelan operations using the cost method of accounting (see Note 17).

We utilize monthly foreign currency swap contracts to reduce exposures to changes in foreign currency exchange rates including, but not limited to, the Australian Dollar, Canadian Dollar, Brazilian Real, British Pound, Euro, Malaysian Ringgit and Mexican Peso. The impact from these swap contracts was not material as of and for the year ended December 31, 2016, as of and for the seven months ended December 31, 2015 nor for the years ended May 31, 2015 and 2014.

Defined Benefit Pension Plans. Pension benefit costs and liabilities are dependent on assumptions used in calculating such amounts. The primary assumptions include factors such as discount rates, expected investment return on plan assets, mortality rates and retirement rates. These rates are reviewed annually and adjusted to reflect current conditions. These rates are determined based on reference to yields. The expected return on plan assets is derived from detailed periodic studies, which include a review of asset allocation strategies, anticipated future long-term performance of individual asset classes, risks (standard deviations) and correlations of returns among the asset classes that comprise the plans' asset mix. While the studies give appropriate consideration to recent plan performance and historical returns, the assumptions are primarily long-term, prospective rates of return. Mortality and retirement rates are based on actual and anticipated plan experience. In accordance with GAAP, actual results that differ from the assumptions are accumulated and are subject to amortization over future periods and, therefore, generally affect recognized expense in future periods. While we believe that the assumptions used are appropriate, differences in actual experience or changes in assumptions may affect the pension obligation and future expense.

Reclassifications. Certain reclassifications were made to previously reported amounts in the consolidated financial statements and notes thereto to make them consistent with the current presentation format.

Newly Adopted Accounting Principles

ASU No. 2015-03 and ASU No. 2015-15. In April 2015, the FASB issued Accounting Standards Update ("ASU") No. 2015-03, Interest—Imputation of Interest: Simplifying the Presentation of Debt Issuance Costs ("ASU 2015-03"), which requires that debt issuance costs be presented as a direct deduction from the carrying amount of the related debt liability, consistent with the presentation of debt discounts. Prior to the issuance of ASU 2015-03, debt issuance costs were required to be presented as other assets, separate from the related debt liability. ASU 2015-03 does not change the recognition and measurement requirements for debt issuance costs.

In August 2015, the FASB issued ASU No. 2015-15, Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements ("ASU 2015-15"), that adds SEC paragraphs pursuant to the SEC Staff Announcement at the June 18, 2015, Emerging Issues Task Force meeting about the presentation and subsequent measurement of debt issuance costs associated with line-of-credit arrangements. Given the absence of authoritative guidance within ASU 2015-03 for debt issuance costs related to line-of-credit arrangements, ASU 2015-15 states the SEC staff would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. Team adopted ASU 2015-15 effective upon adoption of ASU 2015-03 on January 1, 2016. Because essentially all of Team's deferred debt issuance costs relate to line-of-credit arrangements, we have elected to continue presenting such costs as an asset. Therefore, adoption of ASU 2015-03 and ASU 2015-15 did not have any impact on our results of operations, financial position or cash flows.

Accounting Principles Not Yet Adopted

ASU No. 2014-09. In May 2014, the FASB issued Accounting Standards Update ("ASU") ASU No. 2014-09, Revenue from Contracts with Customers ("ASU 2014-09"), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in GAAP when it becomes effective. The new standard is effective for us on

January 1, 2018, with early application permitted as of January 1, 2017. ASU 2014-09 permits the use of either the retrospective or cumulative effect transition method. We will not elect early application and therefore we will apply ASU 2014-09 on January 1, 2018. To adopt the new standard, we anticipate applying the cumulative effect transition method, pursuant to which we will record an adjustment to the opening balance of retained earnings as of January 1, 2018 for the impact of applying ASU 2014-09 to all contracts existing as of the date of application. We are continuing our assessment of ASU 2014-09 and are not able to quantify the potential impacts at the time. However, as most of our projects are short-term in nature and billed on a time and materials basis, we do not currently anticipate that the adoption of ASU 2014-09 will result in substantial changes to the overall pattern or timing of our revenue recognition.

ASU No. 2015-11. In July 2015, the FASB issued ASU 2015-11, Inventory—Simplifying the Measurement of Inventory ("ASU 2015-11"), which requires entities that measure inventory using the first-in, first-out or average cost methods to measure inventory at the lower of cost and net realizable value to more closely align the measurement of inventory in GAAP with International Financial Reporting Standards. Net realizable value is defined as estimated selling price in the ordinary course of business less reasonably predictable costs of completion, disposal and transportation. ASU 2015-11 is effective for fiscal years beginning after December 15, 2016 on a prospective basis, with earlier application permitted. The adoption of this update is not expected to have a material impact on our results of operations, financial position or cash flows.

ASU No. 2015-17. In November 2015, the FASB issued ASU No. 2015-17, Income Taxes: Balance Sheet Classification of Deferred Taxes ("ASU 2015-17"), which simplifies the presentation of deferred taxes by requiring deferred tax assets and liabilities be classified as noncurrent on the balance sheet. ASU 2015-17 is effective for fiscal years beginning after December 15, 2016. The ASU may be adopted prospectively or retrospectively and early adoption is permitted. The adoption of this ASU is not expected to have a material impact on our results of operations, financial position or cash flows.

ASU No. 2016-02. In February 2016, the FASB issued ASU No. 2016-02, Leases ("ASU 2016-02"), which changes the accounting for leases, including a requirement to record all leases on the consolidated balance sheets as assets and liabilities. This ASU is effective for fiscal years beginning after December 15, 2018. We will adopt ASU 2016-02 effective January 1, 2019. We are currently evaluating the impact this ASU will have on our ongoing financial reporting.

ASU No. 2016-09. In March 2016, the FASB issued ASU No. 2016-09, Compensation–Stock Compensation: Improvements to Employee Share-Based Payment Accounting ("ASU 2016-09"), which makes several modifications to GAAP related to share-based payments including the accounting for forfeitures, employee taxes and the financial statement presentation of excess tax benefits or deficiencies. ASU 2016-09 also clarifies the statement of cash flows presentation for certain components of share-based awards. The ASU is effective for interim and annual reporting periods beginning after December 15, 2016, although early adoption is permitted. The adoption of ASU 2016-09 is not expected to have a material impact on our financial position or cash flows. Upon adoption, on a prospective basis, our income tax expense will be impacted by future excess tax benefits or deficiencies that under previous GAAP were recognized within stockholders' equity rather than through the statement of operations.

ASU No. 2016-13. In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments–Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"), which amends GAAP by introducing a new impairment model for financial instruments that is based on expected credit losses rather than incurred credit losses. The new impairment model applies to most financial assets, including trade accounts receivable. ASU 2016-13 is effective for interim and annual reporting periods beginning after December 15, 2019, although it may be adopted one year earlier, and requires a modified retrospective transition approach. We are currently evaluating the impact this ASU will have on our ongoing financial reporting.

ASU No. 2016-15. In August 2016, the FASB issued ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"), which clarifies the classification in the statement of cash flows of certain items, including debt prepayment or extinguishment costs, settlement of contingent consideration arising from a business combination, insurance settlement proceeds, and cash receipts and payments having aspects of more than one class of cash flows. ASU 2016-15 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted. We do not expect the adoption of this ASU to have a material impact on our statements of cash flows.

ASU No. 2016-16. In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory ("ASU 2016-16"), which will require an entity to recognize the income tax consequences of an intra-entity transfer of an asset, other than inventory, when the transfer occurs. ASU 2016-16 is effective on January 1, 2018 with early adoption permitted. We are currently evaluating the impact this ASU will have on our ongoing financial reporting.

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2. ACQUISITIONS

Furmanite

In November 2015, Team and Furmanite entered into an Agreement and Plan of Merger (the "Merger Agreement") pursuant to which we acquired all the outstanding shares of Furmanite in a stock transaction whereby Furmanite shareholders received 0.215 shares of Team common stock for each share of Furmanite common stock they owned. The merger was completed on February 29, 2016. Outstanding Furmanite share-based payment awards were generally converted into comparable share-based awards of Team, with certain awards vesting upon the closing of the merger, pursuant to the Merger Agreement. The combination doubled the size of Team's mechanical services capabilities and established a deeper, broader talent and resource pool that better supports customers across standard and specialty mechanical services. In addition, our expanded capability and capacity offers an enhanced single-point of accountability and flexibility in addressing some of the most critical needs of clients; whether as individual services or as part of an integrated specialty industrial services solution.

The acquisition-date fair value of the consideration transferred totaled $282.3 million, which consisted of the following (in thousands, except shares):

	February 29, 2016
Common stock (8,208,006 shares)	$209,529
Converted share-based payment awards	2,001
Cash	70,811
Total consideration	$282,341

The fair value of the 8,208,006 common shares issued was determined based on the closing market price of our common shares on the acquisition date of February 29, 2016. The issuance of common shares in the acquisition is a non-cash financing activity that has been excluded from the consolidated statement of cash flows. The fair value of the converted share-based payment awards reflects an apportionment of the fair value of the awards, based on the closing market price of our common shares and other assumptions as of the acquisition date, that is attributable to employee service completed prior to the acquisition date. The fair value of the awards attributable to service after the acquisition date is recognized as share-based compensation expense over the applicable vesting periods. The cash consideration represents amounts Team paid, immediately prior to the closing of the acquisition, to settle Furmanite's outstanding debt and certain related liabilities, which were not assumed by Team. The cash portion of the consideration was financed through additional borrowings under our banking credit facility.

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The following table presents the purchase price allocation for Furmanite (in thousands):

	February 29, 2016
Cash and cash equivalents	$37,734
Accounts receivable	65,925
Inventory	25,847
Current deferred tax assets	19,857
Prepaid expenses and other current assets	23,044
Current assets of discontinued operations	18,623
Property, plant and equipment	63,259
Intangible assets	88,958
Goodwill	89,646
Other non-current assets	687
Non-current deferred tax assets	2,542
Total assets acquired	436,122
Accounts payable	12,359
Other accrued liabilities	33,127
Income taxes payable	229
Current liabilities of discontinued operations	1,434
Non-current deferred tax liabilities	91,431
Defined benefit pension liability	13,509
Other long-term liabilities	1,692
Total liabilities assumed	153,781
Net assets acquired	$282,341

The purchase price allocation shown above is based upon the fair values at the acquisition date. The fair values recorded are “Level 3” measurements as defined in Note 10.

Of the $89.0 million of acquired intangible assets, $69.8 million was assigned to customer relationships with an estimated useful life of 12 years, $16.9 million was assigned to trade names with a weighted-average estimated useful life of 12 years and $2.3 million was assigned to developed technology with an estimated useful life of 10 years.

The $89.6 million of goodwill was assigned to the TeamFurmanite segment. The goodwill recognized is attributable primarily to expected synergies and the assembled workforce of Furmanite. None of the goodwill recognized is expected to be deductible for income tax purposes.

The fair value of accounts receivable acquired was $65.9 million with the gross contractual amount being $88.0 million. We expect $7.9 million to be uncollectible. Additionally, we acquired accounts receivable with a fair value of $13.6 million associated with discontinued operations, which is included in the current assets of discontinued operations line above.

Current assets of discontinued operations as of the acquisition date includes $3.3 million of goodwill and $1.6 million of intangible assets that were allocated to a business that we sold in December 2016, as discussed in Note 15. The amount of current assets of discontinued operations acquired shown above is net of costs to sell of $1.1 million.

For the year ended December 31, 2016 and for the seven months ended December 31, 2015, we recognized a total of $6.7 million and $3.0 million, respectively, of acquisition costs related to the Furmanite acquisition, which were included in selling, general and administrative expenses in the consolidated statements of operations.

Our consolidated statement of operations for the year ended December 31, 2016 includes the activity of Furmanite beginning on the acquisition date of February 29, 2016. Subsequent to the acquisition date, we commenced integration activities relative to Furmanite. As a result, certain business operations have been consolidated and/or transferred from legacy Furmanite operations to legacy Team operations to facilitate the new operating structure. Revenues of $216 million and a net loss of $6.4 million are included in the year ended December 31, 2016 and only include operating results that are directly

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attributable to legacy Furmanite operations. These amounts do not reflect any attempt to adjust for the effects of integration activities, which are not practicable to determine.

Certain transactions related to the Furmanite acquisition were recognized separately from the acquisition of assets and assumption of liabilities in accordance with GAAP. These transactions, which were attributable to certain compensation (both cash and share-based) that was paid or became payable in conjunction with the closing of the acquisition, totaled $4.7 million and were recognized as selling, general and administrative expenses during the year ended December 31, 2016.

Our unaudited pro forma consolidated results of operations are shown below as if the acquisition of Furmanite had occurred on June 1, 2015. These results are not necessarily indicative of the results that would actually have occurred if the acquisition had taken place at June 1, 2015, nor are they necessarily indicative of future results (in thousands, except per share data).

	Pro forma data Year Ended December 31, 2016 (unaudited)	Pro forma data Seven Months Ended December 31, 2015 (unaudited)
Revenues	$1,240,466	$ 787,914
Income (loss) from continuing operations attributable to Team shareholders	$(7,497)	$ 15,979
Earnings (loss) per share from continuing operations:		
Basic	$(0.25)	$ 0.55
Diluted	$(0.25)	$ 0.54

These amounts have been calculated after applying Team’s accounting policies and adjusting the results of Furmanite to reflect the additional depreciation and amortization that would have been charged assuming the fair value adjustments to property, plant and equipment and intangible assets had been applied on June 1, 2015, together with the related tax effects. Additionally, these pro forma results exclude discontinued operations as well as the impact of transaction and integration-related costs associated with the Furmanite acquisition included in the historical results.These pro forma results also assume the Qualspec acquisition, which is discussed below, had been completed as of June 1, 2014.

Qualspec

In July 2015, we acquired 100% of the membership interests in Qualspec for total cash consideration of $255.5 million. Qualspec is a leading provider of NDT services in the United States, with significant operations in the West Coast, Gulf Coast and Mid-Western areas of the country. Qualspec adds strength to our resident refinery inspection programs with major customer relationships across the U.S., and to add to our already strong capabilities in advanced inspection services, rope access services and the delivery of innovative technologies to our customers. The purchase of Qualspec was financed through borrowings under our banking credit facility.

The initial purchase price could have been increased by $10.0 million depending upon the operating results of Qualspec through the end of calendar year 2015. The fair value of the contingent consideration arrangement at the acquisition date was initially estimated at $5.8 million. However, based on Qualspec results through December 31, 2015, there was no additional amount payable and, accordingly, we have reversed our initial contingent consideration obligation of $5.8 million to zero with a corresponding decrease to goodwill.

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The following table presents purchase price allocation for Qualspec (in thousands):

	July 7, 2015
Cash and cash equivalents	$ 3,981
Accounts receivable	21,495
Current deferred tax assets	279
Prepaid expenses	1,049
Plant, property and equipment	15,472
Intangible assets	78,100
Goodwill	148,482
Other assets	138
Total assets acquired	268,996
Accounts payable	2,892
Other accrued liabilities	7,581
Non-current deferred tax liability	2,982
Total liabilities assumed	13,455
Net assets acquired	$ 255,541

The purchase price allocation shown above is based upon the fair values at the acquisition date. The fair values recorded are “Level 3” measurements as defined in Note 10.

Of the $78.1 million of acquired intangible assets, $75.2 million was assigned to customer relationships with an estimated useful life of 15 years, $1.6 million was assigned to non-compete agreements with an estimated useful life of 5 years and $1.3 million was assigned to trade names with an estimated useful life of 1 year.

The $148.5 million of goodwill was assigned to the TeamQualspec segment. The goodwill recognized is attributable primarily to expected synergies and the assembled workforce of Qualspec. About $109.6 million of the goodwill is expected to be deductible for income tax purposes.

The fair value of accounts receivables acquired was $21.5 million, with the gross contractual amount being $22.5 million. We expect $1.0 million to be uncollectible.

Our consolidated results include the activity of Qualspec beginning on the acquisition date of July 7, 2015. Revenues of $79.3 million and net income of $2.7 million of Qualspec are included in the consolidated statement of operations (in the TeamQualspec segment) for the seven months ended December 31, 2015.

Our unaudited pro forma consolidated results of operations are shown below as if the acquisition of Qualspec had occurred at June 1, 2014. These results are not necessarily indicative of the results which would actually have occurred if the acquisition had taken place at June 1, 2014, nor are they necessarily indicative of future results (in thousands, except per share data).

	Pro forma data Seven Months Ended December 31, 2015 (unaudited)	Pro forma data Year Ended May 31, 2015 (unaudited)
Revenues	$ 589,553	$ 1,011,829
Income from continuing operations attributable to Team shareholders	$ 9,215	$ 41,597
Earnings per share from continuing operations:		
Basic	$ 0.44	$ 2.03
Diluted	$ 0.43	$ 1.92

These amounts have been calculated after applying Team’s accounting policies, reflecting additional interest expense and adjusting the results of Qualspec to reflect the additional depreciation and amortization that would have been charged assuming

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the fair value adjustments to property, plant and equipment and intangible assets had been applied on June 1, 2014, together with the consequential tax effects.

Quest Integrity

In November 2010, we purchased 95% of Quest Integrity Group, LLC, a leading provider of proprietary in-line inspection and advanced engineering and assessment services. Pursuant to a "Put/Call Agreement" that was executed at the time of the Quest Integrity acquisition, on August 31, 2015, we issued 728,266 shares of restricted common stock and paid $5.9 million in cash to acquire the noncontrolling interest. Prior to August 31, 2015, these shares were included as dilutive securities in the earnings per share calculation as set forth herein.

Other

In June 2016, we acquired a mechanical furnace and pipe cleaning business in Europe, Turbinate International B.V. ("Turbinate") for approximately $8 million. Recognized as a service leader in the European market, Turbinate specializes in de-coking and cleaning of fired heaters and unpiggable refinery assets as well as mechanical cleaning of furnaces and pipes from two to 18 inches by means of pigging, endoscopy and ultra sound inspection services. Turbinate is located in Vianen, the Netherlands. Turbinate is reported in the Quest Integrity segment.

In April 2016, we acquired two related businesses in Europe: Quality Inspection Services ("QIS") and TiaT Europe ("TiaT") for a total of approximately $9 million. QIS is an NDT inspection company and TiaT is an NDT training school and consultancy and engineering company recognized as a specialist in aerospace inspections. Both companies are located in Roosendaal, the Netherlands. The businesses add about 65 employees to our organization in Europe and serve steel construction, ship repair, off-shore and storage tank customers, as well as the aerospace industry. QIS is the fourth largest NDT inspection company in the Netherlands and represents Team's first inspection operation outside of North America. QIS and TiaT are reported in the TeamQualspec segment.

In June 2015, we purchased DK Amans Valve, an advanced valve leader located in Long Beach, California, with a portfolio of projects from various sectors including oil and gas refining, pipelines and power generation for a total consideration of $12.3 million, net of cash acquired of $0.1 million. The purchase price also included $1.8 million of contingent consideration. The contingent consideration is based upon the achievement of certain performance targets over a three-year period for an additional amount of up to $4.0 million. During the year ended December 31, 2016, we recorded a loss of $2.2 million associated with the revaluation of the contingent consideration based on actual performance to date. DK Amans Valve is reported in the TeamFurmanite segment.

In August 2014, we purchased a valve repair company in the U.K. for total consideration of $3.1 million, net of cash acquired of $0.2 million, including estimated contingent consideration of $0.3 million.

In July 2013, we purchased a leading provider of industrial rope access services, for total consideration of approximately $12.9 million including net working capital of $1.3 million and $11.6 million allocated to goodwill and intangible assets. We expect $9.2 million of the goodwill recognized to be deductible for tax purposes. The purchase price allocation included contingent consideration valued at $1.9 million. The contingent consideration is based upon the achievement of operating earnings thresholds over a six-year period for an amount of up to $4.0 million.

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3. RECEIVABLES

A summary of accounts receivable as of December 31, 2016 and December 31, 2015 is as follows (in thousands):

	December 31, 2016	December 31, 2015
Trade accounts receivable	$230,889	$170,774
Unbilled revenues	39,719	47,098
Allowance for doubtful accounts	(7,835)	(3,548)
Total	$262,773	$214,324

The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is remote. The following summarizes the activity in the allowance for doubtful accounts as of December 31, 2016, December 31, 2015, and May 31, 2015 and 2014 (in thousands):

	Twelve Months Ended December 31,	Seven Months Ended December 31,	Twelve Months Ended May 31,	
	2016	2015	2015	2014
Balance at beginning of period	$ 3,548	$ 2,775	$4,784	$5,438
Provision for doubtful accounts	6,336	1,819	233	2,140
Write-off of bad debts	(2,049)	(1,046)	(2,242)	(2,794)
Balance at end of period	$ 7,835	$ 3,548	$2,775	$4,784

4. INVENTORY

A summary of inventory as of December 31, 2016 and 2015 is as follows (in thousands):

	December 31, 2016	December 31, 2015
Raw materials	$ 6,844	$ 3,167
Work in progress	2,713	1,018
Finished goods	40,014	23,751
Total	$ 49,571	$ 27,936

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5. PROPERTY, PLANT AND EQUIPMENT

A summary of property, plant and equipment as of December 31, 2016 and 2015 is as follows (in thousands):

	December 31, 2016	December 31, 2015
Land	$7,429	$3,124
Buildings and leasehold improvements	42,257	29,690
Machinery and equipment	233,063	174,222
Furniture and fixtures	8,431	6,561
Capitalized ERP system development costs	44,876	25,606
Computers and computer software	11,775	8,062
Automobiles	5,370	5,280
Construction in progress	12,997	5,177
Total	366,198	257,722
Accumulated depreciation and amortization	(163,068)	(132,739)
Property, plant, and equipment, net	$203,130	$124,983

At the end of 2013, we initiated the design and implementation of a new ERP system, which is expected to be substantially installed by the end of 2017. Amortization of the enterprise resource planning ("ERP") system development costs will be computed by the straight-line method, commencing in the period when substantial testing is completed and the asset is ready for its intended use. Through December 31, 2016, we have capitalized $44.9 million associated with the project which includes $1.4 million of capitalized interest.

6. INTANGIBLE ASSETS

A summary of intangible assets as of December 31, 2016 and 2015 is as follows (in thousands):

	December 31, 2016		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer relationships	$174,742	$ (25,508)	$149,234
Non-compete agreements	5,397	(3,896)	1,501
Trade names	24,624	(4,216)	20,408
Technology	7,812	(3,364)	4,448
Licenses	838	(325)	513
Total	$213,413	$ (37,309)	$176,104

	December 31, 2015		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Customer relationships	$103,288	$ (12,995)	$90,293
Non-compete agreements	4,898	(3,468)	1,430
Trade names	6,299	(1,940)	4,359
Technology	5,112	(2,541)	2,571
Licenses	683	(217)	466
Total	$120,280	$ (21,161)	$99,119

Amortization expense for the twelve months ended December 31, 2016, the seven months ended December 31, 2015, and twelve months ended May 31, 2015 and 2014 was $16.1 million, $5.5 million, $3.8 million, and $3.7 million, respectively.

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Amortization expense for current intangible assets is forecast to be approximately $16 million per year in 2017, 2018 and 2019, and approximately $15 million per year in 2020 and 2021. The weighted average amortization period for intangible assets subject to amortization is 13.2 years. The weighted average amortization period is 13.5 years for customer relationships, 4.5 years for non-compete agreements, 12.5 years for trade names, 9.5 years for technology, and 8.8 years for licenses.

7. OTHER ACCRUED LIABILITIES

A summary of other accrued liabilities as of December 31, 2016 and 2015 is as follows (in thousands):

	December 31, 2016	December 31, 2015
Payroll and other compensation expenses	$ 38,214	$ 21,879
Insurance accruals	13,896	7,008
Property, sales and other non-income related taxes	5,599	3,058
Lease commitments	2,119	1,721
Deferred revenue	3,433	1,355
Accrued commission	1,355	1,159
Accrued interest	603	984
Volume discount	1,067	1,280
Contingent consideration	2,103	3,638
Other	11,515	7,714
Total	$ 79,904	$ 49,796

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8. INCOME TAXES

For the twelve months ended December 31, 2016, the seven months ended December 31, 2015, and the twelve months ended May 31, 2015 and 2014, we were taxed on income (loss) from continuing operations at an effective tax rate of 20%, 34%, 36% and 35%, respectively. Our income tax provision (benefit) on continuing operations for twelve months ended December 31, 2016, the seven months ended December 31, 2015, and the twelve months ended May 31, 2015 and 2014, was $(3.1) million, $4.6 million, $22.8 million and $16.2 million, respectively, and includes federal, state and foreign taxes. The components of our tax provision (benefit) on continuing operations were as follows (in thousands):

	Current	Deferred	Total
Twelve months ended December 31, 2016:			
U.S. Federal	$(2,048)	$(5,262)	$(7,310)
State & local	(1,338)	206	(1,132)
Foreign jurisdictions	4,529	820	5,349
	$1,143	$(4,236)	$(3,093)
Seven months ended December 31, 2015:			
U.S. Federal	$(4)	$1,667	$1,663
State & local	90	187	277
Foreign jurisdictions	2,128	505	2,633
	$2,214	$2,359	$4,573
Twelve months ended May 31, 2015:			
U.S. Federal	$17,183	$606	$17,789
State & local	2,634	(141)	2,493
Foreign jurisdictions	3,598	(1,087)	2,511
	$23,415	$(622)	$22,793
Twelve months ended May 31, 2014:			
U.S. Federal	$11,933	$358	$12,291
State & local	1,759	319	2,078
Foreign jurisdictions	3,573	(1,706)	1,867
	$17,265	$(1,029)	$16,236

The components of pre-tax income (loss) from continuing operations for the twelve months ended December 31, 2016, the seven months ended December 31, 2015, and the twelve months ended May 31, 2015 and 2014 were as follows (in thousands):

	Twelve Months Ended December 31,	Seven Months Ended December 31,	Twelve Months Ended May 31,	
	2016	2015	2015	2014
Domestic	$(25,488)	$ 6,627	$51,784	$38,214
Foreign	9,830	6,824	11,506	8,171
	$(15,658)	$ 13,451	$63,290	$46,385

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Income tax expense (benefit) attributable to income (loss) from continuing operations differed from the amounts computed by applying the U.S. Federal income tax rate of 35% to pre-tax income (loss) from continuing operations as a result of the following (in thousands):

	Twelve Months Ended December 31, 2016	Seven Months Ended December 31, 2015	Twelve Months Ended May 31, 2015	Twelve Months Ended May 31, 2014
Pre-tax income (loss) from continuing operations	$(15,658)	$13,451	$63,290	$46,385
Computed income taxes at statutory rate	(5,481)	$4,710	$22,153	$16,235
State income taxes, net of federal benefit	(713)	258	1,670	1,505
Foreign tax rate differential	(707)	(648)	(1,318)	(1,004)
Production activity deduction	—	(10)	(136)	(174)
Deferred taxes on investment in foreign subsidiaries	1,777	(335)	819	(1,133)
Non-deductible expenses	871	335	513	510
Foreign tax credits	(2,302)	(19)	(11)	(1,942)
Other tax credits	(1,033)	(446)	(223)	(244)
Dividend from foreign subsidiaries	2,021	—	—	2,062
Valuation allowance	1,986	771	(394)	414
Other	488	(43)	(280)	7
Total provision (benefit) for income tax on continuing operations	$(3,093)	$4,573	$22,793	$16,236

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are presented below (in thousands):

	December 31, 2016	December 31, 2015
Deferred tax assets:		
Accrued compensation and benefits	$12,559	$4,023
Receivables	3,856	739
Inventory	3,539	552
Stock options	1,526	2,241
Foreign currency translation and other equity adjustments	6,359	5,189
Other accrued liabilities	5,811	1,473
Tax credit carry forward	4,769	—
Net operating loss carry forwards	25,061	1,420
Other	4,227	1,174
Deferred tax assets	67,707	16,811
Less: Valuation allowance	(13,168)	(857)
Deferred tax assets, net	54,539	15,954
Deferred tax liabilities:		
Property, plant and equipment	(28,700)	(11,840)
Goodwill and intangible costs	(43,737)	(10,496)
Unremitted earnings of foreign subsidiaries	(51,087)	(1,669)
Prepaids	(775)	(580)
Other	(827)	(499)
Deferred tax liabilities	(125,126)	(25,084)
Net deferred tax liability	$(70,587)	$(9,130)

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As of December 31, 2016, we had a valuation allowance of $13.2 million to reduce our deferred tax assets to an amount more likely than not to be recovered. This valuation allowance relates primarily to net operating loss carry forwards related to various foreign subsidiaries in the amount of $41.0 million. In assessing the realizability of deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. We consider factors including the reversal of future taxable temporary differences, projected future taxable income and tax planning strategies in making this assessment.

As of December 31, 2016, we had net foreign net operating loss carry forwards totaling $4.3 million that were expected to be realized in the future periods. A total of $3.4 million has an unlimited carry forward period and will therefore not expire.

At December 31, 2016, we also have net operating loss carry forwards for U.S. federal income tax purposes of $30.7 million, which are available, subject to certain limitations, to offset future taxable income, if any, through the year 2034. In addition, we have alternative minimum tax credit carry forwards of approximately $1.2 million, which are available to reduce future regular federal income taxes, if any, over an indefinite period.

At December 31, 2016, undistributed earnings of foreign operations totaling $16.4 million were considered to be permanently reinvested. We have recognized no deferred tax liability for the remittance of such earnings to the U.S. since it is our intention to utilize those earnings in the foreign operations. Generally, such earnings become subject to U.S. tax upon the remittance of dividends and under certain other circumstances. Determination of the unrecognized deferred U.S. income tax liability is not practicable due to uncertainties related to the timing and source of any potential distribution of such funds, along with other important factors such as the amount of associated foreign tax credits.

At December 31, 2016, we have established liabilities for uncertain tax positions of $0.9 million, inclusive of interest and penalties. To the extent these uncertainties are ultimately resolved favorably, the resulting reduction of recorded liabilities would have an effect on our effective tax rate. In accordance with ASC 740-10, our policy is to recognize interest and penalties related to unrecognized tax benefits through the tax provision.

We file income tax returns in the U.S. with federal and state jurisdictions as well as various foreign jurisdictions. With few exceptions, we are no longer subject to U.S. Federal, state and local or non-U.S. income tax examinations by tax authorities for years prior to 2015. We are currently in the examination phase of IRS audits for the tax years ended May 31, 2015 and December 31, 2015. The income tax laws and regulations are voluminous and are often ambiguous. As such, we are required to make certain subjective assumptions and judgments regarding our tax positions that may have a material effect on our results of operations, financial position or cash flows. We believe, however, that there is appropriate support for the income tax positions taken, and to be taken, on our returns, and that our accruals for tax liabilities are adequate for all open tax years based on an assessment of many factors including past experience and interpretations of tax law applied to the facts of each matter.

Set forth below is a reconciliation of the changes in our unrecognized tax benefits associated with uncertain tax positions (in thousands):

	Twelve Months Ended December 31,	Year Ended Seven Months Ended December 31,	Twelve Months Ended May 31,	
	2016	2015	2015	2014
Balance at beginning of year	$ 539	$ 477	$715	$697
Acquisition of Furmanite uncertain tax positions	660	—	—	—
Additions based on current year tax positions	464	—	—	—

Additions based on tax positions related to prior years	96	62	68	110
Reductions based on tax positions related to prior years	(564)	—	(306)	—
Settlements	(337)	—	—	—
Reductions resulting from a lapse of the applicable statute of limitations	—	—	—	(92)
Balance at end of year	$ 858	$ 539	$477	$715

We believe that in the next twelve months it is reasonably possible that $0.4 million of liabilities recorded for tax uncertainties will be effectively settled.

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Recent Legislation

The Protecting Americans From Tax Hikes Act of 2015 (the “PATH Act”) was signed into law on December 18, 2015 and included an extension of the 50% bonus depreciation allowance, with a phase down of the bonus percentage amount for later years. The extended provision for 50% bonus depreciation specifically applies to qualifying property placed in service after December 31, 2014 and before January 1, 2018. The acceleration of deductions for the year ended December 31, 2016 and the seven months ended December 31, 2015 on qualifying capital expenditures resulting from the bonus depreciation provision had no impact on our current period effective tax rate because the acceleration of deductions does not result in permanent differences between asset bases for financial reporting purposes and income tax purposes. However, the ability to accelerate depreciation deductions decreased our cash taxes for the year ended December 31, 2016 and the seven-month period ended December 31, 2015 by approximately $3.9 million and $1.7 million, respectively. Taking the accelerated tax depreciation will result in increased cash taxes in subsequent periods when the deductions for these capital expenditures would have otherwise been taken. The PATH Act also reinstated and made permanent the research and development credit retroactively from January 1, 2015. This change in legislation resulted in a permanent decrease in income tax expense for the year ended December 31, 2016 and seven months ended December 31, 2015 of $0.8 million and $0.4 million, respectively.

9. LONG-TERM DEBT, DERIVATIVES AND LETTERS OF CREDIT

In July 2015, we renewed our banking credit facility (the “Credit Facility”). In accordance with the second amendment to the Credit Facility, which was signed in February 2016, the Credit Facility has a borrowing capacity of up to borrowing capacity of up to $600 million and consists of a $400 million, five-year revolving loan facility and a $200 million five-year term loan facility, the proceeds of which were used to fund, in part, the Company’s acquisition of Qualspec. The swing line facility is $35.0 million. The Credit Facility matures in July 2020, bears interest based on a variable Eurodollar rate option (LIBOR plus 2.25% margin at December 31, 2016) and has commitment fees on unused borrowing capacity (0.40% at December 31, 2016). The Credit Facility limits our ability to pay cash dividends without the consent of our bank syndicate. The Credit Facility also contains financial covenants, which were amended in August 2016 pursuant to the third amendment to the Credit Facility. The covenants, as amended, require the Company to maintain as of the end of each fiscal quarter (i) a maximum ratio of consolidated funded debt to consolidated EBITDA (the “Total Leverage Ratio”, as defined in the Credit Facility agreement) of not more than 4.50 to 1.00 as of December 31, 2016, not more than 4.25 to 1.00 as of March 31, 2017 and June 30, 2017, not more than 3.75 to 1.00 as of September 30, 2017 and thereafter the maximum ratio decreases by 0.25 to 1.00 every quarter until it reaches 3.00 to 1.00, (ii) a maximum ratio of senior secured debt to consolidated EBITDA of not more than 3.00 to 1.00 and (iii) an interest coverage ratio of less than 3.00 to 1.00. As of December 31, 2016, we are in compliance with these covenants. With respect to the Total Leverage Ratio, our ratio stood at 4.19 to 1.00 as of December 31, 2016. At December 31, 2016, we had $46.2 million of cash on hand and approximately $29 million of available borrowing capacity through our Credit Facility. In connection with the renewal of our credit facility, we are amortizing $3.0 million of associated debt issuance costs over the life of the Credit Facility.

Future maturities of long-term debt, are as follows (in thousands):

December 31	
2017	$20,000
2018	20,000
2019	20,000
2020	306,911
2021	—
Thereafter	—
Total	$366,911

In order to secure our casualty insurance programs we are required to post letters of credit generally issued by a bank as collateral. A letter of credit commits the issuer to remit specified amounts to the holder, if the holder demonstrates that we failed to meet our obligations under the letter of credit. If this were to occur, we would be obligated to reimburse the issuer for any payments the issuer was required to remit to the holder of the letter of credit. We were contingently liable for outstanding stand-by letters of credit totaling $21.6 million at December 31, 2016, and $13.2 million at December 31, 2015. Outstanding letters of credit reduce amounts available under our Credit Facility and are considered as having been funded for purposes of calculating our financial covenants under the Credit Facility.

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ASC 815, Derivatives and Hedging ("ASC 815"), established accounting and reporting standards requiring that derivative instruments be recorded at fair value and included in the balance sheet as assets or liabilities. The accounting for changes in the fair value of a derivative instrument depends on the intended use of the derivative and the resulting designation, which is established at the inception date of a derivative. Special accounting for derivatives qualifying as fair value hedges allows derivatives' gains and losses to offset related results on the hedged item in the statement of operations. For derivative instruments designated as cash flow hedges, changes in fair value, to the extent the hedge is effective, are recognized in other comprehensive income until the hedged item is recognized in earnings. Hedge effectiveness is measured at least quarterly based on the relative cumulative changes in fair value between the derivative contract and the hedged item over time. Credit risks related to derivatives include the possibility that the counter-party will not fulfill the terms of the contract. We consider counter-party credit risk to our derivative contracts when valuing our derivative instruments.

Our borrowing of €12.3 million under the Credit Facility serves as an economic hedge of our net investment in our European operations as fluctuations in the fair value of the borrowing attributable to the U.S. Dollar/Euro spot rate will offset translation gains or losses attributable to our investment in our European operations. At December 31, 2016 the €12.3 million borrowing had a U.S. Dollar value of $13.0 million.

The amounts recognized in other comprehensive income (loss), and reclassified into income, for the twelve months ended December 31, 2016, seven months ended December 31, 2015, and the twelve months ended May 31, 2015 and 2014 are as follows (in thousands):

	Gain (Loss) Recognized in Other Comprehensive Income (Loss)				Gain (Loss) Reclassified from Other Comprehensive Income (Loss) to Earnings (Loss)			
	Twelve Months Ended December 31,	Seven Months Ended December 31,	Twelve months ended May 31,		Twelve Months Ended December 31,	Seven Months Ended December 31,	Twelve months ended May 31,	
	2016	2015	2015	2014	2016	2015	2015	2014
Net investment hedge	$481	$ 101	$3,237	$(775)	$ —	$ —	$ —	$ —

The following table presents the fair value totals and balance sheet classification for derivatives designated as hedges under ASC 815 (in thousands):

	December 31, 2016			December 31, 2015		
	Classification	Balance Sheet Location	Fair Value	Classification	Balance Sheet Location	Fair Value
Net investment hedge	Liability	Long-term debt	$(5,048)	Liability	Long-term debt	$(4,567)

We enter into operating leases to rent facilities and obtain vehicles and equipment for our field operations. Our obligations under non-cancellable operating leases, primarily consisting of facility and auto leases, were approximately $110.1 million at December 31, 2016 and are as follows (in thousands):

Twelve Months Ended December 31,	Operating Leases
2017	$32,418
2018	25,200
2019	17,447
2020	10,941
2021	7,825
Thereafter	16,295

Total	$ 110,126

Total rent expense resulting from operating leases for the twelve months ended December 31, 2016, the seven months ended December 31, 2015 and the twelve months ended May 31, 2015 and 2014 was $40.0 million, $18.8 million, $29.5 million and $26.2 million, respectively.

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10. FAIR VALUE MEASUREMENTS

We apply the provisions of ASC 820, which among other things, requires enhanced disclosures about assets and liabilities carried at fair value.

As defined in ASC 820, fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. We utilize market data or assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable. We primarily apply the market approach for recurring fair value measurements and endeavor to utilize the best information available. Accordingly, we utilize valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. The use of unobservable inputs is intended to allow for fair value determinations in situations in which there is little, if any, market activity for the asset or liability at the measurement date. We are able to classify fair value balances based on the observability of those inputs. ASC 820 establishes a fair value hierarchy such that “Level 1” measurements include unadjusted quoted market prices for identical assets or liabilities in an active market, “Level 2” measurements include quoted market prices for identical assets or liabilities in an active market which have been adjusted for items such as effects of restrictions for transferability and those that are not quoted but are observable through corroboration with observable market data, including quoted market prices for similar assets, and “Level 3” measurements include those that are unobservable and of a highly subjective measure.

The following table sets forth, by level within the fair value hierarchy, our financial assets and liabilities that are accounted for at fair value on a recurring basis as of December 31, 2016 and 2015. As required by ASC 820, financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement (in thousands):

	December 31, 2016			
	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Liabilities:				
Contingent consideration[1]	$ —	$ —	$ 3,739	$ 3,739
Net investment hedge	$ —	$ (5,048)	$ —	$ (5,048)

	December 31, 2015			
	Quoted Prices in Active Markets for Identical Items (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Liabilities:				
Contingent consideration[1]	$ —	$ —	$ 3,638	$ 3,638
Net investment hedge	$ —	$ (4,567)	$ —	$ (4,567)

[1] Inclusive of both current and noncurrent portions.

There were no transfers in and out of Level 1 & Level 2 during the twelve months ended December 31, 2016 and seven months ended December 31, 2015. There were no transfers in and out of Level 3 for the year ended December 31, 2016, but there was a transfer in and out of of Level 3 of $5.8 million relating to a revaluation of contingent consideration during the seven months ended December 31, 2015.

The fair value of contingent consideration liabilities classified in the table above were estimated using a discounted cash flow technique with significant inputs that are not observable in the market and thus represents a Level 3 fair value measurement as defined in ASC 820. The significant inputs in the Level 3 measurement not supported by market activity include a combination of actual cash flows and probability-weighted assessments of expected future cash flows related to the acquired businesses, appropriately discounted considering the uncertainties associated with the obligation, and as calculated in accordance with the terms of the acquisition agreement.

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The following table represents the changes in the fair value of Level 3 contingent consideration (in thousands):

	Twelve Months Ended December 31, 2016	Seven Months Ended December 31, 2015
Beginning balance	$ 3,638	$ 1,407
Accretion of liability	366	139
Foreign currency effects	80	—
Payment	(4,000)	(230)
Revaluation	2,184	(5,256)
Acquisitions	1,471	7,578
Ending balance	$ 3,739	$ 3,638

11. SHARE-BASED COMPENSATION

We have adopted stock incentive plans and other arrangements pursuant to which our Board of Directors may grant stock options, restricted stock, stock units, stock appreciation rights, common stock or performance awards to officers, directors and key employees. At December 31, 2016, there were approximately 0.8 million stock options, restricted stock units and performance awards outstanding to officers, directors and key employees. The exercise price, terms and other conditions applicable to each form of share-based compensation under our plans are generally determined by the Compensation Committee of our Board at the time of grant and may vary.

Our share-based payments consist primarily of stock units, performance awards, common stock and stock options. In May 2016, our shareholders approved the 2016 Team, Inc. Equity Incentive Plan (the “Plan”), which replaced all of our previous equity compensation plans. The Plan authorizes the issuance of share-based awards representing up to 2,000,000 shares of common stock. Shares issued in connection with our share-based compensation are issued out of authorized but unissued common stock.

In connection with the acquisition of Furmanite in February 2016, we assumed the share plan related to Furmanite employee grants. As provided for in the Merger Agreement, each option to purchase Furmanite common stock outstanding immediately prior to the closing of the acquisition was converted into an option to purchase Team common stock, adjusted by the 0.215 exchange ratio. Similarly, each previously existing Furmanite restricted share, restricted stock unit or performance stock unit outstanding immediately prior to the acquisition were converted into Team restricted stock units, also at the 0.215 exchange ratio. The converted awards generally have the same terms and conditions as the replaced awards, except the vesting of certain awards was accelerated to the acquisition date and any performance conditions associated with the Furmanite awards no longer apply. The fair value of the options was determined using a Black-Scholes model, while the fair value of the restricted stock units was determined based on the market price on the acquisition date. The fair value of the converted Furmanite awards was allocated between consideration transferred in the acquisition and future share-based compensation expense, based on past service completed and future service required. The converted Furmanite awards have been identified, as applicable, in the tables that follow.

Compensation expense related to share-based compensation totaled $7.3 million, $3.5 million, $4.8 million, and $4.2 million for the twelve months ended December 31, 2016, the seven months ended December 31, 2015, and the years ended May 31, 2015, and 2014 respectively. At December 31, 2016, $16.7 million of unrecognized compensation expense related to share-based compensation is expected to be recognized over a remaining weighted-average period of 3.0 years. The excess tax benefit (deficiency) derived when share-based awards result in a tax deduction for the company was $(0.5) million, $0.4 million, $3.0 million, and $1.1 million for the twelve months ended December 31, 2016, the seven months ended December 31, 2015, and the years ended May 31, 2015, and 2014, respectively.

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Stock units are settled with common stock upon vesting unless it is not legally feasible to issue shares, in which case the value of the award is settled in cash. We determine the fair value of each stock unit based on the market price on the date of grant. Stock units generally vest in annual installments over four years and the expense associated with the units is recognized over the same vesting period. We also grant common stock to our directors which typically vests immediately. Compensation expense related to stock units and director stock grants totaled $7.2 million, $3.0 million, $4.1 million and $3.7 million for the twelve months ended December 31, 2016, the seven months ended December 31, 2016, years ended May 31, 2015, and 2014 respectively. Transactions involving our stock units and director stock grants during the twelve months ended December 31, 2016, the seven months ended December 31, 2016 and the years ended May 31, 2015, and 2014 are summarized below:

	Twelve Months Ended December 31, 2016		Seven Months Ended December 31, 2015	
	No. of Stock Units (in thousands)	Weighted Average Fair Value	No. of Stock Units (in thousands)	Weighted Average Fair Value
Stock and stock units, beginning of year	371	$ 36.26	304	$ 36.23
Changes during the year:				
Granted	322	$ 34.23	197	$ 35.14
Assumed - Furmanite Acquisition	40	$ 25.63	—	$ —
Vested and settled	(180)	$ 34.19	(126)	$ 34.43
Cancelled	(18)	$ 30.75	(4)	$ 39.27
Stock and stock units, end of year	535	$ 35.11	371	$ 36.26

	Year Ended May 31, 2015		Year Ended May 31, 2014	
	No. of Stock Units (in thousands)	Weighted Average Fair Value	No. of Stock Units (in thousands)	Weighted Average Fair Value
Stock and stock units, beginning of year	310	$ 31.42	329	$ 26.07
Changes during the year:				
Granted	156	$ 39.51	136	$ 36.70
Vested and settled	(133)	$ 29.23	(139)	$ 24.32
Cancelled	(29)	$ 34.12	(16)	$ 28.01
Stock and stock units, end of year	304	$ 36.23	310	$ 31.42

Under a performance stock unit award program adopted on November 4, 2014, Long-Term Performance Stock Unit (“LTPSU”) awards granted to our Executive Officers are subject to a three year performance period and a concurrent three year service period. Under this program, the Company communicates “target awards” to the Executive Officers at the beginning of a performance period. The performance target is based on results of operations over the three year performance period with possible payouts ranging from 0% to 300% of the “target awards”. LTPSU awards cliff vest with achievement of the performance goals and completion of the three year service period. Settlement occurs with common stock within 20 business days of vesting. We determine the fair value of each LTPSU award based on the market price on the date of grant. Compensation expense is recognized on a straight-line basis over the vesting term of three years based upon the probable performance target that will be met. Compensation expense (credit) of $(0.4) million, $0.3 million and $0.2 million related to performance awards was recognized for the twelve months ended December 31, 2016, the seven months ended December 31, 2015 and the year ended May 31, 2015, respectively.

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Transactions involving our performance awards during the year ended December 31, 2016, the seven months ended December 31, 2015, and the year ended May 31, 2015 are summarized below:

	Twelve Months Ended December 31, 2016		Seven Months Ended December 31, 2015	
	No. of Long-Term Performance Stock Units (in thousands)	Weighted Average Fair Value	No. of Long-Term Performance Stock Units (in thousands)	Weighted Average Fair Value
Long-term performance stock units, beginning of year	59	$ 37.16	23	$ 42.25
Changes during the year:				
Granted	—	$ —	36	$ 33.91
Vested and settled	—	$ —	—	$ —
Cancelled	—	$ —	—	$ —
Long-term performance stock units, end of year	59	$ 37.16	59	$ 37.16

	Year Ended May 31, 2015	
	No. of Long-Term Performance Stock Units (in thousands)	Weighted Average Fair Value
Long-term performance stock units, beginning of year	—	$ —
Changes during the year:		
Granted	23	$ 42.25
Vested and settled	—	$ —
Cancelled	—	$ —
Long-term performance stock units, end of year	23	$ 42.25

Performance awards are settled with common stock upon vesting unless it is not legally feasible to issue shares, in which case the value of the award is settled in cash. We determine the fair value of each performance award based on the market price on the date of grant. Performance awards granted to our Chairman of our Board vest over the longer of four years or the achievement of performance goals based upon our future results of operations. Compensation expense related to performance awards was $0.3 million for the twelve months ended December 31, 2016, $0.5 million for the seven months ended December 31, 2015 and $0.6 million for each of the years ended May 31, 2015 and 2014. Transactions involving our performance awards during the twelve months ended December 31, 2016, the seven months ended December 31, 2016, and the years ended May 31, 2015, and 2014 are summarized below:

	Twelve Months Ended December 31,	Seven Months Ended December 31,

	2016		2015	
	No. of Performance Awards (in thousands)	Weighted Average Fair Value	No. of Performance Awards (in thousands)	Weighted Average Fair Value
Performance awards, beginning of year	13	$ 35.15	28	$ 32.86
Changes during the year:				
Granted	—	$ —	—	$ —
Vested and settled	(13)	$ 35.15	(15)	$ 30.82
Cancelled	—	$ —	—	$ —
Performance awards, end of year	—	$ —	13	$ 35.15

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	Year Ended May 31, 2015		Year Ended May 31, 2014	
	No. of Performance Awards (in thousands)	Weighted Average Fair Value	No. of Performance Awards (in thousands)	Weighted Average Fair Value
Performance awards, beginning of year	50	$ 30.63	57	$ 25.47
Changes during the year:				
Granted	—	$ —	17	$ 36.40
Vested and settled	(22)	$ 27.66	(24)	$ 22.65
Cancelled	—	$ —	—	$ —
Performance awards, end of year	28	$ 32.86	50	$ 30.63

We determine the fair value of each stock option at the grant date using a Black-Scholes model and recognize the resulting expense of our stock option awards over the period during which an employee is required to provide services in exchange for the awards, usually the vesting period. There was $0.2 million in compensation expense related to stock options for the twelve months ended December 31, 2016, but none for the seven months ended December 31, 2015, or the years ended May 31, 2015, and 2014, as all stock option awards were fully vested. Our options typically vest in equal annual installments over a four year service period. Expense related to an option grant is recognized on a straight line basis over the specified vesting period for those options. Stock options generally have a ten year term. Transactions involving our stock options during the twelve months ended December 31, 2016, the seven months ended December 31, 2015, and the years ended May 31, 2015, and 2014 are summarized below:

	Twelve Months Ended December 31, 2016		Seven Months Ended December 31, 2015	
	No. of Options (in thousands)	Weighted Average Exercise Price	No. of Options (in thousands)	Weighted Average Exercise Price
Shares under option, beginning of year	376	$ 25.71	490	$ 24.80
Changes during the year:				
Granted	—	$ —	—	$ —
Assumed - Furmanite Acquisition	132	$ 33.20	—	$ —
Exercised	(251)	$ 23.50	(109)	$ 21.41
Cancelled	(50)	$ 35.00	—	$ —
Expired	(4)	$ 44.62	(5)	$ 30.33
Shares under option, end of year	203	$ 30.63	376	$ 25.71
Exercisable at end of year	203	$ 30.63	376	$ 25.71

	Year Ended May 31, 2015		Year Ended May 31, 2014	
	No. of Options (in thousands)	Weighted Average Exercise Price	No. of Options (in thousands)	Weighted Average Exercise Price
Shares under option, beginning of year	816	$ 19.61	1,052	$ 20.24
Changes during the year:				

Granted	—	$ —	—	$ —
Exercised	(326)	$ 11.79	(232)	$ 22.69
Cancelled	—	$ —	—	$ —
Expired	—	$ —	(4)	$ 6.96
Shares under option, end of year	490	$ 24.80	816	$ 19.61
Exercisable at end of year	490	$ 24.80	816	$ 19.61

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Options exercisable at December 31, 2016 had a weighted-average remaining contractual life of 2.7 years. For total options outstanding at December 31, 2016, the range of exercise prices and remaining contractual lives are as follows:

Range of Prices	No. of Options	Weighted Average Exercise Price	Weighted Average Remaining Life
	(in thousands)		(in years)
\$20.19 to \$30.28	44	\$ 25.80	1.9
\$30.28 to \$40.38	152	\$ 31.08	2.7
\$40.38 to \$50.47	7	\$ 50.47	7.4
	203	\$ 30.63	2.7

12. EMPLOYEE BENEFIT PLANS

Defined Contribution Plan

Under the Team, Inc. Salary Deferral Plan (the "Plan"), contributions are made to the Plan by qualified employees at their election and our matching contributions to the Plan are made at specified rates. Our contributions to the Plan in the twelve months ended December 31, 2016, seven months ended December 31, 2015 and twelve months ended May 31, 2015 and 2014, were approximately \$7.1 million, \$3.0 million, \$4.8 million and \$4.4 million, respectively.

Defined Benefit Plans

In connection with our acquisition of Furmanite, we assumed liabilities associated with the defined benefit pension plans of two foreign subsidiaries, one plan covering certain United Kingdom employees (the "U.K. Plan") and the other covering certain of its Norwegian employees (the "Norwegian Plan"). As the Norwegian Plan represents approximately 1 percent of both the Company's total pension plan liabilities and total pension plan assets, only the schedules of net periodic pension cost and changes in benefit obligation and plan assets include combined amounts from the two plans, while all other assumption, detail and narrative information relates solely to the U.K. Plan. As the plans were assumed during 2016, comparative information for periods prior to the acquisition date is not applicable to Team's consolidated financial statements.

Benefits for the U.K. Plan are based on the average of the employee's salary for the last three years of employment. The U.K. Plan has had no new participants added since the plan was frozen in 1994 and accruals for future benefits ceased in connection with a plan curtailment in 2013. Plan assets are primarily invested in unitized pension funds managed by U.K. registered fund managers. The most recent valuation of the U.K. Plan was performed as of December 31, 2016. Estimated defined benefit pension plan contributions for 2017 are expected to be approximately \$1.4 million. We expect future plan contributions will increase by approximately 3% per year, in accordance with certain funding commitments.

Pension benefit costs and liabilities are dependent on assumptions used in calculating such amounts. The primary assumptions include factors such as discount rates, expected investment return on plan assets, mortality rates and retirement rates. The discount rate assumption used to determine end of year benefit obligations was 2.7%. These rates are reviewed annually and adjusted to reflect current conditions. These rates are determined appropriate based on reference to yields. The expected return on plan assets of 4.5% for 2017 is derived from detailed periodic studies, which include a review of asset allocation strategies, anticipated future long-term performance of individual asset classes, risks (standard deviations) and correlations of returns among the asset classes that comprise the plans' asset mix. While the studies give appropriate consideration to recent plan performance and historical returns, the assumptions are primarily long-term, prospective rates of return. Mortality and retirement rates are based on actual and anticipated plan experience. In accordance with GAAP, actual results that differ from the assumptions are accumulated and are subject to amortization over future periods and, therefore, generally affect recognized expense in future periods. While management believes that the assumptions used are appropriate, differences in actual experience or changes in assumptions may affect the pension obligation and future expense.

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Net pension cost included the following components (in thousands):

	Twelve Months Ended December 31, 2016[1]
Service cost	$ 79
Interest cost	2,504
Expected return on plan assets	(2,577)
Net periodic pension cost	$ 6

[1] Reflects net pension cost from the date of the Furmanite acquisition.

The weighted average assumptions used to determine benefit obligations at December 31, 2016 and February 29, 2016, the date of the Furmanite acquisition, are as follows:

	December 31, 2016	February 29, 2016
Discount rate	2.7 %	4.0 %
Rate of compensation increase[1]	Not applicable	Not applicable
Inflation	3.3 %	2.8 %

[1] Not applicable due to plan curtailment.

The weighted average assumptions used to determine net periodic benefit cost for the twelve months ended December 31, 2016 are as follows:

	Twelve Months Ended December 31, 2016
Discount rate	4.0 %
Expected long-term return on plan assets	4.9 %
Rate of compensation increase[1]	Not applicable
Inflation	2.8 %

[1] Not applicable due to plan curtailment.

The plan actuary determines the expected return on plan assets based on a combination of expected yields on equity securities and corporate bonds and considering historical returns.

The expected long-term rate of return on plan assets for 2017 is determined based on the weighted average of expected returns on asset investment categories as follows: 4.5% overall, 5.8% for equities and 1.8% for debt securities.

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The following table sets forth the changes in the benefit obligation and plan assets for the twelve months ended December 31, 2016 (in thousands):

	December 31, 2016
Projected benefit obligation:	
Beginning of year	$—
Acquisition of Furmanite	80,410
Service cost	79
Interest cost	2,504
Actuarial loss	18,233
Benefits paid	(2,804)
Foreign currency translation adjustment and other	(9,216)
End of year	89,206
Fair value of plan assets:	
Beginning of year	—
Acquisition of Furmanite	66,901
Actual gain on plan assets	10,222
Employer contributions	1,182
Benefits paid	(2,804)
Foreign currency translation adjustment and other	(7,534)
End of year	67,967
Excess projected obligation under (over) fair value of plan assets at end of year	$(21,239)
Amounts recognized in accumulated other comprehensive loss:	
Net actuarial loss	$10,518

No material amounts of accumulated other comprehensive loss are expected to be amortized as a component of net periodic benefit cost during 2017.

The accumulated benefit obligation for the U.K. Plan was $88.1 million at December 31, 2016.

At December 31, 2016, expected future benefit payments are as follows for the years ended December 31, (in thousands):

2017	$2,689
2018	2,681
2019	3,119
2020	3,742
2021	3,738
2022-2026	21,413
Total	$37,382

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The following table summarizes the plan assets of the U.K. Plan measured at fair value on a recurring basis (at least annually) as of December 31, 2016 (in thousands):

Asset Category	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2) (a)	Significant Unobservable Inputs (Level 3) (a)
Cash	$744	$ 744	$ —	$ —
Equity securities:				
U.K. equity (b)	13,927	—	13,927	—
U.S. equity index (c)	3,453	—	3,453	—
European equity index (d)	3,421	—	3,421	—
Pacific rim equity index (e)	2,645	—	2,645	—
Japanese equity index (f)	2,185	—	2,185	—
Emerging markets equity index (g)	2,014	—	2,014	—
Diversified growth fund (h)	11,637	—	11,637	—
Global absolute return fund (i)	5,821	—	5,821	—
Fixed income securities:				
Cash fund (j)	7,921	—	7,921	—
U.K. government fixed income securities (k)	5,454	—	5,454	—
U.K. government index-linked securities (l)	7,825	—	7,825	—
Total as of December 31, 2016	$67,047	$ 744	$ 66,303	$ —

a) The net asset value of the commingled equity and fixed income funds are determined by prices of the underlying securities, less the funds' liabilities, and then divided by the number of shares outstanding. As the funds are not traded in active markets, the commingled funds are classified as Level 2 or Level 3 assets. The net asset value is corroborated by observable market data (e.g., purchase or sale activities) for Level 2 assets.

b) This category includes investments in U.K. companies and aims to achieve a return that is consistent with the return of the FTSE All-Share Index.

c) This category includes investments in a variety of large and small U.S. companies and aims to achieve a return that is consistent with the return of the FTSE All-World USA Index.

d) This category includes investments in a variety of large and small European companies and aims to achieve a return that is consistent with the return of the FTSE All-World Developed Europe ex-U.K. Index.

e) This category includes investments in a variety of large and small companies across the Australian, Hong Kong, New Zealand and Singapore markets and aims to achieve a return that is consistent with the return of the FTSE-All-World Developed Asia Pacific ex-Japan Index.

f) This category includes investments in a variety of large and small Japanese companies and aims to achieve a return that is consistent with the return of the FTSE All-World Japan Index.

g) This category includes investments in companies in the Emerging Markets to achieve a return that is consistent with the return of the IFC Investable Index ex-Malaysia.

h) This category includes investments in a diversified portfolio of equity, bonds, alternatives and cash markets and aims to achieve a return that is consistent with the return of the Libor GBP 3 month +3% Index.

i) This category includes investments in a diversified portfolio of equity and bonds combined with investment strategies based on advanced derivative techniques and aims to achieve a return over rolling three-year periods equivalent to cash plus 5% per year, gross of fees.

j) This category includes investments in British pound sterling-denominated money market instruments and fixed-income securities issued by governments, corporations or other issuers which may be listed or traded on a recognized market.

k)

This category includes investments in funds with the objective to provide a leveraged return to U.K. government fixed income securities (gilts) that have maturity dates in 2040 and 2052.

l) This category includes investments in funds with the objective to provide a leveraged return to various U.K. government indexed-linked securities (gilts), with maturity periods ranging from 2022 to 2062. The funds invest in U.K. government bonds and derivatives.

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Investment objectives for the U.K. Plan, as of December 31, 2016, are to:
- optimize the long-term return on plan assets at an acceptable level of risk
- maintain a broad diversification across asset classes
- maintain careful control of the risk level within each asset class

The trustees of the U.K. Plan have established a long-term investment strategy comprising global investment weightings targeted at 65% (range of 60% to 70%) for equity securities/diversified growth funds and 35% (range of 30% to 40%) for debt securities. Diversified growth funds are actively managed absolute return funds that hold a combination of debt and equity securities. Selection of the targeted asset allocation was based upon a review of the expected return and risk characteristics of each asset class, as well as the correlation of returns among asset classes. Actual allocations to each asset class vary from target allocations due to periodic investment strategy changes, market value fluctuations and the timing of benefit payments and contributions.

The following table sets forth the weighted average asset allocation and target asset allocations as of December 31, 2016 by asset category:

	Asset Allocations		Target Asset Allocations	
Equity securities and diversified growth funds[1]	67.3	%	65.0	%
Debt securities[2]	31.6	%	35.0	%
Other	1.1	%	—	%
Total	100.0	%	100.0	%

1 Diversified growth funds refer to actively managed absolute return funds that hold a combination of equity and debt securities.

2 Includes investments in funds with the objective to provide leveraged returns to U.K. government fixed income securities and U.K. government indexed-linked securities.

13. COMMITMENTS AND CONTINGENCIES

Con Ed Matter—We have, from time to time, provided temporary leak repair services for the steam operations of Consolidated Edison Company of New York (“Con Ed”) located in New York City. In July 2007, a Con Ed steam main located in midtown Manhattan ruptured causing one death and other injuries and property damage. As of December 31, 2016, ninety-two lawsuits are currently pending against Con Ed, the City of New York and Team in the Supreme Courts of New York located in Kings, New York and Bronx County, alleging that our temporary leak repair services may have contributed to the cause of the rupture. The lawsuits seek generally unspecified compensatory damages for personal injury, property damage and business interruption. Additionally, on March 31, 2008, we received a letter from Con Ed alleging that our contract with Con Ed requires us to indemnify and defend Con Ed for additional claims filed against Con Ed as a result of the rupture. Con Ed filed an action to join Team and the City of New York as defendants in all lawsuits filed against Con Ed that did not include Team and the City of New York as direct defendants. We are vigorously defending the lawsuits and Con Ed’s claim for indemnification. We are unable to estimate the amount of liability to us, if any, associated with these lawsuits and the claim for indemnification. We filed a motion to dismiss in December 2016. Based upon the current briefing schedule, a ruling on the motion is anticipated in the fall of 2017. We maintain insurance coverage, subject to a deductible limit of $250,000, which we believe should cover these claims. We have not accrued any liability in excess of the deductible limit for the lawsuits. We do not believe the ultimate outcome of these matters will have a material adverse effect on our financial position, results of operations, or cash flows. We anticipate a trial on the merits during the first half of 2018.

Patent Infringement Matters—In December 2014, our subsidiary, Quest Integrity, filed three patent infringement lawsuits against three different defendants, two in the U.S. District of Delaware (the “Delaware Cases”) and one in the U.S. District of Western Washington (“Washington Case”). Quest Integrity alleges that the three defendants infringed Quest Integrity’s patent, entitled “2D and 3D Display System and Method for Furnace Tube Inspection”. This Quest Integrity patent generally teaches a system and method for displaying inspection data collected during the inspection of furnace tubes in petroleum and petro-chemical refineries. The subject patent litigation is specific to the visual display of the collected data and does not relate to Quest Integrity's underlying advanced inspection technology. In these lawsuits Quest Integrity is seeking temporary and permanent injunctive relief, as well as monetary damages. Defendants have denied they infringe any valid claim of Quest Integrity's patent, and have asserted declaratory judgment counterclaims that the patent at issue is invalid and/or unenforceable, and not infringed. In June 2015, the U.S. District of Delaware denied our motions for preliminary injunctive relief in the

Delaware Cases (that is, our request that the defendants stop using our patented systems and methods during the pendency of the actions). The Delaware Cases are expected to proceed to trial in the second quarter of 2017. The Washington Case does not have a trial date scheduled.

We are involved in various other lawsuits and are subject to various claims and proceedings encountered in the normal conduct of business. In our opinion, any uninsured losses that might arise from these lawsuits and proceedings will not have a materially adverse effect on our consolidated financial statements.

We establish a liability for loss contingencies, when information available to us indicates that it is probable that a liability has been incurred and the amount of loss can be reasonably estimated.

14. ENTITY WIDE DISCLOSURES

ASC 280, Segment Reporting, requires we disclose certain information about our operating segments where operating segments are defined as "components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance." We conduct operations in three segments: TeamQualspec Group, TeamFurmanite Group and Quest Integrity Group. All three operating segments operate under a business segment manager who reports directly to Team's Chief Executive Officer who operates as the chief operating decision maker. Furmanite, which we acquired in the first quarter of 2016 (see Note 2), is included in the TeamFurmanite segment, except that Furmanite's corporate-related activities are included within corporate and shared support services in the tables below. Discontinued operations are not allocated to the segments. Segment data for our three operating segments are as follows (in thousands):

	Twelve Months Ended December 31, 2016	Seven Months Ended December 31, 2015	Twelve Months Ended May 31, 2015	2014
Revenues:				
TeamQualspec	$589,478	$351,949	$467,099	$408,259
TeamFurmanite	539,627	178,238	300,456	275,322
Quest Integrity	67,591	41,531	74,492	65,946
Total	$1,196,696	$571,718	$842,047	$749,527

	Twelve Months Ended December 31, 2016	Seven Months Ended December 31, 2015	Twelve Months Ended May 31, 2015	2014
Operating income (loss):				
TeamQualspec	$43,367	$31,175	$60,198	$47,787
TeamFurmanite	27,283	14,335	28,713	26,177
Quest Integrity	4,780	5,491	13,196	9,260
Corporate and shared support services	(78,548)	(31,839)	(33,642)	(29,803)
Total	$(3,118)	$19,162	$68,465	$53,421

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	Twelve Months Ended December 31, 2016	Seven Months Ended December 31, 2015	Twelve Months Ended May 31, 2015	2014
Capital expenditures:				
TeamQualspec	$ 8,803	$ 6,557	$10,276	$8,104
TeamFurmanite	15,077	5,656	4,916	6,114
Quest Integrity	2,007	1,993	2,961	4,366
Corporate and shared support services	19,956	11,596	10,616	14,432
Total	$ 45,843	$ 25,802	$28,769	$33,016

	Twelve Months Ended December 31, 2016	Seven Months Ended December 31, 2015	Twelve Months Ended May 31, 2015	2014
Depreciation and amortization:				
TeamQualspec	$ 19,853	$ 10,568	$8,413	$7,953
TeamFurmanite	21,387	4,779	7,583	7,208
Quest Integrity	5,323	3,403	5,704	5,475
Corporate and shared support services	2,110	676	1,087	832
Total	$ 48,673	$ 19,426	$22,787	$21,468

Separate measures of Team’s assets by operating segment are not produced or utilized by management to evaluate segment performance.

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A geographic breakdown of our revenues for the twelve months ended December 31, 2016, for the seven months ended December 31, 2015, and for the twelve months ended May 31, 2015 and 2014 and our total assets as of December 31, 2016 and 2015 are as follows (in thousands):

	Total Revenues[1]	Total Assets
Twelve months ended December 31, 2016		
United States	$889,967	$788,780
Canada	128,122	66,056
Europe	108,720	234,847
Other foreign countries	69,887	57,735
Total	$1,196,696	$1,147,418
Seven months ended December 31, 2015		
United States	$448,508	$682,124
Canada	71,325	59,626
Europe	27,718	33,271
Other foreign countries	24,167	23,970
Total	$571,718	$798,991
Twelve months ended May 31, 2015		
United States	$625,044	$399,173
Canada	132,573	68,043
Europe	47,524	34,612
Other foreign countries	36,906	22,005
Total	$842,047	$523,833
Twelve months ended May 31, 2014		
United States	$540,967	$353,624
Canada	126,874	68,515
Europe	42,248	38,870
Other foreign countries	39,438	23,932
Total	$749,527	$484,941

[1] Revenues attributable to individual countries/geographic areas are based on the country of domicile of the legal entity that performs the work.

15. DISCONTINUED OPERATIONS

As part of our acquisition of Furmanite, we acquired a pipeline inspection business that primarily performs process management inspection services to contractors and operators participating primarily in the midstream oil and gas market in the United States. The business generates approximately $60 million in annual revenues. Upon acquisition, we concluded that this business was not a strategic fit for Team and therefore we decided not to retain it and began a process of marketing the business to prospective buyers. In December 2016, we completed the sale of this business and received proceeds of $13.3 million cash (net of costs to sell) and a $1.5 million principal amount of a note from the buyer that bears interest at a 5% stated rate per annum, payable quarterly in arrears, with the principal amount due in full at maturity in January 2020.

We concluded that this business qualifies as a discontinued operation upon its acquisition under GAAP. Therefore, we classified the operating results as discontinued operations in our consolidated statements of operations. Discontinued operations does not include any allocation of corporate overhead expense or interest expense. Due to the acquisition of this business and the completion of its sale all within the twelve months ended December 31, 2016, there are no assets or liabilities of discontinued operations reported as held for sale in the consolidated balance sheets at December 31, 2016 or 2015. For information about the assets and liabilities of discontinued operations acquired in the Furmanite acquisition, see Note 2.

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Loss from discontinued operations, net of income tax, from the date of the Furmanite acquisition, consists of the following (in thousands):

	Year Ended December 31, 2016
Revenues	$ 46,771
Operating expenses	43,081
Gross margin	3,690
Selling, general and administrative expenses	1,939
Gain on disposal	7
Income from discontinued operations, before income tax	1,758
Less: Provision for income taxes	1,869
Loss from discontinued operations, net of income tax	$ (111)

The provision for income taxes on discontinued operations includes the effect of a permanent difference associated with non-deductible goodwill that was derecognized as part of the disposal transaction.

Cash flows attributable to our discontinued operations are included in our statements of consolidated cash flows. For the year ended December 31, 2016, there were no material amounts of depreciation, amortization, capital expenditures or significant operating non-cash items related to discontinued operations. The $1.5 million principal amount note receivable from the buyer, which was part of the consideration received from the sale of discontinued operations, is a non-cash investing activity.

16. EXIT COSTS AND OTHER RELATED CHARGES

Exit costs and other related charges for the year ended December 31, 2016 are associated with the restructuring/closure of the acquired Furmanite operations in Western Europe in the TeamFurmanite segment. Due to continued economic softness in these particular markets and unfavorable cost structures, we committed to a plan to exit these operations in the fourth quarter of 2016 and communicated the plan to the affected employees. We expect the closures to be essentially complete by end of the second quarter of 2017. Of the total $5.5 million of exit and other related charges recognized during the year ended December 31, 2016, $4.8 million is associated with accruals for employee separation costs, substantially all of which are expected to be settled during the first half of 2017, and $0.7 million is attributable to an impairment loss on property, plant and equipment in these operations. We estimate that we will incur additional costs, primarily related to lease terminations, of approximately $1.3 million in 2017 as the closures are completed.

17. VENEZUELAN OPERATIONS

In June 2015, we disposed of our Venezuelan operations and realized no gain or loss from the transaction. Our annual revenues have historically been less than one percent of our consolidated revenues for all periods presented. Because of the uncertain political environment in Venezuela, starting in the quarter ended February 28, 2010, we began to account for Venezuelan operations pursuant to accounting guidance for hyperinflationary economies. Following the designation of the Venezuelan economy as hyperinflationary, we ceased taking the effects of currency fluctuations to accumulated other comprehensive income and began reflecting all effects as a component of other income in our statement of operations.

Prior to February 1, 2015, we included the results of our Venezuelan operations in our consolidated financial statements using the consolidation method of accounting. Venezuelan exchange control regulations have resulted in an other-than-temporary lack of exchangeability between the Venezuelan Bolivar and U.S. Dollar, and have restricted our Venezuelan operations' ability to pay dividends and obligations denominated in U.S. Dollars. These exchange regulations, combined with other recent Venezuelan regulations, have constrained equipment availability and are now significantly limiting our Venezuelan operations' ability to maintain normal operations. As a result of these conditions, and in accordance with ASC 810, Consolidation, we began reporting the results of our Venezuelan operations using

the cost method of accounting. The change, which we made effective February 1, 2015, resulted in a pre-tax charge of $1.2 million for the twelve months ended May 31, 2015.
During the year ended May 31, 2014, we began using an alternative Venezuelan, state-run exchange rate, commonly referred to as SICAD-1, to translate local currency financial statements. As a result of the revaluation, we recognized a $1.9

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million foreign currency loss in the quarter ended February 28, 2014. In March 2014, a market-based, state-run exchange, commonly referred to as SICAD-2, was initiated by the Central Bank of Venezuela. From March 2014, Team began using the nascent market-based, state-run exchange rate, commonly referred to as SICAD-2 (approximately 50 Bolivars to the U.S. Dollar) to translate local currency financial statements, changing from the SICAD-1 rate (which fluctuated between 10 and 11.8 Bolivars per U.S. Dollar). As a result, Team incurred an additional $2.1 million currency exchange loss associated with a further revaluation of our Venezuelan business in the quarter ended May 31, 2014.

18. ACCUMULATED OTHER COMPREHENSIVE LOSS

A summary of changes in accumulated other comprehensive loss included within shareholders' equity is as follows (in thousands):

	Twelve Months Ended December 31, 2016					Seven Months Ended December 31, 2015			
	Foreign Currency Translation Adjustments	Foreign Currency Hedge	Defined benefit pension plans	Tax Provision	Total	Foreign Currency Translation Adjustments	Foreign Currency Hedge	Tax Provision	Total
Balance at beginning of year	$(28,124)	$ 4,567	$—	$ 5,183	$(18,374)	$(20,896)	$ 4,466	$ 2,892	$(13,538)
Other comprehensive income (loss) before tax	(3,849)	481	(10,518)	3,260	(10,626)	(7,228)	101	2,291	(4,836)
Balance at end of year	$(31,973)	$ 5,048	$(10,518)	$ 8,443	$(29,000)	$(28,124)	$ 4,567	$ 5,183	$(18,374)

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The following table represents the related tax effects allocated to each component of other comprehensive income (loss) (in thousands):

	Twelve Months Ended December 31, 2016			Seven Months Ended December 31, 2015		
	Gross Amount	Tax Effect	Net Amount	Gross Amount	Tax Effect	Net Amount
Foreign currency translation adjustments	$(3,849)	$1,351	$(2,498)	$(7,228)	$2,330	$(4,898)
Foreign currency hedge	481	(181)	300	101	(39)	62
Defined benefit pension plans	(10,518)	2,090	(8,428)	—	—	—
Total	$(13,886)	$3,260	$(10,626)	$(7,127)	$2,291	$(4,836)

	Twelve Months Ended May 31, 2015			Twelve Months Ended May 31, 2014		
	Gross Amount	Tax Effect	Net Amount	Gross Amount	Tax Effect	Net Amount
Foreign currency translation adjustments	$(15,822)	$2,559	$(13,263)	$(1,613)	$1,213	$(400)
Foreign currency hedge	3,237	(904)	2,333	(775)	285	(490)
Total	$(12,585)	$1,655	$(10,930)	$(2,388)	$1,498	$(890)

19. ISSUANCE AND REPURCHASE OF COMMON STOCK

At-the-Market Equity Issuance Program

On November 28, 2016, we filed with the SEC a prospectus supplement, to our October 2016 shelf registration statement on Form S-3 (the “Shelf Registration Statement”), under which we may sell up to $150.0 million of our common stock through an “at-the-market” equity offering program (the “ATM Program”). Through December 31, 2016, we sold 167,931 shares of common stock under the ATM Program. The net proceeds from such sales were $6.0 million after deducting the aggregate commissions paid of approximately $0.1 million and were used to reduce outstanding indebtedness. The Company intends to use the net proceeds from any future sales under the ATM Program primarily to reduce outstanding indebtedness, which may include amounts outstanding under the Company’s Credit Facility, and for general corporate purposes. The timing of any additional sales of common stock made pursuant to the ATM Program will depend on a variety of factors to be determined by the Company. In connection with the filing of the Shelf Registration Statement and the commencement of the ATM Program, we capitalized costs totaling $0.7 million, which are being allocated as issuance costs as sales of securities occur.

Common Stock Repurchase Plan

On October 1, 2013, our Board approved an initial $25 million stock repurchase plan, superseding and replacing our previous stock repurchase plan. During the quarter ended November 30, 2013, we repurchased 369,900 shares for a total cost of $13.3 million. These shares, along with 89,569 shares purchased under a previous plan in a prior period at a cost of $1.3 million, were retired and are not included in common stock issued and outstanding as of May 31, 2014. The retirement of the shares purchased resulted in a reduction in common stock of $0.1 million, a reduction of $2.2 million to additional paid-in capital, and a $12.3 million reduction in retained earnings.

On June 23, 2014, our Board authorized an increase in the stock repurchase plan limit to $50.0 million (net of the $13.3 million repurchased in the quarter ended November 30, 2013). During twelve months ended May 31, 2015, we repurchased 546,977 shares for a total cost of $21.1 million. During the year ended December 31, 2016, we repurchased 274,110 shares for a total cost of $7.6 million. In the fourth quarter of 2016, these 821,087 shares were retired and are not included in common stock issued and outstanding as of December 31, 2016. The retirement of the shares resulted in a reduction in common stock of $0.2 million, a reduction of $9.1 million to additional paid-in capital, and a $19.4 million reduction to retained earnings.At December 31, 2016, $7.9 million remained available to repurchase shares under the stock repurchase plan.

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20. TWELVE MONTHS ENDED DECEMBER 31, 2015 AND SEVEN MONTHS ENDED DECEMBER 31, 2014 COMPARATIVE DATA (Unaudited)

The condensed consolidated statements of income for the twelve months ended December 31, 2015 and the seven months ended December 31, 2014 is as follows: (in thousands, except per share data)

	Twelve Months Ended December 31, 2015	Seven Months Ended December 31, 2014
Revenues	$926,356	$487,408
Operating expenses	655,465	337,977
Gross margin	270,891	149,431
Selling, general and administrative expenses	223,078	109,348
Loss on revaluation of contingent consideration	522	—
Operating income	47,291	40,083
Interest expense, net	5,792	1,332
Foreign currency loss	1,125	1,197
Other expense, net	1,184	—
Earnings from continuing operations before income taxes	39,190	37,554
Less: Provision for income taxes	13,744	13,622
Income from continuing operations	25,446	23,932
Income from discontinued operations, net of income tax	—	—
Net income	25,446	23,932
Less: income attributable to noncontrolling interest	213	214
Net income available to Team shareholders	$25,233	$23,718
Income from continuing operations per share and net income per share: Basic	$1.21	$1.15
Income from continuing operations per share and net income per share: Diluted	$1.18	$1.08
Weighted average shares outstanding:		
Basic	20,780	20,593
Diluted	21,378	21,907

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21. QUARTERLY FINANCIAL DATA (Unaudited)

The following is a summary of selected unaudited quarterly financial data for the years ended December 31, 2016 and 2015 (in thousands, except per share data):

	Year Ended December 31, 2016				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total Year
Revenues	$250,854	$336,440	$289,577	$319,825	$1,196,696
Operating income (loss)	$(7,380)	$14,008	$(4,043)	$(5,703)	$(3,118)
Income (loss) from continuing operations	$(6,560)	$6,970	$(4,537)	$(8,438)	$(12,565)
Net income (loss) available to Team shareholders	$(6,434)	$7,356	$(4,221)	$(9,377)	$(12,676)
Basic earnings (loss) per share:					
Continuing operations	$(0.27)	$0.24	$(0.15)	$(0.29)	$(0.45)
Net income (loss)	$(0.27)	$0.25	$(0.14)	$(0.32)	$(0.45)
Diluted earnings (loss) per share:					
Continuing operations	$(0.27)	$0.24	$(0.15)	$(0.29)	$(0.45)
Net income (loss)	$(0.27)	$0.25	$(0.14)	$(0.32)	$(0.45)

	Year Ended December 31, 2015				
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total Year
Revenues	$192,407	$235,399	$243,552	$254,998	$926,356
Operating income	$7,699	$22,034	$6,857	$10,701	$47,291
Income from continuing operations	$3,366	$14,068	$2,547	$5,465	$25,446
Net income available to Team shareholders	$3,306	$13,915	$2,547	$5,465	$25,233
Basic earnings per share:					
Continuing operations	$0.16	$0.69	$0.13	$0.26	$1.21
Net income	$0.16	$0.69	$0.13	$0.26	$1.21
Diluted earnings per share:					
Continuing operations	$0.15	$0.65	$0.12	$0.26	$1.18
Net income	$0.15	$0.65	$0.12	$0.26	$1.18

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FIVE YEAR COMPARISON

The following table presents our selected financial data. This information has been derived from our audited consolidated financial statements. This historical data should be read in conjunction with the Consolidated Financial Statements and the related notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations." (In thousands, except per share data)

	Year Ended December 31,	Seven Months Ended December 31,	Years Ended May 31,			
	2016	2015	2015	2014	2013	2012
Statements of operations data:						
Revenues	$1,196,696	$571,718	$842,047	$749,527	$714,311	$623,740
Operating income (loss)	$(3,118)	$19,162	$68,465	$53,421	$55,602	$56,497
Income (loss) from continuing operations	$(12,565)	$8,878	$40,497	$30,149	$32,714	$33,068
Net income (loss) available to Team shareholders	$(12,676)	$8,878	$40,070	$29,855	$32,436	$32,911
Basic earnings (loss) per share:						
Continuing operations	$(0.45)	$0.43	$1.95	$1.46	$1.61	$1.67
Net income (loss)	$(0.45)	$0.43	$1.95	$1.46	$1.61	$1.67
Diluted earnings (loss) per share:						
Continuing operations	$(0.45)	$0.41	$1.85	$1.40	$1.53	$1.59
Net income (loss)	$(0.45)	$0.41	$1.85	$1.40	$1.53	$1.59
Weighted-average shares outstanding						
Basic	28,095	20,852	20,500	20,439	20,203	19,667
Diluted	28,095	21,425	21,651	21,285	21,166	20,660
Balance sheet data:						
Total assets	$1,147,418	$798,991	$523,833	$484,941	$460,203	$403,788
Long-term debt and other long-term liabilities	$464,060	$368,685	$97,234	$92,753	$95,209	$97,131
Stockholders' equity	$535,637	$338,146	$335,375	$317,045	$292,190	$245,001
Working capital	$253,636	$222,399	$197,472	$173,671	$174,114	$157,019
Noncontrolling interest	$—	$—	$6,034	$5,678	$5,384	$5,097
Other financial data:						
Depreciation and amortization	$48,673	$19,426	$22,787	$21,468	$19,664	$17,469
Share-based compensation	$7,313	$3,469	$4,838	$4,239	$3,931	$4,386
Capital expenditures	$45,843	$25,802	$28,769	$33,016	$26,068	$23,924

OTTOM:3px solid #000000" BGCOLOR="#dddddd" ALIGN="right">**(1,204)** **18** **(1,186)** **(3,676)** **(205)** **(210)** *30 June 2012 compared with 31 December 2011* Half-year to 30 June 2012 (1H12) compared with half-year to 31 December 2011 (2H11)

2H11

as reported

US$m

Currency

Translation[10]

US$m

2H11

at 1H12

exchange

rates

US$m

1H12 as reported US$m	Reported change[11] %	Constant currency change[11] %

Net interest expense

(430) 12 (418) (464) 8 11

Net fee income

31 (5) 26 100 223 285

Changes in fair value[12]

4,076 (38) 4,038 (2,170)

Other income[13]

3,440 (19) 3,421 2,872 (17) (16)

Net operating income[14]

7,117 (50) 7,067 338 (95) (95)

Loan impairment (charges)/recoveries and other credit risk provisions

(2) 5 3 100 (100)

Net operating income

7,115 (45) 7,070 338 (95) (95)

Operating expenses

(4,206) 27 (4,179) (4,049) 4 3

Operating profit/(loss)

2,909 (18) 2,891 (3,711)

Share of profit/(loss) in associates and joint ventures

(43) 1 (42) 35

Profit/(loss) before tax

2,866 (17) 2,849 (3,676)

For footnotes, see page 100.

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Reconciliation of reported and underlying revenue[15]

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported revenue	**338**	2,028	(83)	**338**	7,117	(95)
Constant currency		(59)			(12)	
Own credit spread	**2,170**	143		**2,170**	(4,076)	
Acquisitions, disposals and dilutions	**(130)**	(181)		**(130)**	(27)	
Underlying revenue	**2,378**	1,931	23	**2,378**	3,002	(21)

Reconciliation of reported and underlying loan impairment charges and other credit risk provisions (LIC s)

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported LICs		2	(100)		(2)	100
Constant currency		(2)			5	
Acquisitions, disposals and dilutions						
Underlying LICs					3	(100)

Reconciliation of reported and underlying operating expenses

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported operating expenses	**(4,049)**	(3,286)	(23)	**(4,049)**	(4,206)	4
Constant currency		82			27	
Acquisitions, disposals and dilutions						
Underlying operating expenses	**(4,049)**	(3,204)	(26)	**(4,049)**	(4,179)	3
Underlying cost efficiency ratio	**170.3%**	165.9%		**170.3%**	139.2%	

Reconciliation of reported and underlying profit before tax

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported profit before tax	**(3,676)**	(1,204)	(205)	**(3,676)**	2,866	
Constant currency		18			21	
Own credit spread	**2,170**	143		**2,170**	(4,076)	
Acquisitions, disposals and dilutions	**(130)**	(181)		**(130)**	21	
Underlying profit before tax	**(1,636)**	(1,224)	(34)	**(1,636)**	(1,168)	(40)

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Analysis by global business

HSBC profit/(loss) before tax and balance sheet data

	Half-year to 30 June 2012						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other[46] US$m	Inter-segment elimination[57] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/ (expense)	10,774	5,144	3,625	672	(464)	(375)	19,376
Net fee income	3,760	2,224	1,598	625	100		8,307
Trading income/(expense) excluding net interest income	20	315	2,785	254	(240)		3,134
Net interest income on trading activities	14	6	950	5	35	375	1,385
Net trading income/ (expense)[51]	34	321	3,735	259	(205)	375	4,519
Net income/(expense) from financial instruments designated at fair value	519	72	501		(2,275)		(1,183)
Gains less losses from financial investments	20	2	700	(4)	305		1,023
Dividend income	13	10	55	4	21		103
Net earned insurance premiums	5,792	882	17	9	(4)		6,696
Gains on disposal of US branch network and cards business	3,597	212					3,809
Other operating income	738	208	117	84	2,860	(2,985)	1,022
Total operating income	25,247	9,075	10,348	1,649	338	(2,985)	43,672
Net insurance claims[58]	(5,932)	(822)	(13)	(8)			(6,775)
Net operating income[48]	19,315	8,253	10,335	1,641	338	(2,985)	36,897
Loan impairment charges and other credit risk provisions	(3,273)	(924)	(598)	(4)			(4,799)
Net operating income	16,042	7,329	9,737	1,637	338	(2,985)	32,098
Employee expenses[59]	(2,944)	(1,106)	(2,181)	(617)	(4,057)		(10,905)
Other operating income/ (expenses)	(7,274)	(2,630)	(2,892)	(496)	8	2,985	(10,299)
Total operating expenses	(10,218)	(3,736)	(5,073)	(1,113)	(4,049)	2,985	(21,204)
Operating profit/(loss)	5,824	3,593	4,664	524	(3,711)		10,894
Share of profit in associates and joint ventures	586	836	383	3	35		1,843
Profit/(loss) before tax	6,410	4,429	5,047	527	(3,676)		12,737

	%	%	%	%	%		%
Share of HSBC s profit before tax	**50.3**	**34.8**	**39.6**	**4.1**	**(28.8)**		**100.0**
Cost efficiency ratio	**52.9**	**45.3**	**49.1**	**67.8**			**57.5**
Balance sheet data[47]							
	US$m	**US$m**	**US$m**	**US$m**	**US$m**		**US$m**
Loans and advances to customers (net)	**363,353**	**272,817**	**290,749**	**44,018**	**4,048**		**974,985**
Total assets	**526,069**	**351,157**	**1,905,455**	**119,271**	**179,703**	**(429,321)**	**2,652,334**
Customer accounts	**531,782**	**317,077**	**316,219**	**109,101**	**4,310**		**1,278,489**

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HSBC HOLDINGS PLC

Interim Management Report (continued)

HSBC profit/(loss) before tax and balance sheet data (continued)

	Half-year to 30 June 2011						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other[46] US$m	Inter-segment elimination[57] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/ (expense)	12,086	4,814	3,603	729	(481)	(516)	20,235
Net fee income	4,212	2,131	1,730	731	3		8,807
Trading income/(expense) excluding net interest income	166	280	2,830	198	(243)		3,231
Net interest income on trading activities	22	16	997	9	21	516	1,581
Net trading income/ (expense)[51]	188	296	3,827	207	(222)	516	4,812
Net income/(expense) from financial instruments designated at fair value	343	55	(212)		(286)		(100)
Gains less losses from financial investments	70	2	414	(3)	2		485
Dividend income	14	8	39	4	22		87
Net earned insurance premiums	5,698	985	23		(6)		6,700
Other operating income	688	263	280	21	2,997	(2,964)	1,285
Total operating income	23,299	8,554	9,704	1,689	2,029	(2,964)	42,311
Net insurance claims[58]	(5,727)	(874)	(15)		(1)		(6,617)
Net operating income[48]	17,572	7,680	9,689	1,689	2,028	(2,964)	35,694
Loan impairment (charges)/ recoveries and other credit risk provisions	(4,270)	(642)	(334)	(22)	2		(5,266)
Net operating income	13,302	7,038	9,355	1,667	2,030	(2,964)	30,428
Employee expenses[59]	(3,169)	(1,210)	(2,396)	(688)	(3,058)		(10,521)
Other operating expenses	(7,577)	(2,255)	(2,464)	(429)	(228)	2,964	(9,989)
Total operating expenses	(10,746)	(3,465)	(4,860)	(1,117)	(3,286)	2,964	(20,510)
Operating profit/(loss)	2,556	3,573	4,495	550	(1,256)		9,918
Share of profit in associates and joint ventures	570	616	316	2	52		1,556
Profit/(loss) before tax	3,126	4,189	4,811	552	(1,204)		11,474
	%	%	%	%	%		%
Share of HSBC s profit before tax	27.3	36.5	41.9	4.8	(10.5)		100.0
Cost efficiency ratio	61.2	45.1	50.2	66.1	162.0		57.5

Balance sheet data[47]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	400,944	268,037	321,061	44,612	3,234		1,037,888
Total assets	557,952	336,094	1,942,835	122,888	189,912	(458,694)	2,690,987
Customer accounts	541,998	301,169	359,757	115,245	818		1,318,987

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HSBC HOLDINGS PLC

Interim Management Report (continued)

	Half-year to 31 December 2011						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other[46]	Inter-segment elimination[57]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit before tax							
Net interest income/ (expense)	12,015	5,117	3,660	710	(430)	(645)	20,427
Net fee income	4,014	2,160	1,497	651	31		8,353
Trading income/(expense) excluding net interest income	(728)	285	476	217	(198)		52
Net interest income on trading activities	21	3	901	7	65	645	1,642
Net trading income/ (expense)[51]	(707)	288	1,377	224	(133)	645	1,694
Net income/(expense) from financial instruments designated at fair value	(1,104)	(22)	140		4,525		3,539
Gains less losses from financial investments	54	18	347	6	(3)		422
Dividend income	13	7	36	3	3		62
Net earned insurance premiums	5,184	971	24		(7)		6,172
Other operating income	219	220	297	9	3,130	(3,394)	481
Total operating income	19,688	8,759	7,378	1,603	7,116	(3,394)	41,150
Net insurance claims[58]	(3,727)	(828)	(10)		1		(4,564)
Net operating income[48]	15,961	7,931	7,368	1,603	7,117	(3,394)	36,586
Loan impairment charges and other credit risk provisions	(5,049)	(1,096)	(650)	(64)	(2)		(6,861)
Net operating income	10,912	6,835	6,718	1,539	7,115	(3,394)	29,725
Employee expenses[59]	(3,369)	(974)	(1,800)	(663)	(3,839)		(10,645)
Other operating expenses	(7,087)	(2,782)	(3,062)	(486)	(367)	3,394	(10,390)
Total operating expenses	(10,456)	(3,756)	(4,862)	(1,149)	(4,206)	3,394	(21,035)
Operating profit	456	3,079	1,856	390	2,909		8,690
Share of profit/(loss) in associates and joint ventures	688	679	382	2	(43)		1,708
Profit before tax	1,144	3,758	2,238	392	2,866		10,398
	%	%	%	%	%		%
Share of HSBC s profit before tax	11.0	36.1	21.5	3.8	27.6		100.0
Cost efficiency ratio	65.5	47.4	66.0	71.7	59.1		57.5
Balance sheet data[47]							
	US$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

For footnotes, see page 100.

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Disposals, held for sale and run-off portfolios

In implementing our strategy, we have sold or agreed to sell a number of businesses across the Group. We expect these disposals to have a significant adverse effect on both the revenue and the profitability of the global businesses in the future, particularly RBWM due to the sale of the profitable US Card and Retail Services portfolio. In addition, two significant portfolios are being run

down. We expect the losses on these portfolios to continue to adversely affect RBWM and GB&M in the future.

The table below presents the historical results of these businesses. We do not expect the historical results to be indicative of future results because of disposal or run-off. Fixed allocated costs, included in total operating costs, will not necessarily be removed upon disposal and have been separately identified on page 38.

Summary income statements for disposals, held for sale and run-off portfolios[43,44]

	Half-year to 30 June 2012				
	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
Net interest income	2,812	75	28	5	(1)
Net fee income/(expense)	411	(10)	(4)	2	
Net trading income[51]	(223)	2	22	1	1
Net income/(expense) from financial instruments designated at fair value	2	1	5		(513)
Gains less losses from financial investments	15	1	(37)		
Dividend income	2				
Net earned insurance premiums	309	132	20		
Other operating income	(8)	16	(3)		
Total operating income	3,320	217	31	8	(513)
Net insurance claims incurred and movement in liabilities to policyholders	(156)	(84)	(13)		
Net operating income[14]	3,164	133	18	8	(513)
Loan impairment charges and other credit risk provisions	(1,927)	(1)	(268)	0	
Net operating income	1,237	132	(250)	8	(513)

Total operating expenses	(1,337)	(97)	(76)	(10)	(9)
Operating profit/(loss)	**(100)**	**35**	**(326)**	**(2)**	**(522)**
Share of profit in associates and joint ventures		1			1
Profit/(loss) before tax	**(100)**	**36**	**(326)**	**(2)**	**(521)**
By geographical region					
Europe			(369)		
Hong Kong	19		2		
Rest of Asia-Pacific	2	4	(1)	(2)	1
Middle East and North Africa	10		25		
North America	(159)	9	(9)		(513)
Latin America	28	23	26		(9)
Profit/(loss) before tax	(100)	36	(326)	(2)	(521)
Gain on sale	3,837	247	18	67	130

For footnotes, see page 100.

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Geographical regions

Summary

In the analysis of profit and loss by geographical region that follows, operating income and operating expenses include intra-HSBC items of US$1,630m (first half of 2011: US$1,567m; second half of 2011: US$1,854m).

Profit/(loss) before tax

	Half-year to					
	30 June 2012		30 June 2011		31 December 2011	
	US$m	%	US$m	%	US$m	%
Europe	**(667)**	**(5.2)**	2,147	18.7	2,524	24.3
Hong Kong	**3,761**	**29.5**	3,081	26.9	2,742	26.4
Rest of Asia-Pacific	**4,372**	**34.3**	3,742	32.6	3,729	35.8
Middle East and North Africa	**772**	**6.1**	747	6.5	745	7.2
North America	**3,354**	**26.3**	606	5.3	(506)	(4.9)
Latin America	**1,145**	**9.0**	1,151	10.0	1,164	11.2
	12,737	**100.0**	11,474	100.0	10,398	100.0

Total assets[47]

	At 30 June 2012		At 30 June 2011		At 31 December 2011	
	US$m	%	US$m	%	US$m	%
Europe	**1,375,553**	**51.9**	1,379,308	51.2	1,281,945	50.3
Hong Kong	**486,608**	**18.3**	474,044	17.6	473,024	18.5

Rest of Asia-Pacific	**334,978**	**12.6**	298,590	11.1	317,816	12.4
Middle East and North Africa	**62,881**	**2.4**	58,038	2.2	57,464	2.2
North America	**500,590**	**18.9**	529,386	19.7	504,302	19.7
Latin America	**138,968**	**5.2**	163,611	6.1	144,889	5.7
Intra-HSBC items	**(247,244)**	**(9.3)**	(211,990)	(7.9)	(223,861)	(8.8)
	2,652,334	**100.0**	2,690,987	100.0	2,555,579	100.0

Risk-weighted assets[60]

	At 30 June 2012		At 30 June 2011		At 31 December 2011	
	US$bn	**%**	US$bn	%	US$bn	%
Total	**1,159.9**		1,168.5		1,209.5	
Europe	**329.5**	**27.9**	315.7	26.9	340.2	27.8
Hong Kong	**108.0**	**9.1**	110.8	9.5	105.7	8.6
Rest of Asia-Pacific	**303.2**	**25.7**	241.1	20.6	279.3	22.8
Middle East and North Africa	**63.0**	**5.3**	58.1	5.0	58.9	4.8
North America	**279.2**	**23.6**	335.8	28.6	337.3	27.6
Latin America	**99.8**	**8.4**	110.5	9.4	102.3	8.4

For footnotes, see page 100.

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Europe

Our principal banking operations in Europe are HSBC Bank plc in the UK, HSBC France, 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 operations we provide a wide range of banking, treasury and financial services to personal, commercial and corporate customers across Europe.

	Half-year to		
	30 Jun 2012 US$m	30 Jun 2011 US$m	31 Dec 2011 US$m
Net interest income	**5,073**	5,566	5,435
Net fee income	**3,023**	3,131	3,105
Net trading income	**1,851**	2,007	154
Other income/(expense)	**(280)**	636	4,212
Net operating income[48]	**9,667**	11,340	12,906
Impairment charges[49]	**(1,037)**	(1,173)	(1,339)
Net operating income	**8,630**	10,167	11,567
Total operating expenses	**(9,289)**	(8,014)	(9,055)
Operating profit/(loss)	**(659)**	2,153	2,512
Income from associates[50]	**(8)**	(6)	12
Profit/(loss) before tax	**(667)**	2,147	2,524
Cost efficiency ratio	**96.1%**	70.7%	70.2%
RoRWA[40]	**(0.4%)**	1.4%	1.6%
Period-end staff numbers	**73,143**	76,879	74,892

12%

reduction in reported

loan impairment charges[49]

11%

market share of new

UK mortgage lending

Strong trade revenue growth

For footnotes, see page 100.

The commentary on Europe is on a constant currency basis unless stated otherwise.

Economic background

The **UK** economy remained weak in the first half of 2012. In the second quarter, the level of real Gross Domestic Product (GDP) fell by 0.7%, the third consecutive quarterly contraction. Despite this, the unemployment rate fell slightly to 8.1% in the three months to May, from 8.4% at the end of 2011, although much of the job creation was in part-time work. Consumer Prices Index (CPI) inflation fell sharply from 4.2% in December 2011 to 2.4% in June, in part reflecting the removal of last year s rise in VAT from the annual comparison. The Bank of England left interest rates unchanged at 0.5% but loosened monetary policy by extending its programme of asset purchases by £50bn to £325bn (US$510bn). Strains in the banking system arising from the eurozone sovereign crisis contributed to a tightening in credit conditions for both households and firms, prompting the UK authorities to announce more direct measures aimed at boosting the flow of credit.

The **eurozone** economy continued to face stresses related to the sovereign debt crisis in the first half of 2012. While the economy as a whole stagnated in the first quarter, divergences between countries in the north of the region and those in the south continued to widen. Concerns surrounding the health of the financial sector led the ECB to provide greater liquidity through a long-term repo operation in February 2012. As oil prices eased, eurozone inflation began to moderate towards the ECB s price stability target, allowing it to maintain the refi rate at 1.0% in the period. Worries over the sovereign bond market and the banking sector intensified during the first half of 2012, and the eurozone member states offered up to 100bn (US$124bn) of financial assistance to recapitalise the Spanish banking sector.

Review of performance

Our European operations reported a pre-tax loss of US$0.7bn, compared with a profit of US$2.1bn in the first half of 2011. On a constant currency basis, pre-tax profits declined by US$2.7bn.

In the first half of 2012, we reported adverse fair value movements of US$1.6bn 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$71m in the first half of 2011. On an underlying basis, pre-tax profits decreased by 55% due to higher operating expenses as a result of a rise in customer redress provisions, coupled with a credit relating to pension obligations in the UK in the first half of 2011 which did not recur.

Interim Management Report (continued)

Profit/(loss) before tax by country within global businesses

	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Total US$m
Half-year to 30 June 2012						
UK	**(166)**	**521**	**357**	**108**	**(2,437)**	**(1,617)**
France[36]	**29**	**114**	**330**	**(5)**	**(175)**	**293**
Germany	**16**	**28**	**153**	**15**	**(28)**	**184**
Malta	**21**	**32**	**16**			**69**
Switzerland				**66**		**66**
Turkey	**5**	**43**	**50**			**98**
Other	**3**	**36**	**137**	**52**	**12**	**240**
	(92)	**774**	**1,043**	**236**	**(2,628)**	**(667)**
Half-year to 30 June 2011						
UK	634	761	483	108	(862)	1,124
France[36]	139	111	274	10	(89)	445
Germany	23	38	121	21	6	209
Malta	31	34	6			71
Switzerland		(5)		122		117
Turkey	11	42	31			84
Other	(69)	63	87	54	(38)	97
	769	1,044	1,002	315	(983)	2,147
Half-year to 31 December 2011						
UK	696	466	(748)	84	1,899	2,397
France[36]	(70)	81	(468)	6	107	(344)
Germany	13	31	82	7	10	143
Malta		38	15			53
Switzerland		(3)		103		100
Turkey	(4)	20	56	2		74
Other	(82)	10	138	40	(5)	101
	553	643	(925)	242	2,011	2,524

For footnote, see page 100.

We continued to make progress in rationalising our operation in Europe using the Group s five filters framework, reducing fragmentation in the region by announcing an exit from operations in Slovakia and entering into agreements to sell our equities broking business in Greece, certain private banking assets in Monaco and our Irish insurance businesses in run-off. We have progressed with the business exits announced in 2011, primarily in Eastern Europe. The disposal of non-core businesses improved capital discipline by simplifying our European portfolio and concentrating our operations on businesses where we can deliver sustainable profits and growth.

We maintained our focus on improving our cost efficiency and organisational effectiveness. Building on the significant initiatives in 2011 across Europe, we announced a restructuring programme in the UK to align each of our businesses to their respective global business operating models in order to reduce bureaucracy and complexity and lower our costs in a sustainable way. As a result of this and other initiatives across the region, total restructuring costs (including impairment of assets) of US$200m were incurred, notably in the UK.

In RBWM, we delivered further strong growth in mortgage balances in the UK, reflecting the success of our competitive offerings and marketing campaigns. Our share of new UK mortgage lending remained at 11% in the first half of the year, which was significantly higher than our total market share of 6%, while maintaining a conservative loan to value ratio of 56%. We have committed to lend at least £17bn (US$26bn) to UK mortgage customers in 2012, of which £4bn (US$6bn) is specifically set aside for first time buyers and had approved new mortgage lending of more than £10bn (US$15bn) at the end of June 2012. In Continental Europe, we continued to target the mass affluent market and build a strong credit card business in Turkey.

In CMB, we continued to invest in the UK in the business by recruiting additional international commercial managers who focus exclusively on international customers. We launched a £4bn (US$6bn) International SME Fund to support UK businesses that trade, or aspire to trade, internationally, and had approved new loans of more than £2.5bn (US$4bn) at the end of June 2012. We also committed to increase gross new lending

Interim Management Report (continued)

facilities to UK SMEs by £12bn (US$18bn). We continued to invest in our businesses in Turkey and Germany to support business growth. Our focus on international customers, together with targeted growth initiatives including deposit acquisition and regional pricing strategies, led to a rise in Payments and Cash Management and Global Trade and Receivable Finance income. CMB s partnership with GB&M delivered income growth of 12% compared with the first half of 2011 to more than US$370m, notably from foreign exchange products, as we continued to support our commercial customers financing and treasury risk management requirements.

In GB&M, we continued to focus on cross-border initiatives to enable us to capture opportunities from increasing trade flows and connect to faster-growing markets. We won a number of mandates in our Payments and Cash Management business, reflecting investment in these areas in previous years. In April 2012, HSBC issued the first international renminbi bond outside sovereign Chinese territory reflecting our commitment to establish the UK as a leading offshore renminbi centre. In addition, we actively reduced our legacy credit exposure in Europe by exiting certain positions. We will seek to further reduce the size of this portfolio as opportunities become available. The financial effect of the legacy credit portfolio on the results of our Europe operations can be seen on page 38.

Within our GPB business, we concentrated on navigating a number of regulatory challenges affecting the industry, by implementing a new target operating model designed to enable us to manage the business globally, better service the needs of clients through global product offerings, and improve risk and compliance standards. We continued to provide access to international investment opportunities and we put in place dedicated resources in both CMB and GPB to increase referral activity and jointly service the diverse corporate and personal investment needs of the Group s largest ultra-high net worth clients.

The forthcoming legislation in relation to the report of the UK Independent Commission on Banking (ICB), which will define the products, services and customers which are either required to be within the ring-fenced bank or prohibited from it, 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. These changes would take an extended period to implement, and would have a significant effect on the costs of both establishing

and running the ongoing operations as restructured (see page 106).

The following commentary is on a constant currency basis.

Net interest income decreased by 5%, mainly due to the decline in Balance Sheet Management revenues as yield curves continued to flatten and interest rates remained low, together with a reduction in the available-for-sale debt security portfolio as a result of disposals. In addition, there was a fall in effective yields and a reduction in the size of the legacy Credit portfolio. This was partly offset by higher net interest income in CMB, driven by an increase in average term lending balances in the UK and Continental Europe as a result of targeted campaigns in 2011 and the first half of 2012. Net interest income also benefited from strong residential mortgage balance growth in RBWM in the UK and deposit growth across the region as a result of marketing campaigns. This was offset in part by strong competition for deposits in the UK which resulted in lower deposit spreads.

Net fee income was broadly in line with the first half of 2011. Fees in RBWM increased due to lower commissions paid as a result of the non-renewal and transfer to third parties of certain contracts in the Irish reinsurance business. This was largely offset by lower fee income in GPB due to a fall in average assets under management which was driven by net new money outflows, a fall in client numbers and adverse movements in the financial markets in the second half of 2011. In addition, in GB&M, primary revenues in the Rates business decreased as a result of a reduction in bond issuances and lower equity capital markets revenues, which were driven by a decline in deal volumes due to the challenging economic environment.

Net trading income decreased by 5%, mainly due to adverse foreign exchange movements on trading assets held as economic hedges of foreign currency debt designated at fair value, compared with gains in the first half of 2011. These offset favourable foreign exchange movements on the foreign currency debt which is reported in Net expense from financial instruments designated at fair value . Revenues in our legacy Credit portfolio (see page 284) declined due to write-downs compared with net releases in the first half of 2011. There were also adverse movements on non-qualifying hedges in European operating entities as interest rates fell. In addition, there were unfavourable fair value movements on structured liabilities as spreads tightened, along with lower Equities revenues, reflecting a less favourable trading environment.

Interim Management Report (continued)

These factors were partly offset by higher Rates trading revenues, notably in the first quarter of 2012 following the ECB s announcement of the LTRO. Excluding legacy credit, Credit trading revenues increased as credit spreads tightened resulting in gains on corporate bonds. In addition, Foreign Exchange reported strong revenue growth driven by a rise in customer activity, in part due to collaboration with CMB and a favourable trading environment for foreign exchange compared with the first half of 2011.

Net expense from financial instruments designated at fair value increased by US$700m. Excluding adverse fair value movements due to the change in credit spreads on our own debt held at fair value, net income from financial instruments designated at fair value of US$669m in the first half of 2012 compared with a net expense of US$165m in the first half of 2011. This was driven by favourable foreign exchange movements on foreign currency debt designated at fair value issued as part of our overall funding strategy, compared with adverse foreign exchange movements in the same period in 2011, with an offset reported in Net trading income . In addition, investment returns on the fair value of assets held to meet liabilities under insurance and investment contracts were higher than in the first half of 2011 as market conditions improved. To the extent that these investment gains were attributed to policyholders holding unit-linked insurance policies and insurance or investment contracts with DPF, the corresponding movement in liabilities to customers is recorded under Net insurance claims incurred and movement in liabilities to policyholders .

Gains less losses from financial investments increased by US$148m. Balance Sheet Management reported significantly higher gains on the disposal of available-for-sale debt securities, mainly in the UK, as part of structural interest rate risk management activities. This was partly offset by realised losses on the disposal of specific bond positions in the legacy credit portfolio, higher impairment charges on available-for-sale equity investments and lower realised gains from the sale of available-for-sale equity investments due to weaker economic conditions.

Net earned insurance premiums decreased by 17%, primarily due to lower life insurance sales in RBWM in France of investment contracts with DPF resulting from the adverse economic environment and increased competition from other banking products. In addition, there was a reduction in premiums due to the non-renewal and transfer to

third parties of certain contracts in our Irish business during 2011.

Other operating income decreased by 26%, largely reflecting the non-recurrence of the benefit from a refinement of the calculation of the PVIF asset during the first half of 2011 (see footnote 27 on page 100), together with a reduction in the PVIF asset in the first half of 2012 due to the effect of experience and assumption updates. In addition, losses arose on the sale of certain syndicated loans.

Net insurance claims incurred and movement in liabilities to policyholders decreased by 7%. This reflected lower reserves established for new business in line with the decline in premiums in France, together with the non-renewal and transfer to third parties of certain contracts in our Irish business during 2011. This was partly offset by an increase in the movement in liabilities to policyholders reflecting investment gains in the first half of 2012.

Loan impairment charges and other credit risk provisions decreased by 9% to US$1.0bn. This mainly reflected a continued reduction in impairments in RBWM, primarily in the UK, as we focused our lending growth on higher quality assets and continued to pro-actively monitor and identify customers facing financial hardship. This resulted in lower delinquency rates across both the secured and unsecured lending portfolios. In CMB, loan impairment charges were higher due to individually assessed provisions across a range of sectors, reflecting the challenging economic conditions. In GB&M, we incurred higher loan impairment charges due to a small number of significant individually assessed provisions, together with a rise in loan impairment charges in our legacy Credit business. These were partly offset by lower credit risk provisions, primarily driven by reduced impairments on available-for-sale ABSs in legacy credit due to losses arising in the underlying collateral pools, which generated lower charges, coupled with a fall in the impairment charge on Greek sovereign debt.

Operating expenses in the first half of 2012 included additional provisions of US$1.3bn relating to UK customer redress programmes for the possible mis-selling of PPI policies and interest rate protection products in previous years, compared with a charge of US$598m (US$611m as reported) in the first half of 2011 (see page 248). In addition, restructuring costs (including impairment of assets) of US$200m were incurred, largely in the UK, compared with US$86m in the first half of 2011. The first half of 2011 also included a credit of US$570m (US$587m as reported) relating to defined benefit pension obligations in the UK, which did not recur.

Interim Management Report (continued)

Excluding these items, operating expenses increased, mainly driven by higher performance costs in GB&M reflecting the increase in net operating income. This was partly offset by a decline in operating expenses in RBWM as average staff numbers fell as a result of organisational effectiveness programmes and disposals. We achieved sustainable cost savings of about US$280m in the first half of 2012, which enabled us to reinvest and support business growth.

Operating expenses in Europe

	Half-year to		
	30 Jun 2012	30 Jun 2011	31 Dec 2011
	US$m	US$m	US$m
HSBC Holdings	**510**	470	1,194
UK	**6,195**	4,754	5,235
Continental Europe	**2,656**	2,833	2,730
Intra-region eliminations	**(72)**	(43)	(104)
Total operating expenses	**9,289**	8,014	9,055

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Profit/(loss) before tax and balance sheet data – Europe

	Half-year to 30 June 2012						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[57] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	2,643	1,607	750	428	(345)	(10)	5,073
Net fee income	1,317	809	421	431	45		3,023
Trading income/(expense) excluding net interest income	27	12	1,126	113	(197)		1,081
Net interest income on trading activities	3	5	729	5	18	10	770
Net trading income/(expense)[51]	30	17	1,855	118	(179)	10	1,851
Changes in fair value of long-term debt issued and related derivatives					(1,165)		(1,165)
Net income/(expense) from other financial instruments designated at fair value	194	36	488		(489)		229
Net income/(expense) from financial instruments designated at fair value	194	36	488		(1,654)		(936)
Gains less losses from financial investments	5	(1)	449	(4)			449
Dividend income	1	1	37	3	1		43
Net earned insurance premiums	1,647	208		9	(4)		1,860
Other operating income	29	30	13	5	346	45	468
Total operating income/ (expense)	5,866	2,707	4,013	990	(1,790)	45	11,831
Net insurance claims[58]	(1,933)	(223)		(8)			(2,164)
Net operating income/ (expense)[48]	3,933	2,484	4,013	982	(1,790)	45	9,667
Loan impairment charges and other credit risk provisions	(187)	(412)	(431)	(7)			(1,037)
Net operating income/ (expense)	3,746	2,072	3,582	975	(1,790)	45	8,630
Operating expenses	(3,840)	(1,297)	(2,531)	(738)	(838)	(45)	(9,289)
Operating profit/(loss)	(94)	775	1,051	237	(2,628)		(659)
Share of profit/(loss) in associates and joint ventures	2	(1)	(8)	(1)			(8)
Profit/(loss) before tax	(92)	774	1,043	236	(2,628)		(667)
	%	%	%	%	%		%
Share of HSBC s profit before tax	(0.7)	6.1	8.2	1.9	(20.7)		(5.2)
Cost efficiency ratio	97.6	52.2	63.1	75.2	(46.8)		96.1

Balance sheet data[47]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	**157,336**	**101,709**	**156,290**	**29,390**	**720**		**445,445**
Total assets	**224,545**	**129,330**	**1,013,553**	**78,814**	**58,641**	**(129,330)**	**1,375,553**
Customer accounts	**181,540**	**116,308**	**171,280**	**59,512**	**889**		**529,529**

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Interim Management Report (continued)

Profit/(loss) before tax and balance sheet data Europe (continued)

	Half-year to 30 June 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$m	Inter-segment elimination[57] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/ (expense)	2,861	1,522	1,107	476	(271)	(129)	5,566
Net fee income/ (expense)	1,323	813	516	496	(17)		3,131
Trading income/(expense) excluding net interest income	36	6	1,268	84	(196)		1,198
Net interest income on trading activities	6	8	636	9	21	129	809
Net trading income/ (expense)[51]	42	14	1,904	93	(175)	129	2,007
Changes in fair value of long-term debt issued and related derivatives					(371)		(371)
Net income/(expense) from other financial instruments designated at fair value	105	25	(211)		212		131
Net income/(expense) from financial instruments designated at fair value	105	25	(211)		(159)		(240)
Gains less losses from financial investments	56	1	254	(4)	5		312
Dividend income	1	1	19	3	1		25
Net earned insurance premiums	2,201	191			(6)		2,386
Other operating income	142	40	96	8	264	102	652
Total operating income/(expense)	6,731	2,607	3,685	1,072	(358)	102	13,839
Net insurance claims[58]	(2,316)	(180)			(3)		(2,499)
Net operating income/(expense)[48]	4,415	2,427	3,685	1,072	(361)	102	11,340
Loan impairment (charges)/recoveries and other credit risk provisions	(394)	(369)	(382)	(34)	6		(1,173)
Net operating income/(expense)	4,021	2,058	3,303	1,038	(355)	102	10,167
Operating expenses	(3,249)	(1,013)	(2,299)	(723)	(628)	(102)	(8,014)
Operating profit/(loss)	772	1,045	1,004	315	(983)		2,153
Share of loss in associates and joint ventures	(3)	(1)	(2)				(6)
Profit/(loss) before tax	769	1,044	1,002	315	(983)		2,147
	%	%	%	%	%		%
Share of HSBC s profit before tax	6.7	9.1	8.7	2.8	(8.6)		18.7
Cost efficiency ratio	73.6	41.7	62.4	67.4	(173.5)		70.7

Balance sheet data[47]

	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	154,055	100,140	200,498	30,354	1,284		486,331
Total assets	221,095	123,446	1,075,148	80,073	72,488	(192,942)	1,379,308
Customer accounts	178,819	101,195	207,891	60,906			548,811

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Interim Management Report (continued)

	Half-year to 31 December 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$m	Inter-segment elimination[57] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/ (expense)	2,792	1,585	995	460	(303)	(94)	5,435
Net fee income	1,310	827	473	446	49		3,105
Trading income/(expense) excluding net interest income	4	(1)	(666)	107	(5)		(561)
Net interest income on trading activities	5	8	569	7	32	94	715
Net trading income/ (expense)[51]	9	7	(97)	114	27	94	154
Changes in fair value of long-term debt issued and related derivatives					3,551		3,551
Net income/(expense) from other financial instruments designated at fair value	(777)	(46)	146		(166)		(843)
Net income/(expense) from financial instruments designated at fair value	(777)	(46)	146		3,385		2,708
Gains less losses from financial investments	(5)	(2)	199	5	6		203
Dividend income			23	1			24
Net earned insurance premiums	1,567	190			(7)		1,750
Other operating income/ (expense)	(47)	18	91	(3)	496	(28)	527
Total operating income	4,849	2,579	1,830	1,023	3,653	(28)	13,906
Net insurance claims[58]	(896)	(107)			3		(1,000)
Net operating income[48]	3,953	2,472	1,830	1,023	3,656	(28)	12,906
Loan impairment charges and other credit risk provisions	(202)	(591)	(494)	(48)	(4)		(1,339)
Net operating income	3,751	1,881	1,336	975	3,652	(28)	11,567
Operating expenses	(3,201)	(1,239)	(2,270)	(733)	(1,640)	28	(9,055)
Operating profit/(loss)	550	642	(934)	242	2,012		2,512
Share of profit/(loss) in associates and joint ventures	3	1	9		(1)		12
Profit/(loss) before tax	553	643	(925)	242	2,011		2,524
	%	%	%	%	%		%
Share of HSBC s profit before tax	5.3	6.2	(8.9)	2.3	19.3		24.2
Cost efficiency ratio	81.0	50.1	124.0	71.7	44.9		70.2

Balance sheet data[47]

	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

For footnotes, see page 100.

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HSBC HOLDINGS PLC

Interim Management Report (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 over 60% by value of banknotes in circulation in the first half of 2012.

	Half-year to		
	30 Jun 2012 US$m	30 Jun 2011 US$m	31 Dec 2011 US$m
Net interest income	**2,599**	2,249	2,442
Net fee income	**1,618**	1,612	1,485
Net trading income	**762**	669	520
Other income	**1,154**	884	821
Net operating income[48]	**6,133**	5,414	5,268
Impairment charges[49]	**(32)**	(25)	(131)
Net operating income	**6,101**	5,389	5,137
Total operating expenses	**(2,396)**	(2,339)	(2,419)
Operating profit	**3,705**	3,050	2,718
Income from associates[50]	**56**	31	24
Profit before tax	**3,761**	3,081	2,742
Cost efficiency ratio	**39.1%**	43.2%	45.9%
RoRWA[40]	**7.1%**	5.6%	5.0%
Period-end staff numbers	**27,976**	30,214	28,984

Leading international bank in

offshore renminbi products

19%

growth in revenues from the

collaboration between CMB and GB&M

Best domestic bank in Hong Kong

(Asiamoney 2012)

For footnotes, see page 100.

The commentary on Hong Kong is on a constant currency basis unless stated otherwise.

Economic background

GDP in **Hong Kong** grew by just 0.4% in the first quarter of 2012, as a slowdown in external demand from Europe and mainland China served to depress activity. The sharp contraction in export orders, however, was more than offset by ongoing strength in the domestic economy. The unemployment rate remained steady at close to 3.3% and, although 3 month HIBOR was 0.4% during the first half of 2012, up from 0.26% in June 2011, it remained very low, helping to underpin robust rates of private consumption and investment spending, which increased by 5.6% and 12.2%, respectively, on the year in the first quarter. Inflationary pressures and residential property price inflation eased, the latter slowing to 4.6% in May from 26% a year earlier.

Review of performance

Reported pre-tax profits from our operations in Hong Kong were US$3.8bn compared with US$3.1bn in the first half of 2011, an increase of 22% on both a reported and a constant currency basis.

The increase in profits was driven by higher net interest income in RBWM and CMB coupled with the gain on sale of our shares in two Indian banks. Trading revenues were higher in GB&M from positive performance in the Rates, Foreign Exchange and Credit businesses. These increases were partly offset by higher operating expenses, including staff costs.

In RBWM, we were awarded the Best Wealth Management Award from *The Asian Banker*. We announced the sale of our general insurance business enabling us to focus on life insurance manufacturing where we maintained our market leadership position. We launched a dual currency Hong Kong dollar and renminbi credit card for customers who travel frequently between Hong Kong and mainland China that offers payment flexibility and protection against fluctuating exchange rates. We maintained our market leadership position in deposits, mortgages and mandatory provident funds as well as credit cards where we received 26 awards from Visa, MasterCard and China UnionPay.

In CMB, we capitalised on our international connectivity and our standing as a leading trade finance bank to grow trade-related revenues, particularly with mainland China. Cross-border referrals between Hong Kong and mainland China grew by 13% and by 10% between Hong Kong and the rest of the world. The collaboration between CMB and GB&M continued to strengthen, with growth of 19% in revenues which are shared

HSBC HOLDINGS PLC

Interim Management Report (continued)

Profit/(loss) before tax by global business

	Half-year to		
	30 June 2012	30 June 2011	31 December 2011
	US$m	US$m	US$m
Retail Banking and Wealth Management	**1,753**	1,599	1,423
Commercial Banking	**1,001**	825	783
Global Banking and Markets	**786**	631	685
Global Private Banking	**122**	130	58
Other	**99**	(104)	(207)
Profit before tax	**3,761**	3,081	2,742

between the global businesses, most notably from the provision of foreign exchange products to our corporate customers. We also won the Best SME Partner Award from the *Hong Kong General Chamber of Small and Medium Business* for the seventh consecutive year, and the Capital Weekly Service Excellence Award SME Banking for the fourth consecutive year.

On a reported basis we achieved record revenues in GB&M. We led the market in Hong Kong dollar bond issuance and participated in several significant debt capital markets transactions. We continued to lead the market in offshore renminbi bond issuance with several high-profile deals completed in the first half of 2012 for multinationals accessing the market.

We reinforced our position as a leading international bank for offshore renminbi products, topping all seven product categories in *Asiamoney s* inaugural Offshore Renminbi Survey, including the Best Overall Products and Services , the Best Clearance, Transaction Banking and Settlement and Best for Deposits .

The following commentary is on a constant currency basis.

Net interest income was 15% higher than in the first half of 2011, notably in RBWM and in CMB, driven primarily by wider deposit spreads and growth in balances of both customer loans and deposits.

In RBWM we experienced growth in average mortgage balances as we maintained our market leadership position. Average personal lending balances also grew. In CMB, average trade-related lending balances were higher as we capitalised on trade and capital flows. Growth in trade-related lending returned in the first half of 2012 following reductions in the second half of 2011.

Net interest income also rose due to higher average deposit balances as we focused on funding lending growth with deposit acquisition.

These were partly offset by narrower asset spreads, notably in residential mortgages in RBWM, as funding costs increased.

Net interest income from Balance Sheet Management was higher in the first half of 2012, through improved fund deployment amidst a consistently low interest rate environment.

Net fee income of US$1.6bn was broadly unchanged. Fees rose from the collaboration between CMB and GB&M and from higher trade-related volumes as we successfully captured opportunities from international trade and capital flows. We also benefited from our participation in several debt capital markets transactions in the first half of 2012. The increase was offset in RBWM, mainly by a reduction in brokerage income from lower market turnover as a result of weaker investor sentiment, and by lower fee income from unit trusts where the customer preference shifted towards lower risk products with lower fees.

Net trading income increased by 14%, driven by a positive performance in GB&M, notably in Rates trading activities, which reflected greater market volatility and tightening of spreads, and in Foreign Exchange, due to increased client activity and, in part, enhanced collaboration with CMB. Credit trading revenues also rose due to the tightening of spreads and increased volumes.

Net income from financial instruments designated at fair value was US$44m compared with US$26m in the first half of 2011 due to higher investment gains on assets held by the insurance business as a result of more favourable equity market conditions. To the extent that these investment gains were attributed to policyholders of unit-linked insurance policies and insurance contracts with DPF, there was a corresponding increase in *Net insurance claims incurred and movement in liabilities to policyholders*.

Net earned insurance premiums increased by 19%, notably on insurance contracts with DPF, following higher sales volumes reflecting strong

Interim Management Report (continued)

sales and renewals of life insurance products as a result of product launches and marketing campaigns. The growth in premiums resulted in a corresponding increase in Net insurance claims incurred and movement in liabilities to policyholders .

Gains less losses from financial investments were US$261m higher, driven by the gain of US$275m from the sale of our shares in Axis Bank Limited and Yes Bank Limited, two non-strategic investments in India.

Other operating income of US$825m was US$90m lower than in the first half of 2011. The fall in income was primarily due to the non-recurrence of the gain from the refinement to the PVIF calculation methodology in the first half of 2011 (see footnote 27 on page 100), partly offset by a rise in PVIF reflecting favourable assumption updates and increased insurance sales in the first six months of

2012. In addition, the gain on revaluation of investment properties was lower in 2012 than in the first half of 2011.

Loan impairment charges and other credit risk provisions stayed at a low level at US$32m as the credit environment remained stable and we maintained our focus on high levels of asset quality.

Operating expenses increased by 2%, primarily due to wage inflation across the business and higher performance-related costs in GB&M reflecting increased revenue. Premises and equipment costs rose, mainly relating to systems implementation programmes and higher volume-driven processing charges, as well as increased property maintenance and rental costs. We continued to maintain strict cost control and progressed with the implementation of our organisational effectiveness programme that started in 2011.

HSBC HOLDINGS PLC

Interim Management Report (continued)

Profit/(loss) before tax and balance sheet data Hong Kong

	Half-year to 30 June 2012						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[57] US$m	Total US$m
Profit before tax							
Net interest income/(expense)	1,396	768	553	76	(238)	44	2,599
Net fee income	825	433	272	77	11		1,618
Trading income/(expense) excluding net interest income	85	85	392	94	(25)		631
Net interest income on trading activities	2		166		7	(44)	131
Net trading income/(expense)[51]	87	85	558	94	(18)	(44)	762
Net income/(expense) from financial instruments designated at fair value	61	(18)	16		(15)		44
Gains less losses from financial investments			4		275		279
Dividend income			2		16		18
Net earned insurance premiums	2,690	385	4				3,079
Other operating income	357	35	27	6	539	(139)	825
Total operating income	5,416	1,688	1,436	253	570	(139)	9,224
Net insurance claims[58]	(2,745)	(341)	(5)				(3,091)
Net operating income[48]	2,671	1,347	1,431	253	570	(139)	6,133
Loan impairment (charges)/ recoveries and other credit risk provisions	(44)	(2)	12	2			(32)
Net operating income	2,627	1,345	1,443	255	570	(139)	6,101
Operating expenses	(893)	(350)	(660)	(133)	(499)	139	(2,396)
Operating profit	1,734	995	783	122	71		3,705
Share of profit in associates and joint ventures	19	6	3		28		56
Profit before tax	1,753	1,001	786	122	99		3,761
	%	%	%	%	%		%
Share of HSBC s profit before tax	13.6	7.9	6.2	1.0	0.8		29.5
Cost efficiency ratio	33.4	26.0	46.1	52.6	87.5		39.1

Balance sheet data[47]							
	US$m	**US$m**	**US$m**	**US$m**	**US$m**		**US$m**
Loans and advances to customers (net)	**58,290**	**58,694**	**40,699**	**6,192**	**1,329**		**165,204**
Total assets	**89,464**	**67,566**	**242,783**	**19,901**	**82,901**	**(16,007)**	**486,608**
Customer accounts	**184,857**	**80,383**	**34,340**	**18,819**	**421**		**318,820**

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Profit/(loss) before tax and balance sheet data Hong Kong (continued)

	Half-year to 30 June 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$m	Inter-segment elimination[57] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	1,249	625	501	88	(234)	20	2,249
Net fee income	908	356	241	97	10		1,612
Trading income/(expense) excluding net interest income	89	86	320	69	(9)		555
Net interest income on trading activities	4		124		6	(20)	114
Net trading income/(expense)[51]	93	86	444	69	(3)	(20)	669
Net income/(expense) from financial instruments designated at fair value	50	(27)	2		1		26
Gains less losses from financial investments			20		(2)		18
Dividend income		1	11		19		31
Net earned insurance premiums	2,193	390	5				2,588
Other operating income	375	83	22	6	556	(131)	911
Total operating income	4,868	1,514	1,246	260	347	(131)	8,104
Net insurance claims[58]	(2,344)	(342)	(5)		1		(2,690)
Net operating income[48]	2,524	1,172	1,241	260	348	(131)	5,414
Loan impairment (charges)/ recoveries and other credit risk provisions	(38)	(7)	22	(1)	(1)		(25)
Net operating income	2,486	1,165	1,263	259	347	(131)	5,389
Operating expenses	(889)	(342)	(633)	(129)	(477)	131	(2,339)
Operating profit/(loss)	1,597	823	630	130	(130)		3,050
Share of profit in associates and joint ventures	2	2	1		26		31
Profit/(loss) before tax	1,599	825	631	130	(104)		3,081
	%	%	%	%	%		%
Share of HSBC s profit before tax	13.9	7.2	5.5	1.1	(0.8)		26.9
Cost efficiency ratio	35.2	29.2	51.0	49.6	137.1		43.2
Balance sheet data[47]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	53,999	58,529	39,124	5,949	1,769		159,370
Total assets	82,184	66,563	232,057	21,545	81,316	(9,621)	474,044

Customer accounts	175,641	74,760	34,348	20,378	599	305,726

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Interim Management Report (continued)

	Half-year to 31 December 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$m	Inter-segment elimination[57] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	1,322	692	550	85	(230)	23	2,442
Net fee income	833	350	234	63	5		1,485
Trading income/(expense) excluding net interest income	31	83	332	66	(107)		405
Net interest income on trading activities	5	1	122		10	(23)	115
Net trading income/ (expense)[51]	36	84	454	66	(97)	(23)	520
Net income/(expense) from financial instruments designated at fair value	(525)	(45)	(7)		14		(563)
Gains less losses from financial investments	3	10	1		(8)		6
Dividend income			3		5		8
Net earned insurance premiums	2,124	368	8				2,500
Other operating income	130	92	57	2	629	(137)	773
Total operating income	3,923	1,551	1,300	216	318	(137)	7,171
Net insurance claims[58]	(1,543)	(355)	(4)		(1)		(1,903)
Net operating income[48]	2,380	1,196	1,296	216	317	(137)	5,268
Loan impairment (charges)/recoveries and other credit risk provisions	(39)	(59)	1	(35)	1		(131)
Net operating income	2,341	1,137	1,297	181	318	(137)	5,137
Operating expenses	(922)	(361)	(615)	(123)	(535)	137	(2,419)
Operating profit/(loss)	1,419	776	682	58	(217)		2,718
Share of profit in associates and joint ventures	4	7	3		10		24
Profit/(loss) before tax	1,423	783	685	58	(207)		2,742
	%	%	%	%	%		%
Share of HSBC s profit before tax	13.7	7.5	6.6	0.6	(2.0)		26.4
Cost efficiency ratio	38.7	30.2	47.5	56.9	168.8		45.9
Balance sheet data[47]							
	US$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

For footnotes, see page 100.

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Interim Management Report (continued)

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 Limited, with particularly strong coverage in Australia, India, Indonesia, Malaysia and Singapore.

		Half-year to	
	30 Jun	30 Jun	31 Dec
	2012	2011	2011
	US$m	US$m	US$m
Net interest income	**2,718**	2,381	2,721
Net fee income	**1,078**	1,117	994
Net trading income	**932**	862	796
Other income	**1,219**	988	854
Net operating income[48]	**5,947**	5,348	5,365
Impairment charges[49]	**(298)**	(100)	(167)
Net operating income	**5,649**	5,248	5,198
Total operating expenses	**(2,865)**	(2,836)	(2,970)
Operating profit	**2,784**	2,412	2,228
Income from associates[50]	**1,588**	1,330	1,501
Profit before tax	**4,372**	3,742	3,729
Cost efficiency ratio	**48.2%**	53.0%	55.4%
RoRWA[40]	**3.0%**	3.3%	2.9%
Period-end staff numbers	**86,207**	91,924	91,051

12%

growth in trade-related lending since

June 2011 on a constant currency basis

18%

increase in pre-tax profit

on a constant currency basis

Best Foreign Retail Bank

in China

Asia Banker

For footnotes, see page 100.

The commentary on Rest of Asia-Pacific is on a constant currency basis unless stated otherwise.

Economic background

The **mainland China** economy slowed in the first half of 2012. Annual GDP growth decelerated from 9.2% in 2011 to 7.6% in the second quarter of 2012, reflecting a downturn in demand for Chinese exports and a reduction in the pace of property construction following measures by the authorities to moderate activity in the property market after the rapid price rises in recent years. The slowdown eased inflationary pressures that had been building in 2011, and the annual rate of CPI inflation fell to 2.2% in June. In response to the escalation of the eurozone crisis, policymakers adopted more accommodative measures with cuts in the reserve ratio for banks and deposit and lending rates. A number of fiscal measures were also implemented to support activity such as faster approvals for infrastructure projects, tax incentives to buy energy-efficient home appliances and lower regulatory barriers for investment.

Japan s economy delivered robust growth during the first half of the year, with GDP expanding at almost 5% in the first three months alone on an annualised basis. Domestic demand, led by private consumption and government spending, mostly accounted for the strength. The Bank of Japan also loosened monetary policy by adopting a firmer inflation targeting regime and announcing a further expansion of its asset purchase programme. Economic momentum slowed slightly in the second quarter.

In the early months of 2012, GDP growth in **Singapore** remained robust, driven by investment and private consumption. In the second quarter, GDP growth eased as the eurozone crisis constrained external demand. Annual CPI inflation remained high at nearly 5%, prompting the Monetary Authority of Singapore to tighten monetary policy and strengthen its trade-weighted exchange rate. The recent slowdown in **India s** economy continued in the first quarter of 2012, with annual growth of GDP easing to 5.3% from 6.1% in the final quarter of 2011, the slowest rate since 2004. This reflected the lagged effect of monetary tightening by the Reserve Bank of India (RBI) during 2011 to ease inflationary pressures, the slowdown in external demand and slow progress in key structural reforms. Inflation remained high, so the RBI were only able to cut the key policy rate by half a percentage point in April to 8%.

While the domestic economies in other parts of Asia remained largely firm, the slowdown in demand from mainland China and the West reduced the rate

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Profit/(loss) before tax by country within global businesses

	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Total US$m
Half-year to 30 June 2012						
Australia	**51**	**(34)**	**80**		**(6)**	**91**
India	**35**	**49**	**306**	**4**	**121**	**515**
Indonesia	**19**	**59**	**91**		**6**	**175**
Mainland China	**500**	**853**	**633**	**(2)**	**38**	**2,022**
Associates	**529**	**755**	**284**			**1,568**
Other mainland China	**(29)**	**98**	**349**	**(2)**	**38**	**454**
Malaysia	**93**	**68**	**124**		**3**	**288**
Singapore	**105**	**62**	**126**	**50**	**(8)**	**335**
Taiwan	**38**	**29**	**77**		**2**	**146**
Vietnam	**3**	**28**	**39**		**8**	**78**
Other	**77**	**136**	**258**	**62**	**189**	**722**
	921	**1,250**	**1,734**	**114**	**353**	**4,372**
Half-year to 30 June 2011						
Australia	36	33	70		(4)	135
India	(4)	78	292	3	82	451
Indonesia	(1)	47	68			114
Mainland China	490	617	472	(2)	194	1,771
Associates	524	539	248		181	1,492
Other mainland China	(34)	78	224	(2)	13	279
Malaysia	77	56	114		4	251
Singapore	95	62	126	46	(2)	327
Taiwan	33	11	67		6	117
Vietnam	1	26	40		15	82
Other	39	131	291	2	31	494
	766	1,061	1,540	49	326	3,742
Half-year to 31 December 2011						
Australia	52	73	38		9	172
India	(10)	44	247	2	79	362
Indonesia	7	42	89		7	145
Mainland China	622	723	644	(2)	(77)	1,910
Associates	655	611	281		(64)	1,483
Other mainland China	(33)	112	363	(2)	(13)	427
Malaysia	96	62	114	1	5	278
Singapore	88	71	63	51	(5)	268
Taiwan	12	12	63		6	93
Vietnam	(1)	25	39		9	72
Other	9	133	252	(10)	45	429

875	1,185	1,549	42	78	3,729

of GDP growth. In **South Korea** in the first half of the year, economic activity was supported by strong government spending and investment, but growth is expected to remain below the levels seen in 2011 as persistent global uncertainties weigh on domestic demand and external trade. Quarterly GDP growth accelerated in the first quarter of 2012 in the **Philippines**, rising by 6.4%. Recent export and remittance indicators suggested growth moderated in the second quarter in line with a slowing in the pace of world trade. Annual GDP growth in **Vietnam** accelerated in the second quarter but growth remained significantly below long-term trend rates.

Domestic demand was relatively weak and headline inflation moderated to 6.9% in June. In **Indonesia**, the central bank cut its policy rate by 25bps in February to 5.75%, following concerns about the slowdown in global demand. However, first quarter GDP growth was robust at an annual rate of 6.3%. Domestic demand was also a significant driver of GDP growth in **Malaysia**. The same trends were apparent in **Thailand**. The economy recovered more strongly than expected in the first quarter in response to recovery efforts after 2011 s floods.

Interim Management Report (continued)

Review of performance

Our operations in the Rest of Asia-Pacific region reported pre-tax profits of US$4.4bn compared with US$3.7bn in the first half of 2011, an increase of 17% or 18% on a constant currency basis. Reported profits included gains from the sale of our RBWM business in Thailand of US$108m, our GPB business in Japan of US$67m, and our interest in a property company in the Philippines of US$130m. These were partly offset by the non-recurrence of an accounting gain arising from the dilution of our shareholding in Ping An in the first half of 2011, following its issue of share capital to a third party.

On an underlying basis which excludes the above gains, pre-tax profit rose by 15%, reflecting strong growth in lending and deposit balances, coupled with improved liability spreads. These were offset by higher expenses, in part due to US$114m of restructuring costs arising from the ongoing strategic review of our businesses and support functions in the region, as well as higher loan impairment charges due to a small number of new individual charges in CMB and GB&M. Increased profits from our associates in mainland China also contributed to our improved profitability.

We maintained our focus on our key priority growth markets in the region. In mainland China, pre-tax profits grew due to higher net interest income from Balance Sheet Management activity, balance sheet growth and increased income from our associates. Loan and deposit growth, wider deposit spreads and higher trading income and significant cost reductions in RBWM contributed to improved profits in India.
In Indonesia, a rise in pre-tax profit was driven by increased Rates trading activities following the country s credit ratings upgrade and growth in fee income. In Malaysia, profit growth was due to volume growth in commercial and residential mortgage lending. In Singapore, profit before tax grew on a strong contribution from higher trading revenues and a continued focus on trade-related business. A specific loan impairment charge on a corporate customer resulted in a fall in profits in Australia, though this was partly offset by higher net interest income as a result of lending and deposit growth in both 2011 and the first half of 2012.

In RBWM, we focused on capturing wealth management opportunities in the region. We continued to expand our branch network in mainland China and Malaysia and launched initiatives to enhance our multi-channel capabilities including a mobile banking platform in Vietnam and expansion of our mobile functionality in mainland China,

Australia and Singapore. We also carried out a detailed review of our loan approval process which reduced processing times. In Taiwan we launched Fundmax, a product that offers our customers the ability to invest in unit trusts with monthly management fees as an alternative to upfront fees.

In CMB, trade revenues grew as we capitalised on our global network to capture cross-border trade and capital flows, particularly with mainland China. Cross-border referrals between mainland China and the rest of the world increased by 11%. We were recognised as Financial institution of the year 2011 by the Brazil-China Chamber of Commerce for our contribution to the growth and development of the fast-growing South South trade corridor.

In GB&M, we achieved record revenues on a reported basis and revenues from the collaboration between CMB and GB&M also increased as we enhanced sales coordination between the global businesses. We continued to be a key participant in the internationalisation of the renminbi and we received approval from the People s Bank of China to be a market maker for direct trading between the renminbi and the Japanese yen in mainland China s interbank market.

The following commentary is on a constant currency basis.

Net interest income increased by 17% due to higher average lending balances in CMB and GB&M, most notably in mainland China. Residential mortgage balances also grew, primarily in Singapore and Malaysia, driven by promotional campaigns.

This was partly offset by narrower asset spreads, particularly in RBWM, due to competitive pricing pressures in residential mortgage lending in a number of markets.

Customer deposit balances rose, notably in Payments and Cash Management from new mandates and deposit acquisition as customers made use of our comprehensive product offering. This reflected our strategy of supporting growth in customer lending with core funding.

Net interest income from Balance Sheet Management was higher in the first half of 2012 primarily in mainland China, reflecting growth in the overall investment portfolio.

Net fee income decreased marginally by 1%, most notably in RBWM due to lower fees in Japan following the discontinuation of our Premier business and in Singapore as a result of weak investor sentiment. This was partly offset by increased fee income from CMB due to higher remittance revenues.

Interim Management Report (continued)

Net trading income increased by 12% compared with the first half of 2011, mainly from Rates trading activities in a number of countries in the region due to a favourable movement in interest rates.

Net income from financial instruments designated at fair value rose by US$61m on the first half of 2011 to US$64m, driven by higher investment gains on assets held by the insurance business, primarily in Singapore, due to positive equity market movements during the first half of 2012. To the extent that these investment gains were attributed to policyholders of unit-linked insurance policies and insurance contracts with DPF, there was a corresponding increase in *Net insurance claims incurred and movement in liabilities to policyholders*.

Gains from financial investments were US$25m compared with losses of US$22m in the first half of 2011, due to a disposal gain on investments managed by a private equity fund and a lower impairment loss on an equity investment in the first half of 2012 than in 2011 in GB&M.

Net earned insurance premiums increased by 16% to US$392m, primarily in Singapore, as a result of increased renewals and new business volumes. 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$193m, due to gains from the sale of our RBWM business in Thailand (US$108m), our GPB business in Japan (US$67m) and our interest in a property company in the Philippines (US$130m). These were partly offset

by the non-recurrence of an accounting gain of US$181m arising from the dilution of our shareholding in Ping An following its issue of share capital to a third party in the first half of 2011.

Loan impairment charges and other credit risk provisions increased by US$197m as a result of an individually assessed impairment of a corporate exposure in Australia, individual loan impairment charges in India and New Zealand, and a credit risk provision on an available-for-sale debt security in GB&M.

Operating expenses increased by 4%, due to restructuring costs of US$114m incurred in several countries as part of the ongoing strategic review of our businesses and support functions in the region. This resulted in a net reduction of more than 4,800 staff numbers in the first half of 2012, which was offset by inflationary pressures and business growth, including branch expansion in mainland China and Malaysia. However, we continued to maintain a tight control on costs as part of the organisational effectiveness programme launched in 2011.

Share of profit from associates and joint ventures increased by 15%, driven by higher profits from BoCom as a result of loan growth and wider spreads. Fee income also increased from settlements and credit cards. The contribution from Industrial Bank rose as a result of strong growth in customer lending and a higher fee-based revenue, which was partly offset by a rise in operating expenses. Profits from Ping An were lower as increased income from the banking business following the consolidation of Shenzhen Development Bank and stable insurance income were more than offset by lower securities broking and underwriting income.

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Profit before tax and balance sheet data Rest of Asia-Pacific

	Half-year to 30 June 2012						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other	Inter-segment elimination[57]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit before tax							
Net interest income	896	691	1,120	55	83	(127)	2,718
Net fee income/(expense)	429	264	351	37	(3)		1,078
Trading income/(expense) excluding net interest income	43	98	648	35	(30)		794
Net interest income on trading activities			7		4	127	138
Net trading income/ (expense)[51]	43	98	655	35	(26)	127	932
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	1	(2)		26		66
Net income/(expense) from financial instruments designated at fair value	41	1	(2)		24		64
Gains less losses from financial investments	(1)	1	1		24		25
Dividend income			1		3		4
Net earned insurance premiums	338	54					392
Other operating income	169	44	39	66	840	(82)	1,076
Total operating income	1,915	1,153	2,165	193	945	(82)	6,289
Net insurance claims[58]	(293)	(49)					(342)
Net operating income[48]	1,622	1,104	2,165	193	945	(82)	5,947
Loan impairment charges and other credit risk provisions	(102)	(131)	(65)				(298)
Net operating income	1,520	973	2,100	193	945	(82)	5,649
Operating expenses	(1,132)	(486)	(657)	(79)	(593)	82	(2,865)
Operating profit	388	487	1,443	114	352		2,784
Share of profit in associates and joint ventures	533	763	291		1		1,588
Profit before tax	921	1,250	1,734	114	353		4,372
	%	%	%	%	%		%
Share of HSBC s profit before tax	7.2	9.8	13.6	0.9	2.8		34.3
Cost efficiency ratio	69.8	44.0	30.3	40.9	62.8		48.2

Balance sheet data[47]							
	US$m	**US$m**	**US$m**	**US$m**	**US$m**		**US$m**
Loans and advances to customers (net)	**42,171**	**41,241**	**42,652**	**3,243**	**182**		**129,489**
Total assets	**57,289**	**56,071**	**202,228**	**12,240**	**17,066**	**(9,916)**	**334,978**
Customer accounts	**60,037**	**41,999**	**59,475**	**11,600**	**46**		**173,157**

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HSBC HOLDINGS PLC

Interim Management Report (continued)

	Half-year to 30 June 2011						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other	Inter-segment elimination[57]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit before tax							
Net interest income	891	580	900	58	59	(107)	2,381
Net fee income	463	259	359	32	4		1,117
Trading income/(expense) excluding net interest income	50	75	583	30	(29)		709
Net interest income/(expense) on trading activities			51		(5)	107	153
Net trading income/ (expense)[51]	50	75	634	30	(34)	107	862
Changes in fair value of long-term debt issued and related derivatives					(1)		(1)
Net income/(expense) from other financial instruments designated at fair value	7	2	1		(6)		4
Net income/(expense) from financial instruments designated at fair value	7	2	1		(7)		3
Gains less losses from financial investments		1	(23)	1	(1)		(22)
Dividend income			1				1
Net earned insurance premiums	225	115					340
Other operating income	71	33	35	1	877	(85)	932
Total operating income	1,707	1,065	1,907	122	898	(85)	5,614
Net insurance claims[58]	(173)	(94)			1		(266)
Net operating income[48]	1,534	971	1,907	122	899	(85)	5,348
Loan impairment (charges)/ recoveries and other credit risk provisions	(112)	7	4	2	(1)		(100)
Net operating income	1,422	978	1,911	124	898	(85)	5,248
Operating expenses	(1,188)	(458)	(626)	(75)	(574)	85	(2,836)
Operating profit	234	520	1,285	49	324		2,412
Share of profit in associates and joint ventures	532	541	255		2		1,330
Profit before tax	766	1,061	1,540	49	326		3,742
	%	%	%	%	%		%
Share of HSBC s profit before tax	6.7	9.2	13.4	0.4	2.8		32.6
Cost efficiency ratio	77.4	47.2	32.8	61.5	63.8		53.0
Balance sheet data[47]							
	US$m	US$m	US$m	US$m	US$m		US$m

Loans and advances to customers (net)	41,707	36,128	39,569	3,846	179		121,429
Total assets	54,326	47,028	181,947	12,802	15,215	(12,728)	298,590
Customer accounts	59,352	39,922	56,262	13,014	39		168,589

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Profit before tax and balance sheet data Rest of Asia-Pacific (continued)

	Half-year to 31 December 2011						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other	Inter-segment elimination[57]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit before tax							
Net interest income	947	674	1,064	58	64	(86)	2,721
Net fee income/(expense)	441	254	262	50	(13)		994
Trading income/(expense) excluding net interest income	44	81	570	36	(61)		670
Net interest income/(expense) on trading activities	(2)	1	25		16	86	126
Net trading income/ (expense)[51]	42	82	595	36	(45)	86	796
Changes in fair value of long-term debt issued and related derivatives					5		5
Net income/(expense) from other financial instruments designated at fair value	(45)				21		(24)
Net income/(expense) from financial instruments designated at fair value	(45)				26		(19)
Gains less losses on financial investments		1	(2)				(1)
Dividend income			1				1
Net earned insurance premiums	268	151					419
Other operating income	74	39	40	4	715	(93)	779
Total operating income	1,727	1,201	1,960	148	747	(93)	5,690
Net insurance claims[58]	(178)	(146)			(1)		(325)
Net operating income[48]	1,549	1,055	1,960	148	746	(93)	5,365
Loan impairment (charges)/ recoveries and other credit risk provisions	(110)	3	(61)		1		(167)
Net operating income	1,439	1,058	1,899	148	747	(93)	5,198
Operating expenses	(1,221)	(487)	(642)	(106)	(607)	93	(2,970)
Operating profit	218	571	1,257	42	140		2,228
Share of profit/(loss) in associates and joint ventures	657	614	292		(62)		1,501
Profit before tax	875	1,185	1,549	42	78		3,729
	%	%	%	%	%		%
Share of HSBC s profit before tax	8.4	11.4	14.9	0.4	0.8		35.9

Cost efficiency ratio	78.8	46.2	32.8	71.6	81.4		55.4
Balance sheet data[47]							
	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

For footnotes, see page 100.

Interim Management Report (continued)

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 coverage in the region. Our associate in Saudi Arabia, The Saudi British Bank (40% owned), is the kingdom s fifth largest bank by total assets.

	Half-year to		
	30 Jun	30 Jun	31 Dec
	2012	2011	2011
	US$m	US$m	US$m
Net interest income	**705**	673	759
Net fee income	**302**	327	300
Net trading income	**216**	237	245
Other income/(expense)	**14**	(1)	67
Net operating income[48]	**1,237**	1,236	1,371
Impairment charges[49]	**(135)**	(99)	(194)
Net operating income	**1,102**	1,137	1,177
Total operating expenses	**(537)**	(574)	(585)
Operating profit	**565**	563	592
Income from associates[50]	**207**	184	153
Profit before tax	**772**	747	745
Cost efficiency ratio	**43.4%**	46.4%	42.7%
RoRWA[40]	**2.6%**	2.7%	2.5%
Period-end staff numbers	**9,195**	8,755	8,373

6%

decline in reported expenses driven

by sustainable cost save initiatives

Significant progress on capital

deployment programmes including

key strategic acquisitions

Most impressive bank for Middle Eastern and Africa borrowers	**Best Overall Bank for Cash Management in the Middle East**
EuroWeek Bond Awards 2012	*Global Finance Awards*

For footnotes, see page 100.

The commentary on the Middle East and North Africa is on a constant currency basis unless stated otherwise.

Economic background

Brent crude oil prices in excess of US$100 per barrel in the first half of 2012 helped support revenues and spending across much of the **Middle East**. Data from the HSBC Purchasing Managers Index, consumer indicators and credit growth all demonstrated a pick-up in economic activity driven by the expansionary government spending policies which were announced in the wake of protests in 2011. Saudi Arabia, Qatar and Oman showed the strongest signs of recovery, while the UAE economy was more subdued due to a cautious fiscal policy and lack of credit growth. Activity in Bahrain and, to a lesser extent, Kuwait, was held back by political instability. The non-oil producers were increasingly affected by exposure to the troubled eurozone economies in the first half of the year. Export and tourism activity slowed, which limited corporate investment spending. Despite electing its first president since the revolution, Egypt s economic activity remained subdued.

Review of performance

Our operations in the Middle East and North Africa reported a profit before tax of US$772m, an increase of 3% compared with the first half of 2011. On a constant currency basis, pre-tax profits increased by 4%, reflecting higher income from our associates, modest revenue growth in challenging market conditions and lower costs from the implementation of strategic restructuring programmes, partly offset by higher loan impairment charges.

We continued to make progress on our strategic programmes to improve capital deployment, using the Group s five filters framework to review our existing businesses and assess acquisitions. In the first half of 2012, we completed the merger of our operations in Oman with Oman International Bank S.A.O.G. (OIB), giving us a 51% ownership of the combined entity, HSBC Bank Oman S.A.O.G., now the third largest Bank in the Sultanate. We also entered into an agreement to acquire the onshore retail and commercial banking business of Lloyds Banking Group in the UAE, subject to regulatory approval. Lloyds strong presence in expatriate retail banking and complementary commercial banking is a good strategic fit with our position as the leading international bank in the UAE.

We achieved strong growth in profit before tax in all of our priority markets, including Saudi Arabia through our associate, The Saudi British Bank, which won the *Euromoney* award for excellence as

HSBC HOLDINGS PLC

Interim Management Report (continued)

Profit/(loss) before tax by country within global businesses

	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Total US$m
Half-year to 30 June 2012						
Egypt	**33**	**45**	**62**		**(3)**	**137**
Qatar	**5**	**18**	**42**			**65**
United Arab Emirates	**52**	**147**	**104**		**(4)**	**299**
Other	**14**	**62**	**(18)**		**1**	**59**
MENA (excluding Saudi Arabia)	**104**	**272**	**190**		**(6)**	**560**
Saudi Arabia	**36**	**69**	**96**	**4**	**7**	**212**
	140	**341**	**286**	**4**	**1**	**772**
Half-year to 30 June 2011						
Egypt	15	32	67		(1)	113
Qatar	(1)	23	39			61
United Arab Emirates	40	120	119	(3)	(11)	265
Other	10	62	53			125
MENA (excluding Saudi Arabia)	64	237	278	(3)	(12)	564
Saudi Arabia	37	59	61	2	24	183
	101	296	339	(1)	12	747
Half-year to 31 December 2011						
Egypt	28	23	62		(1)	112
Qatar	(3)	12	42			51
United Arab Emirates	94	120	81	(3)	18	310
Other	7	47	40			94
MENA (excluding Saudi Arabia)	126	202	225	(3)	17	567
Saudi Arabia	20	39	79	2	38	178
	146	241	304	(1)	55	745

The Best Bank in Saudi Arabia and The Best Debt House in Saudi Arabia . Strong performances were also reported in the UAE and Egypt. Despite signs of recovery, political and economic uncertainty continued in the region. The strength of the HSBC brand and resilience of the oil-based regional economies together with our international connectivity, positions us well for future growth.

Delivery of sustainable cost savings is a key priority and we realised substantial benefits from the actions taken in 2011 to reduce our cost base. In the first half of 2012, we took further steps to improve our cost efficiency and drive additional sustainable cost savings through our organisational effectiveness initiatives, including a de-layering of our management structure and the transfer of additional operational processes to our global service centre.

In RBWM, we remained focused on growing Wealth Management revenues, launching a number of new investment funds, bonds and deposit products. We also entered into a ten-year strategic partnership with Zurich Life International to be the exclusive provider of their wealth insurance products in the region. We continued to roll out our digital solution for mobile banking in the region and

launched an Arabic version of the HSBC website in the UAE, becoming the first international bank with a bilingual presence there.

In CMB, we continued to strengthen our position as the leading international trade and business bank. We launched our third International Trade SME Fund in the UAE, pledging US$272m to support SMEs engaged in cross-border trade, and added resources to enhance our international capabilities, particularly in respect of emerging trade corridors. Our Payments and Cash Management business was named Best Cash Management Bank in the Middle East 2012 in the *Euromoney* Awards for Excellence and continued to achieve success by growing deposit balances.

In GB&M, our customers benefited from dedicated coverage teams on our mainland China, South Korea and India desks in the UAE, Saudi Arabia and Oman, leveraging our South-South connectivity to provide access to Asian investors for issuers in the region with funding requirements. We continued to focus on generating incremental revenues through the provision of risk management services to regional clients by leveraging our global expertise, including in equity and energy derivatives.

Interim Management Report (continued)

We also completed a record number of bond issuances in the first half of 2012, which is indicative of continuing investor appetite for Middle East and North Africa debt. We won seven *Euromoney* awards for excellence including The Best Project Finance House in the Middle East and The Best Equity House in the Middle East . GB&M also won a number of *EMEA Finance* Achievement Awards, including Best Sukuk House 2011 , and three of GB&M s customer deals were recognised by *The Banker* Deals of the Year 2012 .

The following commentary is on a constant currency basis.

Net interest income rose by 5%, driven by higher average deposit balances in RBWM as a result of targeted customer acquisition and successful marketing campaigns, together with wider spreads as we repriced our deposits and benefited from higher interest rates in Egypt. Deposit balance growth in our Payments and Cash Management business, reflecting targeted client growth, led to an increase in net interest income in GB&M, while Balance Sheet Management benefited from higher yields on the available-for-sale investment portfolios. This was partly offset by a low level of demand for corporate credit in CMB.

Net fee income decreased by 7% due to lower advisory revenues and Securities Services fees in GB&M, both of which were affected by the continuing challenging political and economic environment. Fees also declined due to the repositioning of RBWM s cards portfolio towards higher quality lending, which resulted in a reduction in late and over-limit fees along with higher reward scheme charges following revisions to the agreement with our partner aimed at improving card utilisation. In addition, fees declined in private banking as we exited our domestic private banking operations in the UAE. This was partly offset by higher trade import fees in CMB which were driven by targeted sales activity.

Net trading income decreased by 8%, mainly from adverse credit valuation adjustments on certain trading positions relating to a small number of exposures in GB&M. This was partly offset by higher Rates trading income from increased client activity in the first half of 2012 and revaluation gains on certain equity holdings in Principal Investments.

Gains less losses from financial investments increased by US$11m, driven principally by the non-recurrence of adverse fair value movements on certain investments in 2011.

Loan impairment charges and other credit risk provisions increased by US$37m as significant loan impairment charges were recorded for a small number of large exposures in GB&M. This was partly offset by lower impairments in RBWM, due to an improvement in credit quality which reflected the repositioning of the book towards higher quality lending in previous periods, and in CMB as we worked closely with customers through the credit cycle.

Operating expenses decreased by 6%, as a result of the sustainable cost saving initiatives implemented in 2011 and the first half of 2012. These particularly affected staff costs as we reduced employee numbers by over 750 from their peak in March 2011, although staff numbers increased by more than 1,000 following the merger of our Oman operations with OIB. Performance-related costs rose as a result of the merger with OIB and legal costs increased in connection with the strategic transactions noted above.

Share of profits from associates and joint ventures increased by 13%, mainly from The Saudi British Bank, driven by higher revenues due to growth in lending and a rise in trade, other lending and guarantee fees, good cost control and a decline in loan impairment charges as operating conditions improved.

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Profit/(loss) before tax and balance sheet data Middle East and North Africa

	Half-year to 30 June 2012						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[57] US$m	Total US$m
Profit before tax							
Net interest income	273	240	191		1		705
Net fee income/(expense)	85	143	77	1	(4)		302
Trading income excluding net interest income	35	48	122		1		206
Net interest income on trading activities			4		6		10
Net trading income[51]	35	48	126		7		216
Net expense from financial instruments designated at fair value					(4)		(4)
Gains less losses from financial investments			5				5
Dividend income			3				3
Other operating income	2	4	5		51	(52)	10
Total operating income	395	435	407	1	51	(52)	1,237
Net insurance claims[58]							
Net operating income[48]	395	435	407	1	51	(52)	1,237
Loan impairment charges and other credit risk provisions	(37)	(12)	(84)	(2)			(135)
Net operating income/ (expense)	358	423	323	(1)	51	(52)	1,102
Operating income/(expenses)	(249)	(151)	(134)	1	(56)	52	(537)
Operating profit/(loss)	109	272	189		(5)		565
Share of profit in associates and joint ventures	31	69	97	4	6		207
Profit before tax	140	341	286	4	1		772
	%	%	%	%	%		%
Share of HSBC s profit before tax	1.1	2.7	2.3				6.1
Cost efficiency ratio	63.0	34.7	32.9	(100.0)	109.8		43.4
Balance sheet data[47]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	5,005	12,554	8,519	1	1,817		27,896
Total assets	6,437	14,482	36,539	53	8,676	(3,306)	62,881
Customer accounts	18,468	11,127	6,555	14	2,865		39,029

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Interim Management Report (continued)

	Half-year to 30 June 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$m	Inter-segment elimination[57] US$m	Total US$m
Profit/(loss) before tax							
Net interest income	253	243	174	1	3	(1)	673
Net fee income/(expense)	90	135	96	8	(2)		327
Trading income/(expense) excluding net interest income	30	48	129		(1)		206
Net interest income on trading activities	1	7	22			1	31
Net trading income/(expense)[51]	31	55	151		(1)	1	237
Net expense from financial instruments designated at fair value					(6)		(6)
Gains less losses from financial investments			(6)				(6)
Dividend income			1		1		2
Other operating income	10	7	3		43	(54)	9
Total operating income	384	440	419	9	38	(54)	1,236
Net insurance claims[58]							
Net operating income[48]	384	440	419	9	38	(54)	1,236
Loan impairment (charges)/ recoveries and other credit risk provisions	(58)	(48)	6		1		(99)
Net operating income	326	392	425	9	39	(54)	1,137
Operating expenses	(263)	(155)	(148)	(12)	(50)	54	(574)
Operating profit/(loss)	63	237	277	(3)	(11)		563
Share of profit in associates and joint ventures	38	59	62	2	23		184
Profit/(loss) before tax	101	296	339	(1)	12		747
	%	%	%	%	%		%
Share of HSBC s profit before tax	0.9	2.6	3.0				6.5
Cost efficiency ratio	68.5	35.2	35.3	133.3	131.6		46.4
Balance sheet data[47]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	4,861	13,189	7,611	31	2		25,694
Total assets	6,383	14,950	34,306	73	4,958	(2,632)	58,038
Customer accounts	19,301	11,101	6,275	363	79		37,119

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Profit/(loss) before tax and balance sheet data Middle East and North Africa (continued)

	Half-year to 31 December 2011						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other	Inter-segment elimination[57]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit/(loss) before tax							
Net interest income/(expense)	336	253	197	1	(1)	(27)	759
Net fee income/(expense)	83	136	77	5	(1)		300
Trading income excluding net interest income	32	47	137	1			217
Net interest income/(expense) on trading activities	(1)	(7)	10		(1)	27	28
Net trading income/(expense)[51]	31	40	147	1	(1)	27	245
Net income from financial instruments designated at fair value					16		16
Gains less losses from financial investments	1	1	(1)		(3)		(2)
Dividend income	1	1	2		(1)		3
Other operating income/(expense)	12	4	8	(1)	81	(54)	50
Total operating income	464	435	430	6	90	(54)	1,371
Net insurance claims[58]							
Net operating income[48]	464	435	430	6	90	(54)	1,371
Loan impairment charges and other credit risk provisions	(68)	(68)	(57)		(1)		(194)
Net operating income	396	367	373	6	89	(54)	1,177
Operating expenses	(272)	(165)	(147)	(9)	(46)	54	(585)
Operating profit/(loss)	124	202	226	(3)	43		592
Share of profit in associates and joint ventures	22	39	78	2	12		153
Profit/(loss) before tax	146	241	304	(1)	55		745
	%	%	%	%	%		%
Share of HSBC s profit before tax	1.4	2.3	2.9		0.5		7.2
Cost efficiency ratio	58.6	37.9	34.2	150.0	51.1		42.7
Balance sheet data[47]							
	US$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

For footnotes, see page 100.

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HSBC HOLDINGS PLC

Interim Management Report (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.

	Half-year to		
	30 Jun 2012 US$m	30 Jun 2011 US$m	31 Dec 2011 US$m
Net interest income	**4,739**	5,849	5,631
Net fee income	**1,443**	1,718	1,590
Net trading income/(expense)	**161**	448	(810)
Gains on disposal of US branch network and cards business	**3,809**		
Other income/(expense)	**(174)**	225	1,349
Net operating income[48]	**9,978**	8,240	7,760
Impairment charges[49]	**(2,161)**	(3,049)	(3,967)
Net operating income	**7,817**	5,191	3,793
Total operating expenses	**(4,462)**	(4,602)	(4,317)
Operating profit/(loss)	**3,355**	589	(524)
Income from associates[50]	**(1)**	17	18
Profit/(loss) before tax	**3,354**	606	(506)
Cost efficiency ratio	**44.7%**	55.8%	55.6%
RoRWA[40]	**2.1%**	0.4%	(0.3%)
Period-end staff numbers	**23,341**	32,605	30,981

US$3.9bn

gain recognised following

the completion of strategic disposals

Gross balances in the CML portfolio

down by US$3.8bn to

US$45.7bn

29%

reduction in loan

impairment charges

For footnotes, see page 100.

The commentary on North America is on a constant currency basis unless stated otherwise.

Economic background

Annualised **US** GDP growth was 1.6% in the first half of 2012. Annualised consumer spending growth remained moderate at 2% as the process of reducing debt after the credit boom of the last decade continued to restrain growth in spending as households attempted to increase their savings. Employment growth remained positive in the first half of 2012 but slowed during the period. The unemployment rate was 8.2% in June, down from 9.1% a year earlier. In response to slow growth and stable core inflation, the Federal Reserve maintained the federal funds rate in a range of zero to 0.25% and, in January, it announced that these exceptionally low levels were likely to remain in place to at least the end of 2014. In June, the Federal Reserve extended its maturity extension programme to the end of 2012, continuing to purchase longer-term Treasury securities while simultaneously selling an equivalent amount of short-term securities.

Canadian GDP rose by an annualised rate of 1.9% in the first quarter of 2012 and domestic demand remained a key driver of GDP growth. March and April 2012 saw the largest gains in employment in a two-month period since 1976 which, alongside modest upward pressure on wages, helped sustain a rebound in Canadian consumer confidence in the first half of the year. The firm domestic backdrop led the Bank of Canada to suggest in mid-April that some policy tightening may become appropriate , but the deterioration in the global economic outlook saw the central bank maintain interest rates at 1% throughout the first half of 2012. With interest rates remaining low, the federal government put in place a number of measures aimed at reducing the pace of price appreciation in the housing market.

Review of performance

In the first half of 2012, our operations in North America reported a profit before tax of US$3.4bn, compared with US$606m in the first half of 2011. Our reported profits included gains in the US of US$3.1bn and US$661m following the completion of the sales of the Card and Retail Services business and the 138 non-strategic branches, respectively, while in Canada we recorded a gain of US$83m from the sale of the Private Client Services business. In addition, we recognised US$559m of adverse movements on our own debt designated at fair value resulting from tightening credit spreads, compared with adverse movements of US$66m in the first half of 2011 and favourable movements of US$1.0bn in the second half of 2011.

Interim Management Report (continued)

Profit/(loss) before tax by country within global businesses

	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Total US$m
Half-year to 30 June 2012						
US	**3,326**	**374**	**384**	**38**	**(1,388)**	**2,734**
Canada	**129**	**307**	**174**		**(8)**	**602**
Bermuda	**18**	**1**	**(9)**	**3**	**4**	**17**
Other	**1**					**1**
	3,474	**682**	**549**	**41**	**(1,392)**	**3,354**
Half-year to 30 June 2011						
US	(568)	177	599	47	(244)	11
Canada	95	297	134		(6)	520
Bermuda	28	14	23	2	8	75
Other						
	(445)	488	756	49	(242)	606
Half-year to 31 December 2011						
US	(2,293)	254	(32)	36	1,026	(1,009)
Canada	52	248	131		14	445
Bermuda	21	12	20	5	1	59
Other					(1)	(1)
	(2,220)	514	119	41	1,040	(506)

On an underlying basis, our profit before tax was US$21m compared with US$483m in the first half of 2011. This decrease was mainly due to lower revenue in CML, reflecting a reduction in average lending balances as the business winds down, and lower revenue in GB&M. Operating expenses also increased, including a provision of US$700m related to US anti-money laundering, BSA and OFAC investigations. Partly offsetting this was a reduction in loan impairment charges in CML. In Canada, we increased our underlying profit before tax by 5% to US$537m. This was mainly due to a rise in revenue, notably from an improved performance in GB&M, partly offset by increased costs.

We continued to make progress in disposing of businesses not aligned with the Group s long-term strategy. On 1 May 2012, we completed the sale and transfer of our US Card and Retail Services business. Associated with the sale, over 5,000 employees and certain real estate facilities were transferred to the purchaser. In addition, we entered into a transition services agreement with the purchaser to support some of the account servicing operations until such time as all systems, processes and equipment are integrated into the purchaser s existing infrastructure. We also completed the sale of 138 of the 195 retail branches in upstate New York that we had agreed to sell, recognising gains of US$449m and US$212m in RBWM and CMB, respectively. In the third quarter of 2012, we expect

to complete the disposal of the remaining 57 branches. In Canada, we completed the sale of the Private Client Services business. The impact of these sales on our results can be seen on page 38. We expect these sales to have a significant adverse effect on both revenue and profit in our North America region in the future.

In the first half of 2012, HSBC Bank USA, N.A. (HSBC Bank USA) entered into a strategic relationship with PHH Mortgage to manage our mortgage origination and servicing operations. Under the terms of the agreement, we will continue to own the mortgage servicing rights (MSRs) associated with our current portfolio of serviced loans, but we will not recognise any additional MSRs upon the completion of the transaction. The value of our existing MSRs will remain subject to interest rate risk, which is mitigated through an economic hedging programme. The conversion of these operations is expected to be completed in the first quarter of 2013. In March 2012, we announced the winding down of our consumer finance business in Canada and, except for existing commitments, ceased the origination of loans.

We incurred additional costs of US$151m in the first half of 2012 following restructuring activities in the region; these related mainly to the business disposals, the closure of our consumer finance operations in Canada and the continuation of our organisational effectiveness initiatives while we achieved some US$220m of additional sustainable

Interim Management Report (continued)

cost savings during the same period. These were mainly derived from operational efficiencies and a delayering programme.

We remained focused on managing the run-off of balances in our CML portfolio, with period-end lending balances of US$45.7bn, a decline of 8% from the end of 2011 of which 44% was attributable to the write-off of balances. We engaged an advisor to assist us in exploring options to accelerate the liquidation of this portfolio and identified certain loan pools that we intend to sell as market conditions permit. The financial effect of our run-off portfolio on the results of our North America operations can be seen on page 38.

Also in RBWM, we continued to develop our Wealth Management capabilities across the region. In Canada, we operate the country s largest Chinese and second largest Indian equity funds and, in the US, we launched a renminbi fixed income fund to provide US investors with the opportunity to access mainland China s rapidly growing bond market.

In CMB and GB&M, we continued to target companies with international banking requirements, while CMB s extended collaboration with GB&M resulted in a 26% rise in revenue from the sales of GB&M products to our CMB customers. This revenue is shared between the two global businesses.

In GB&M, we continued to work on delivering integrated solutions for our customers across the Americas, increasing our lending to Latin American corporates. In addition, we actively reduced our legacy credit exposure in the US by exiting certain positions. We will seek to further reduce the size of this portfolio as opportunities become available. The financial effect of the legacy credit portfolio on the results of our North America operations can be seen on page 38.

The following commentary is on a constant currency basis.

Net interest income fell by 19% to US$4.7bn, mainly due to the loss of income from the Card and Retail Services business along with a reduction in average lending balances and lower yields from operations to the date of sale. Excluding the results of the Card and Retail Services business and the other disposals referred to above, net interest income declined, reflecting the reduction in average lending balances as the CML portfolio continued to run-off, while lending spreads in this portfolio also reduced as the product mix

comprised a higher balance of lower yielding products.

Net fee income declined by 16%, primarily due to the sale of the Card and Retail Services business and, to a lesser extent, the sale of the Private Client Services business in Canada. Excluding the results of the disposed businesses, net fee income was broadly unchanged.

Net trading income fell by 64% to US$161m. The reduction reflected lower revenue in GB&M, mainly in the legacy credit portfolio due to reduced net releases of write-downs in the first half of 2012 resulting from lower price appreciation on assets held in this portfolio, and losses incurred on the exit of certain exposures in advance of their scheduled maturity date. In addition, revenue from Credit declined as a result of unfavourable credit spread movements.

In RBWM, higher trading expense reflected an increase in adverse movements in the fair value of non-qualifying hedges used to hedge floating rate debt issued by HSBC Finance. In the first half of 2012, the effects of falling long-term US interest rates was more pronounced than in the first half of 2011, resulting in adverse fair value movements in HSBC Finance of US$217m compared with US$124m in the first half of 2011 and US$1.1bn in the second half of 2011.

Net expense from financial instruments designated at fair value increased from US$118m in the first half of 2011 to US$639m in the first half of 2012. Narrowing credit spreads resulted in adverse movements in the fair value of our own debt in both periods, though the effects were more pronounced in 2012.

Gains less losses from financial investments were US$175m, a rise of 61% compared with the first half of 2011 due to an increase in gains from sales of assets in Balance Sheet Management in the US, as well as an increase in gains from similar sales in Canada. These transactions were undertaken as part of structural interest rate risk management activities.

Other operating income increased following a reduction in losses on foreclosed properties, reflecting fewer sales.

Loan impairment charges and other credit risk provisions were US$2.2bn, 29% lower than in the first half of 2011. This reflected a marked decline in loan impairment charges in the CML portfolio, as well as the sale of the Card and Retail Services business.

Loan impairment charges in the CML portfolio declined by 28% to US$1.6bn, driven by a reduction in lending balances as the portfolio continued to run off, as well as an improvement in two-months-and-over contractual delinquency on balances less than 180 days past due. Loan impairment charges were adversely affected by delays in expected cash flows from mortgage loans due, in part, to delays in foreclosure processing, though the effects were more pronounced in the first half of 2011. Additionally, in the first half of 2012, we increased our loan impairment allowances having updated our assumptions regarding the timing of expected cash flows received from customers with loan modifications.

Further discussions of delinquency trends in the US personal lending portfolios are provided in Areas of special interest US Personal Lending on page 136.

Operating expenses of US$4.5bn were 3% lower than in the first half of 2011, as our cost base reduced following the completion of various disposals and the closure of the consumer finance business in Canada as well as the success of initiatives to lower cost levels and achieve sustainable savings.

Staff costs in the region reduced as average staff numbers fell by over 5,000 compared with the first half of 2011, the majority of whom transferred as part of the businesses sold. Performance-related costs also fell, while lower marketing costs reflected a reduction in marketing programmes. In addition, the costs of holding foreclosed properties declined reflecting lower inventory following the slowing of foreclosure processing activities. Restructuring costs of US$151m compared with US$190m in the first half of 2011. In the current period, restructuring was primarily associated with our business disposals, the closure of the consumer finance business in Canada and the continuation of our organisational effectiveness initiatives. Offsetting the decline in costs in the region was an increase in provisions, including US$700m related to anti-money laundering, BSA and OFAC investigations, which is reported in Other for the purposes of the segmentation by global business. In addition, we incurred higher compliance costs, largely due to investment in process enhancements and infrastructure related to anti-money laundering and BSA consent orders, along with actions to address the regulatory consent orders relating to foreclosure activities.

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Interim Management Report (continued)

Profit/(loss) before tax and balance sheet data North America

	Half-year to 30 June 2012						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[57] US$m	Total US$m
Profit/(loss) before tax							
Net interest income	3,418	715	491	97	50	(32)	4,739
Net fee income	681	272	375	64	51		1,443
Trading income/(expense) excluding net interest income	(206)	20	245	11	8		78
Net interest income on trading activities	9	1	41			32	83
Net trading income/ (expense)[51]	(197)	21	286	11	8	32	161
Changes in fair value of long-term debt issued and related derivatives					(638)		(638)
Net expense from other financial instruments designated at fair value			(1)				(1)
Net expense from financial instruments designated at fair value			(1)		(638)		(639)
Gains less losses from financial investments	12		158		6		176
Dividend income	8	5	11	1	1		26
Net earned insurance premiums	109						109
Gains on disposal of US branch network and cards business	3,597	212					3,809
Other operating income	109	93	87	5	1,011	(1,079)	226
Total operating income	7,737	1,318	1,407	178	489	(1,079)	10,050
Net insurance claims[58]	(72)						(72)
Net operating income[48]	7,665	1,318	1,407	178	489	(1,079)	9,978
Loan impairment (charges)/ recoveries and other credit risk provisions	(2,084)	(51)	(30)	4			(2,161)
Net operating income	5,581	1,267	1,377	182	489	(1,079)	7,817
Operating expenses	(2,108)	(583)	(828)	(141)	(1,881)	1,079	(4,462)
Operating profit/(loss)	3,473	684	549	41	(1,392)		3,355
Share of profit/(loss) in associates and joint ventures	1	(2)					(1)
Profit/(loss) before tax	3,474	682	549	41	(1,392)		3,354
	%	%	%	%	%		%

Share of HSBC s profit before tax	**27.3**	**5.4**	**4.3**	**0.3**	**(11.0)**		**26.3**
Cost efficiency ratio	**27.5**	**44.2**	**58.8**	**79.2**	**384.7**		**44.7**
Balance sheet data[47]							
	US$m	**US$m**	**US$m**	**US$m**	**US$m**		**US$m**
Loans and advances to customers (net)	**83,060**	**33,754**	**32,068**	**5,109**			**153,991**
Total assets	**110,038**	**46,321**	**347,728**	**7,444**	**12,054**	**(22,995)**	**500,590**
Customer accounts	**58,962**	**45,783**	**29,465**	**14,061**	**89**		**148,360**

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Profit/(loss) before tax and balance sheet data North America (continued)

	Half-year to 30 June 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$m	Inter-segment elimination[57] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/ (expense)	4,617	748	465	94	(37)	(38)	5,849
Net fee income	936	276	420	79	7		1,718
Trading income/(expense) excluding net interest income	(68)	16	344	13	(11)		294
Net interest income/(expense) on trading activities	10	1	106		(1)	38	154
Net trading income/ (expense)[51]	(58)	17	450	13	(12)	38	448
Changes in fair value of long-term debt issued and related derivatives					(116)		(116)
Net income/(expense) from other financial instruments designated at fair value			(4)		1		(3)
Net expense from financial instruments designated at fair value			(4)		(115)		(119)
Gains less losses from financial investments	14		96				110
Dividend income	8	4	7	1	1		21
Net earned insurance premiums	118						118
Other operating income/ (expense)	(28)	60	100	5	1,130	(1,099)	168
Total operating income	5,607	1,105	1,534	192	974	(1,099)	8,313
Net insurance claims[58]	(73)						(73)
Net operating income[48]	5,534	1,105	1,534	192	974	(1,099)	8,240
Loan impairment (charges)/ recoveries and other credit risk provisions	(3,035)	(45)	23	11	(3)		(3,049)
Net operating income	2,499	1,060	1,557	203	971	(1,099)	5,191
Operating expenses	(2,945)	(587)	(801)	(154)	(1,214)	1,099	(4,602)
Operating profit/(loss)	(446)	473	756	49	(243)		589
Share of profit in associates and joint ventures	1	15			1		17
Profit/(loss) before tax	(445)	488	756	49	(242)		606
	%	%	%	%	%		%
Share of HSBC s profit before tax	(3.9)	4.3	6.6	0.4	(2.1)		5.3
Cost efficiency ratio	53.2	53.1	52.2	80.2	124.6		55.8

Balance sheet data[47]

	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)	123,891	31,015	19,988	4,368			179,262
Total assets	153,098	42,971	341,246	6,831	13,009	(27,769)	529,386
Customer accounts	76,266	46,940	25,579	13,747	101		162,633

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HSBC HOLDINGS PLC

Interim Management Report (continued)

	Half-year to 31 December 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$m	Inter-segment elimination[57] US$m	Total US$m
Profit/(loss) before tax							
Net interest income	4,314	780	428	93	46	(30)	5,631
Net fee income/(expense)	900	275	353	70	(8)		1,590
Trading income/(expense excluding net interest income	(878)	18	(83)	4	(15)		(954)
Net interest income on trading activities	15		99			30	144
Net trading income/ (expense)[51]	(863)	18	16	4	(15)	30	(810)
Changes in fair value of long-term debt issued and related derivatives					1,083		1,083
Net income/(expense) from other financial instruments designated at fair value			(1)		1		
Net income/(expense) from financial instruments designated at fair value			(1)		1,084		1,083
Gains less losses from financial investments	44	7	99		2		152
Dividend income	7	5	6	2	(1)		19
Net earned insurance premiums	118						118
Other operating income/ (expense)	(97)	50	93	6	1,114	(1,108)	58
Total operating income	4,423	1,135	994	175	2,222	(1,108)	7,841
Net insurance claims[58]	(81)						(81)
Net operating income[48]	4,342	1,135	994	175	2,222	(1,108)	7,760
Loan impairment (charges)/ recoveries and other credit risk provisions	(3,894)	(60)	(34)	19	2		(3,967)
Net operating income	448	1,075	960	194	2,224	(1,108)	3,793
Operating expenses	(2,670)	(579)	(841)	(153)	(1,182)	1,108	(4,317)
Operating profit/(loss)	(2,222)	496	119	41	1,042		(524)
Share of profit/(loss) in associates and joint ventures	2	18			(2)		18
Profit/(loss) before tax	(2,220)	514	119	41	1,040		(506)

	%	%	%	%	%		%
Share of HSBC s profit before tax	(21.3)	4.9	1.1	0.4	10.0		(4.9)
Cost efficiency ratio	61.5	51.0	84.6	87.4	53.2		55.6

Balance sheet data[47]

	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

For footnotes, see page 100.

Interim Management Report (continued)

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.

	Half-year to		
	30 Jun 2012 US$m	30 Jun 2011 US$m	31 Dec 2011 US$m
Net interest income	**3,542**	3,517	3,439
Net fee income	**843**	902	879
Net trading income	**597**	589	789
Other income	**583**	675	663
Net operating income[48]	**5,565**	5,683	5,770
Impairment charges[49]	**(1,136)**	(820)	(1,063)
Net operating income	**4,429**	4,863	4,707
Total operating expenses	**(3,285)**	(3,712)	(3,543)
Operating profit	**1,144**	1,151	1,164
Income from associates[50]	**1**		
Profit before tax	**1,145**	1,151	1,164
Cost efficiency ratio	**59.0%**	65.3%	61.4%
RoRWA[40]	**2.2%**	2.2%	2.2%
Period-end staff numbers	**51,667**	55,618	54,035

14%

increase in Wealth Management revenues

17%

increase in GB&M revenues on a

constant currency basis

HSBC Brazil best in International

Debt Capital Markets

(Brazilian Financial and Capital Markets Association)

For footnotes, see page 100.

The commentary on Latin America is on a constant currency basis unless stated otherwise.

Economic background

Growth in **Latin America** slowed in the first half of 2012, with a common feature being the slowdown in demand from eurozone economies.

Brazilian economic activity slowed markedly; the annual pace of GDP growth fell to 0.8% in the first quarter. In contrast to the other economies of the region, the loss of momentum in Brazil appeared to be mainly the result of weak domestic investment spending. Inflation moderated, allowing the Central Bank of Brazil to cut the Selic policy rate by 400bps from the peak reached in August 2011.

Mexico produced the strongest performance in the region with the annual pace of GDP growth accelerating to 4.6% in the first quarter of 2012. Despite the weakness of global growth, exports remained a key driver of Mexican activity. Domestic demand was also robust. Inflation remained moderate despite strong fluctuations in the currency and, accordingly, Banco de Mexico left the monetary policy rate unchanged at 4.5% during the period.

In **Argentina,** economic activity decelerated markedly during the first half of 2012. Annualised GDP growth fell from 8.9% in 2011 to 3% in the first five months of 2012. Inflation remained high, and the currency depreciated at an annualised rate of 10%. To counter the deterioration in the current and financial account balances, the government required official authorisation of most transactions involving the acquisition of foreign currency.

Review of performance

In Latin America, our operations reported a profit before tax of US$1.1bn for the first half of 2012, an increase of 1%, or 11% on a constant currency basis compared with the first half of 2011. This included a gain of US$102m following the completion of the sale of our general insurance manufacturing business in Argentina, and a loss of US$135m recognised following the reclassification of our non-strategic businesses to held for sale.

On an underlying basis, which excludes the above US$102m gain, pre-tax profits increased by 3%, mainly due to increased revenue in our CMB and RBWM businesses in Brazil and Argentina following growth in average lending balances, primarily during 2011, higher Balance Sheet Management and Rates and Foreign Exchange revenues in Brazil as interest rates declined, and lower operating expenses resulting from lower restructuring costs and cost saving initiatives. This was partly offset by the loss of US$135m described above.

HSBC HOLDINGS PLC

Interim Management Report (continued)

Profit/(loss) before tax by country within global businesses

	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Total US$m
Half-year to 30 June 2012						
Argentina	**156**	**100**	**98**		**(42)**	**312**
Brazil	**(83)**	**200**	**413**	**10**	**(35)**	**505**
Mexico	**179**	**77**	**111**		**(1)**	**366**
Panama	**13**	**33**	**21**			**67**
Other	**(51)**	**(29)**	**6**		**(31)**	**(105)**
	214	**381**	**649**	**10**	**(109)**	**1,145**
Half-year to 30 June 2011						
Argentina	49	46	67		(8)	154
Brazil	136	294	250	7	(50)	637
Mexico	169	103	171	2	(142)	303
Panama	17	27	26	1	(2)	69
Other	(35)	5	29		(11)	(12)
	336	475	543	10	(213)	1,151
Half-year to 31 December 2011						
Argentina	42	61	81		6	190
Brazil	105	272	265	6	(55)	593
Mexico	234	26	97	2	(36)	323
Panama	6	32	26	2	(7)	59
Other	(20)	1	37		(19)	(1)
	367	392	506	10	(111)	1,164

Performance in Brazil was affected by higher loan impairment charges, following balance sheet growth in RBWM and CMB during previous periods, which benefited from strong customer sentiment in the buoyant economic conditions. Subsequently, as the economy has slowed, delinquency rates have risen.

In line with the Group s strategy, we applied the five filters to our Latin American businesses and decided on a number of disposals. In the first half of 2012, we announced the sale of our businesses in Costa Rica, El Salvador and Honduras, which is expected to be completed in the second half of 2012. We also announced the sale of our businesses in Colombia, Peru, Uruguay and Paraguay, with completion expected in 2013. We will continue to offer full branch services to customers during the transition.

Following a review of our general insurance business, we completed the sale of our general insurance manufacturing business in Argentina and in Mexico, we agreed to sell a portfolio of general insurance assets and liabilities. Under the terms of these agreements, the purchasers will provide general insurance to HSBC s retail customers in the two countries. This long-term collaboration will broaden and strengthen the suite of general insurance products available to these customers.

In our RBWM business, we continued with our strategy of generating strong long-term relationships

and high risk-adjusted returns, capturing wealth creation opportunities from mass-market customers as a feeder to capitalise on upward social mobility. We grew our Wealth Management revenues across the region by 14%. We also continued to manage down certain vehicle finance and payroll loan portfolios in Brazil where there is no relationship-building capacity.

In CMB, we worked closely with GB&M to ensure our clients have access to relevant GB&M products. This collaboration resulted in revenue growth of 3% as more CMB customers started using Global Markets products. Our relationships with CMB payroll customers enabled us to increase personal lending to their employees, who became our RBWM customers.

In GB&M, we continued to target global corporate customers throughout Latin America. We maintained a strong presence in the foreign exchange and derivatives markets. We were also awarded first place in International Debt Capital Markets by the Brazilian Financial and Capital Markets Association.

We continued to implement measures to improve operational efficiency. As a result, we incurred restructuring costs in the first half of 2012 of US$72m and a 4% net reduction of 2,300 staff numbers during the first half of 2012. We also achieved a total of US$140m of additional sustainable savings.

Interim Management Report (continued)

The following commentary is on a constant currency basis.

Net interest income increased by 12% compared with the first half of 2011, driven by strong growth in our RBWM and CMB businesses.

In RBWM, net interest income increased in Brazil, mainly due to a change in the composition of the lending book as we increased our balances of higher-yielding assets and managed down our exposure in certain vehicle finance and payroll loan portfolios as described earlier. Additionally, in Mexico we increased average lending balances, mainly in payroll and personal loans. In CMB, average lending balances in Brazil were higher than the comparative period, mainly in trade and working capital products.

In Brazil, spreads widened across most lending products in RBWM and CMB as interest rates declined, resulting in lower cost of funds while in Argentina lending spreads in CMB were wider on overdrafts.

In Balance Sheet Management, net interest income increased notably in Brazil as we benefited from the downward movements in interest rates which lowered the cost of funding assets in this portfolio.

Net fee income increased by 4% to US$843m, mainly in Brazil due to higher current accounts and Payments and Cash Management revenues, which benefited from repricing initiatives.

Net trading income of US$597m was 15% higher than in the first half of 2011, primarily in Brazil due to higher GB&M revenues which reflected increased revenues in Rates, resulting from tightening spreads on long bond positions, and also in Foreign Exchange products as a result of increased collaboration with CMB clients.

Net income from financial instruments designated at fair value increased by 38%, reflecting the growth of policyholder assets in Brazil. An offsetting increase was recorded in *Net insurance claims incurred and movement in liabilities to policyholders*.

Gains less losses from financial investments of US$89m was 33% higher than in the first half of 2011, primarily in Mexico and Brazil due to disposals of government bonds in GB&M in the first half of 2012, partly offset by the non-recurrence of a gain in GB&M on the sale of shares in a Mexican listed company in the first half of 2011.

Net earned insurance premiums increased by 12% to US$1.3bn, driven by increased sales in Brazil of unit-linked pension products, term life insurance and credit protection products. Premiums also rose in Mexico, mainly due to growth in sales of the endowment product, partly offset by a decrease in Argentina, driven by the sale of the general insurance business reflecting two months less of operations in the first half of 2012.

Other operating income decreased by US$103m, primarily due to the loss recognised following the reclassification of certain businesses to held-for-sale and the non-recurrence of the gain on sale and leaseback of branches in Mexico in the first half of 2011. This was partly offset by the gain on sale of the insurance business in Argentina of US$102m.

Loan impairment charges and other credit risk provisions increased by 57%, mainly in Brazil. This resulted from increased delinquency rates in RBWM in Brazil, following strong balance sheet growth in previous periods which was driven by increased marketing and acquisitions, and strong consumer demand in buoyant economic conditions which subsequently weakened. In CMB, loan impairment charges almost doubled, mainly in Brazil following increased delinquency and a rise in individually assessed loan impairment charges booked in the first half of 2012. We took a number of steps to address the increase in delinquencies in RBWM and CMB including improving our collections capabilities, reducing third-party originations and lowering credit limits where appropriate.

Operating expenses decreased by 1% compared with the first half of 2011. Restructuring costs declined by US$56m as the equivalent period in 2011 included costs associated with the consolidation of the branch network and the reorganisation of regional and country support functions.

The success of these restructuring initiatives and our continued efforts to exercise strict cost control and progress with our organisational effectiveness programmes contributed to about US$140m of additional sustainable cost savings and a net 7% reduction in staff numbers of almost 4,000 compared with the end of June 2011. These savings were partly offset by inflationary pressures, union-agreed wage increases in Brazil and Argentina, and a provision relating to anti-money laundering in Mexico.

Interim Management Report (continued)

Profit/(loss) before tax and balance sheet data Latin America

	Half-year to 30 June 2012						
	Retail Banking and Wealth Management US$m	Commercial Banking US$m	Global Banking and Markets US$m	Global Private Banking US$m	Other US$m	Inter-segment elimination[57] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	2,148	1,123	520	16	(15)	(250)	3,542
Net fee income	423	303	102	15			843
Trading income excluding net interest income	36	52	252	1	3		344
Net interest income on trading activities			3			250	253
Net trading income[51]	36	52	255	1	3	250	597
Net income from financial instruments designated at fair value	223	53			12		288
Gains less losses from financial investments	4	2	83				89
Dividend income	4	4	1				9
Net earned insurance premiums	1,008	235	13				1,256
Other operating income	72	2	(7)	2	73	(95)	47
Total operating income	3,918	1,774	967	34	73	(95)	6,671
Net insurance claims[58]	(889)	(209)	(8)				(1,106)
Net operating income[48]	3,029	1,565	959	34	73	(95)	5,565
Loan impairment charges and other credit risk provisions	(819)	(316)		(1)			(1,136)
Net operating income	2,210	1,249	959	33	73	(95)	4,429
Operating expenses	(1,996)	(869)	(310)	(23)	(182)	95	(3,285)
Operating profit/(loss)	214	380	649	10	(109)		1,144
Share of profit in associates and joint ventures		1					1
Profit/(loss) before tax	214	381	649	10	(109)		1,145
	%	%	%	%	%		%
Share of HSBC s profit before tax	1.7	3.0	5.1	0.1	(0.9)		9.0
Cost efficiency ratio	65.9	55.5	32.3	67.6	249.3		59.0
Balance sheet data[47]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	17,491	24,865	10,521	83			52,960
Total assets	38,296	37,387	62,624	819	365	(523)	138,968
Customer accounts	27,918	21,477	15,104	5,095			69,594

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Profit/(loss) before tax and balance sheet data Latin America (continued)

	Half-year to 30 June 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$m	Inter-segment elimination[57] US$m	Total US$m
Profit/(loss) before tax							
Net interest income/(expense)	2,215	1,096	456	12	(1)	(261)	3,517
Net fee income	492	292	98	19	1		902
Trading income excluding net interest income	29	49	186	2	3		269
Net interest income on trading activities	1		58			261	320
Net trading income[51]	30	49	244	2	3	261	589
Net income from financial instruments designated at fair value	181	55					236
Gains less losses from financial investments			73				73
Dividend income	5	2					7
Net earned insurance premiums	961	289	18				1,268
Other operating income	118	40	24	1	127	(130)	180
Total operating income	4,002	1,823	913	34	130	(130)	6,772
Net insurance claims[58]	(821)	(258)	(10)				(1,089)
Net operating income[48]	3,181	1,565	903	34	130	(130)	5,683
Loan impairment charges and other credit risk provisions	(633)	(180)	(7)				(820)
Net operating income	2,548	1,385	896	34	130	(130)	4,863
Operating expenses	(2,212)	(910)	(353)	(24)	(343)	130	(3,712)
Operating profit/(loss)	336	475	543	10	(213)		1,151
Share of profit/(loss) in associates and joint ventures							
Profit/(loss) before tax	336	475	543	10	(213)		1,151
	%	%	%	%	%		%
Share of HSBC s profit before tax	2.9	4.1	4.7	0.1	(1.8)		10.0
Cost efficiency ratio	69.5	58.1	39.1	70.6	263.8	100	65.3
Balance sheet data[47]							
	US$m	US$m	US$m	US$m	US$m		US$m
Loans and advances to customers (net)	22,431	29,036	14,271	64			65,802
Total assets	40,866	41,136	78,131	1,564	2,926	(1,012)	163,611
Customer accounts	32,619	27,251	29,402	6,837			96,109

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HSBC HOLDINGS PLC

Interim Management Report (continued)

	Half-year to 31 December 2011						
	Retail Banking and Wealth Management	Commercial Banking	Global Banking and Markets	Global Private Banking	Other	Inter-segment elimination[57]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
Profit/(loss) before tax							
Net interest income/(expense)	2,304	1,133	426	13	(6)	(431)	3,439
Net fee income/(expense)	447	318	98	17	(1)		879
Trading income/(expense) excluding net interest income	39	57	186	3	(10)		275
Net interest income/(expense) on trading activities	(1)		76		8	431	514
Net trading income/(expense)[51]	38	57	262	3	(2)	431	789
Net income from financial instruments designated at fair value	243	69	2				314
Gains less losses from financial investments	11	1	51	1			64
Dividend income	5	1	1				7
Net earned insurance premiums	1,107	262	16				1,385
Other operating income	147	17	8	1	95	(120)	148
Total operating income	4,302	1,858	864	35	86	(120)	7,025
Net insurance claims[58]	(1,029)	(220)	(6)				(1,255)
Net operating income[48]	3,273	1,638	858	35	86	(120)	5,770
Loan impairment charges and other credit risk provisions	(736)	(321)	(5)		(1)		(1,063)
Net operating income	2,537	1,317	853	35	85	(120)	4,707
Operating expenses	(2,170)	(925)	(347)	(25)	(196)	120	(3,543)
Operating profit/(loss)	367	392	506	10	(111)		1,164
Share of profit in associates and joint ventures							
Profit/(loss) before tax	367	392	506	10	(111)		1,164
	%	%	%	%	%		%
Share of HSBC s profit before tax	3.5	3.8	4.9	0.1	1.1		11.2
Cost efficiency ratio	66.3	56.5	40.4	71.4	227.9		61.4
Balance sheet data[47]							
	US$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

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Reconciliation of constant currency profit/(loss) before tax

Europe

30 June 2012 compared with 30 June 2011

	Half-year to 30 June 2012 (1H12) compared with half-year to 30 June 2011 (1H11)					
	1H11 as reported US$m	Currency translation[10] US$m	1H11 at 1H12 exchange rates US$m	1H12 as reported US$m	Reported change[11] %	Constant currency change[11] %
Net interest income	5,566	(230)	5,336	5,073	(9)	(5)
Net fee income	3,131	(136)	2,995	3,023	(3)	1
Changes in fair value[12]	(71)		(71)	(1,605)	(2,161)	(2,161)
Other income[13]	2,714	(75)	2,639	3,176	17	20
Net operating income[14]	**11,340**	**(441)**	**10,899**	**9,667**	**(15)**	**(11)**
Loan impairment charges and other credit risk provisions	(1,173)	38	(1,135)	(1,037)	12	9
Net operating income	**10,167**	**(403)**	**9,764**	**8,630**	**(15)**	**(12)**
Operating expenses	(8,014)	300	(7,714)	(9,289)	(16)	(20)
Operating profit/(loss)	**2,153**	**(103)**	**2,050**	**(659)**		
Share of loss in associates and joint ventures	(6)	(8)	(14)	(8)	(33)	43
Profit/(loss) before tax	**2,147**	**(111)**	**2,036**	**(667)**		

30 June 2012 compared with 31 December 2011

	Half-year to 30 June 2012 (1H12) compared with half-year to 31 December 2011 (2H11)					
	2H11 as reported US$m	Currency translation[10] US$m	2H11 at 1H12 exchange rates US$m	1H12 as reported US$m	Reported change[11] %	Constant currency change[11] %
Net interest income	5,435	(110)	5,325	5,073	(7)	(5)

Net fee income	3,105	(70)	3,035	3,023	(3)	(0)
Changes in fair value[12]	3,018	(37)	2,981	(1,605)		
Other income[13]	1,348	46	1,394	3,176	136	128
Net operating income[14]	12,906	(171)	12,735	9,667	(25)	(24)
Loan impairment charges and other credit risk provisions	(1,339)	23	(1,316)	(1,037)	23	21
Net operating income	11,567	(148)	11,419	8,630	(25)	(24)
Operating expenses	(9,055)	123	(8,932)	(9,289)	(3)	(4)
Operating profit/(loss)	2,512	(25)	2,487	(659)		
Share of profit/(loss) in associates and joint ventures	12	2	14	(8)		
Profit/(loss) before tax	2,524	(23)	2,501	(667)		

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Reconciliation of reported and underlying revenue[15]

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported revenue	**9,667**	11,340	(15)	**9,667**	12,906	(25)
Constant currency		(441)			(134)	
Own credit spread	**1,605**	71		**1,605**	(3,018)	
Acquisitions, disposals and dilutions						
Underlying revenue	**11,272**	10,970	3	**11,272**	9,754	16

Reconciliation of reported and underlying loan impairment charges and other credit risk provisions (LIC s)

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported LICs	**(1,037)**	(1,173)	12	**(1,037)**	(1,339)	23
Constant currency		38			23	
Acquisitions, disposals and dilutions						
Underlying LICs	**(1,037)**	(1,135)	9	**(1,037)**	(1,316)	21

Reconciliation of reported and underlying operating expenses

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported operating expenses	**(9,289)**	(8,014)	(16)	**(9,289)**	(9,055)	(3)
Constant currency		300			123	
Acquisitions, disposals and dilutions						
Underlying operating expenses	**(9,289)**	(7,714)	(20)	**(9,289)**	(8,932)	(4)
Underlying cost efficiency ratio	**82.4%**	70.3%		**82.4%**	91.6%	

Reconciliation of reported and underlying profit/(loss) before tax

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported profit before tax	**(667)**	2,147		**(667)**	2,524	
Constant currency		(111)			14	
Own credit spread	**1,605**	71		**1,605**	(3,018)	
Acquisitions, disposals and dilutions						
Underlying profit/(loss) before tax	**938**	2,107	(55)	**938**	(480)	

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Hong Kong

30 June 2012 compared with 30 June 2011

	Half-year to 30 June 2012 (1H12) compared with half-year to 30 June 2011 (1H11)					
	1H11 as reported	Currency translation[10]	1H11 at 1H12 exchange rates	1H12 as reported	Reported change[11]	Constant currency change[11]
	US$m	US$m	US$m	US$m	%	%
Net interest income	2,249	10	2,259	2,599	16	15
Net fee income	1,612	4	1,616	1,618		
Changes in fair value[12]						
Other income[13]	1,553	3	1,556	1,916	23	23
Net operating income[14]	**5,414**	**17**	**5,431**	**6,133**	**13**	**13**
Loan impairment charges and other credit risk provisions	(25)		(25)	(32)	(28)	(28)
Net operating income	**5,389**	**17**	**5,406**	**6,101**	**13**	**13**
Operating expenses	(2,339)	(8)	(2,347)	(2,396)	(2)	(2)
Operating profit	**3,050**	**9**	**3,059**	**3,705**	**21**	**21**
Share of profit in associates and joint ventures	31		31	56	81	81
Profit before tax	**3,081**	**9**	**3,090**	**3,761**	**22**	**22**

30 June 2012 compared with 31 December 2011

	Half-year to 30 June 2012 (1H12) compared with half-year to 31 December 2011 (2H11)					
	2H11 as reported	Currency translation[10]	2H11 at 1H12 exchange rates	1H12 as reported	Reported change[11]	Constant currency change[11]
	US$m	US$m	US$m	US$m	%	%
Net interest income	2,442	7	2,449	2,599	6	6
Net fee income	1,485	5	1,490	1,618	9	9
Changes in fair value[12]						
Other income[13]	1,341	4	1,345	1,916	43	42
Net operating income[14]	5,268	16	5,284	6,133	16	16
Loan impairment charges and other credit risk provisions	(131)	1	(130)	(32)	76	75

Net operating income	5,137	17	5,154	6,101	19	18
Operating expenses	(2,419)	(7)	(2,426)	(2,396)	1	1
Operating profit	2,718	10	2,728	3,705	36	36
Share of profit in associates and joint ventures	24	(1)	23	56	133	143
Profit before tax	2,742	9	2,751	3,761	37	37

For footnotes, see page 100.

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Reconciliation of reported and underlying revenue[15]

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported revenue	**6,133**	5,414	13	**6,133**	5,268	16
Constant currency		17			16	
Own credit spread						
Acquisitions, disposals and dilutions						
Underlying revenue	**6,133**	5,431	13	**6,133**	5,284	16

Reconciliation of reported and underlying loan impairment charges and other credit risk provisions (LIC s)

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported LICs	**(32)**	(25)	(28)	**(32)**	(131)	76
Constant currency					1	
Acquisitions, disposals and dilutions						
Underlying LICs	**(32)**	(25)	(28)	**(32)**	(130)	75

Reconciliation of reported and underlying operating expenses

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported operating expenses	**(2,396)**	(2,339)	(2)	**(2,396)**	(2,419)	1
Constant currency		(8)			(7)	
Acquisitions, disposals and dilutions						
Underlying operating expenses	**(2,396)**	(2,347)	(2)	**(2,396)**	(2,426)	1
Underlying cost efficiency ratio	**39.1%**	43.2%		**39.1%**	45.9%	

Reconciliation of reported and underlying profit before tax

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported profit before tax	**3,761**	3,081	22	**3,761**	2,742	37
Constant currency		9			9	
Own credit spread						

Acquisitions, disposals and dilutions						
Underlying profit before tax	**3,761**	3,090	22	**3,761**	2,751	37

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Rest of Asia-Pacific

30 June 2012 compared with 30 June 2011

	Half-year to 30 June 2012 (1H12) compared with half-year to 30 June 2011 (1H11)					
	1H11 as reported US$m	**Currency translation[10] US$m**	**1H11 at 1H12 exchange rates US$m**	**1H12 as reported US$m**	**Reported change[11] %**	**Constant currency change[11] %**
Net interest income	**2,381**	**(60)**	**2,321**	**2,718**	**14**	**17**
Net fee income	**1,117**	**(32)**	**1,085**	**1,078**	**(3)**	**(1)**
Changes in fair value[12]	**(2)**		**(2)**	**(2)**		
Other income[13]	**1,852**	**(85)**	**1,767**	**2,153**	**16**	**22**
Net operating income[14]	**5,348**	**(177)**	**5,171**	**5,947**	**11**	**15**
Loan impairment charges and other credit risk provisions	**(100)**	**(1)**	**(101)**	**(298)**	**(198)**	**(195)**
Net operating income	**5,248**	**(178)**	**5,070**	**5,649**	**8**	**11**
Operating expenses	**(2,836)**	**92**	**(2,744)**	**(2,865)**	**(1)**	**(4)**
Operating profit	**2,412**	**(86)**	**2,326**	**2,784**	**15**	**20**
Share of profit in associates and joint ventures	**1,330**	**48**	**1,378**	**1,588**	**19**	**15**
Profit before tax	**3,742**	**(38)**	**3,704**	**4,372**	**17**	**18**

30 June 2012 compared with 31 December 2011

	Half-year to 30 June 2012 (1H12) compared with half-year to 31 December 2011 (2H11)					
	2H11 as reported US$m	Currency translation[10] US$m	2H11 at 1H12 exchange rates US$m	1H12 as reported US$m	Reported change[11] %	Constant currency change[11] %
Net interest income	2,721	(41)	2,680	2,718		1
Net fee income	994	(21)	973	1,078	8	11
Changes in fair value[12]	4		4	(2)		
Other income[13]	1,646	(46)	1,600	2,153	31	35
Net operating income[14]	5,365	(108)	5,257	5,947	11	13
Loan impairment charges and other credit risk provisions	(167)	4	(163)	(298)	(78)	(83)

Net operating income	5,198	(104)	5,094	5,649	9	11
Operating expenses	(2,970)	62	(2,908)	(2,865)	4	1
Operating profit	2,228	(42)	2,186	2,784	25	27
Share of profit in associates and joint ventures	1,501	16	1,517	1,588	6	5
Profit before tax	3,729	(26)	3,703	4,372	17	18

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Reconciliation of reported and underlying revenue[15]

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported revenue	**5,947**	5,348	11	**5,947**	5,365	11
Constant currency		(177)			(108)	
Own credit spread	**2**	2		**2**	(4)	
Acquisitions, disposals and dilutions	**(305)**	(184)		**(305)**	(2)	
Underlying revenue	**5,644**	4,989	13	**5,644**	5,251	7

Reconciliation of reported and underlying loan impairment charges and other credit risk provisions (LIC s)

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported LICs	**(298)**	(100)	(198)	**(298)**	(167)	(78)
Constant currency		(1)			4	
Acquisitions, disposals and dilutions						
Underlying LICs	**(298)**	(101)	(195)	**(298)**	(163)	(83)

Reconciliation of reported and underlying operating expenses

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported operating expenses	**(2,865)**	(2,836)	(1)	**(2,865)**	(2,970)	4
Constant currency		92			62	
Acquisitions, disposals and dilutions		2			13	
Underlying operating expenses	**(2,865)**	(2,742)	(4)	**(2,865)**	(2,895)	1
Underlying cost efficiency ratio	**50.8%**	55.0%		**50.8%**	55.1%	

Reconciliation of reported and underlying profit before tax

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported profit before tax	**4,372**	3,742	17	**4,372**	3,729	17
Constant currency		(38)			(26)	

Own credit spread	**2**	2		**2**	(4)	
Acquisitions, disposals and dilutions	**(305)**	(182)		**(305)**	59	
Underlying profit before tax	**4,069**	3,524	15	**4,069**	3,758	8

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Middle East and North Africa

30 June 2012 compared with 30 June 2011

	Half-year to 30 June 2012 (1H12) compared with half-year to 30 June 2011 (1H11)					
	1H11 as reported US$m	**Currency translation[10] US$m**	**1H11 at 1H12 exchange rates US$m**	**1H12 as reported US$m**	**Reported change[11] %**	**Constant currency change[11] %**
Net interest income	**673**	**(4)**	**669**	**705**	**5**	**5**
Net fee income	**327**	**(1)**	**326**	**302**	**(8)**	**(7)**
Changes in fair value[12]	**(4)**		**(4)**	**(4)**		
Other income[13]	**240**	**(2)**	**238**	**234**	**(3)**	**(2)**
Net operating income[14]	**1,236**	**(7)**	**1,229**	**1,237**		**1**
Loan impairment charges and other credit risk provisions	**(99)**	**1**	**(98)**	**(135)**	**(36)**	**(38)**
Net operating income	**1,137**	**(6)**	**1,131**	**1,102**	**(3)**	**(3)**
Operating expenses	**(574)**	**3**	**(571)**	**(537)**	**6**	**6**
Operating profit	**563**	**(3)**	**560**	**565**		**1**
Share of profit in associates and joint ventures	**184**		**184**	**207**	**13**	**13**
Profit before tax	**747**	**(3)**	**744**	**772**	**3**	**4**

30 June 2012 compared with 31 December 2011

	Half-year to 30 June 2012 (1H12) compared with half-year to 31 December 2011 (2H11)					
	2H11 as reported US$m	Currency translation[10] US$m	2H11 at 1H12 exchange rates US$m	1H12 as reported US$m	Reported change[11] %	Constant currency change[11] %
Net interest income	759	(2)	757	705	(7)	(7)
Net fee income	300	(1)	299	302	1	1
Changes in fair value[12]	18		18	(4)		
Other income[13]	294		294	234	(20)	(20)
Net operating income[14]	1,371	(3)	1,368	1,237	(10)	(10)
Loan impairment charges and other credit risk provisions	(194)		(194)	(135)	30	30
Net operating income	1,177	(3)	1,174	1,102	(6)	(6)
Operating expenses	(585)	1	(584)	(537)	8	8
Operating profit	592	(2)	590	565	(5)	(4)
Share of profit in associates and joint ventures	153		153	207	35	35
Profit before tax	745	(2)	743	772	4	4

For footnotes, see page 100.

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Reconciliation of reported and underlying revenue[15]

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported revenue	**1,237**	1,236	0	**1,237**	1,371	(10)
Constant currency		(7)			(3)	
Own credit spread	**4**	4		**4**	(18)	
Acquisitions, disposals and dilutions					(27)	
Underlying revenue	**1,241**	1,233	1	**1,241**	1,323	(6)

Reconciliation of reported and underlying loan impairment charges and other credit risk provisions (LIC s)

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported LICs	**(135)**	(99)	(36)	**(135)**	(194)	30
Constant currency		1				
Acquisitions, disposals and dilutions						
Underlying LICs	**(135)**	(98)	(38)	**(135)**	(194)	30

Reconciliation of reported and underlying operating expenses

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported operating expenses	**(537)**	(574)	6	**(537)**	(585)	8
Constant currency		3			1	
Acquisitions, disposals and dilutions						
Underlying operating expenses	**(537)**	(571)	6	**(537)**	(584)	8
Underlying cost efficiency ratio	**43.3%**	46.3%		**43.3%**	44.1%	

Reconciliation of reported and underlying profit before tax

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported profit before tax	**772**	747	3	**772**	745	4
Constant currency		(3)			(2)	

Own credit spread	**4**	4		**4**	(18)	
Acquisitions, disposals and dilutions					(27)	
Underlying profit before tax	**776**	748	4	**776**	698	11

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Interim Management Report (continued)

North America

30 June 2012 compared with 30 June 2011

	Half-year to 30 June 2012 (1H12) compared with half-year to 30 June 2011 (1H11)					
	1H11 as reported US$m	Currency translation[10] US$m	1H11 at 1H12 exchange rates US$m	1H12 as reported US$m	Reported change[11] %	Constant currency change[11] %
Net interest income	5,849	(22)	5,827	4,739	(19)	(19)
Net fee income	1,718	(10)	1,708	1,443	(16)	(16)
Changes in fair value[12]	(66)		(66)	(559)	(747)	(747)
Gains on sale of US branch network and cards business				3,809		
Other income[13]	739	(1)	738	546	(26)	(26)
Net operating income[14]	8,240	(33)	8,207	9,978	21	22
Loan impairment charges and other credit risk provisions	(3,049)	3	(3,046)	(2,161)	29	29
Net operating income	5,191	(30)	5,161	7,817	51	51
Operating expenses	(4,602)	15	(4,587)	(4,462)	3	3
Operating profit	589	(15)	574	3,355	470	484
Share of profit/(loss) in associates and joint ventures	17	(1)	16	(1)		
Profit before tax	606	(16)	590	3,354	453	468

30 June 2012 compared with 31 December 2011

	Half-year to 30 June 2012 (1H12) compared with half-year to 31 December 2011 (2H11)					
	2H11 as reported US$m	Currency Translation[10] US$m	2H11 at 1H12 exchange rates US$m	1H12 as reported US$m	Reported change[11] %	Constant currency change[11] %
Net interest income	5,631	(4)	5,627	4,739	(16)	(16)
Net fee income	1,590	(1)	1,589	1,443	(9)	(9)
Changes in fair value[12]	1,036	(1)	1,035	(559)		
Gains on disposal of US branch network and cards business				3,809		
Other income/(expense)[13]	(497)		(497)	546		

Net operating income[14]	7,760	(6)	7,754	9,978	29	29
Loan impairment charges and other credit risk provisions	(3,967)		(3,967)	(2,161)	46	46
Net operating income	3,793	(6)	3,787	7,817	106	106
Operating expenses	(4,317)	2	(4,315)	(4,462)	(3)	(3)
Operating profit/(loss)	(524)	(4)	(528)	3,355		
Share of profit/(loss) in associates and joint ventures	18	1	19	(1)		
Profit/(loss) before tax	(506)	(3)	(509)	3,354		

For footnotes, see page 100.

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Reconciliation of reported and underlying revenue[15]

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported revenue	**9,978**	8,240	21	**9,978**	7,760	29
Constant currency		(33)			(5)	
Own credit spread	**559**	66		**559**	(1,036)	
Acquisitions, disposals and dilutions	**(3,892)**	(1,011)		**(3,892)**	(978)	
Underlying revenue	**6,645**	7,262	(8)	**6,645**	5,741	16

Reconciliation of reported and underlying loan impairment charges and other credit risk provisions (LIC s)

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported LICs	**(2,161)**	(3,049)	29	**(2,161)**	(3,967)	46
Constant currency		3				
Acquisitions, disposals and dilutions		369			304	
Underlying LICs	**(2,161)**	(2,677)	19	**(2,161)**	(3,663)	41

Reconciliation of reported and underlying operating expenses

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported operating expenses	**(4,462)**	(4,602)	3	**(4,462)**	(4,317)	(3)
Constant currency		15			2	
Acquisitions, disposals and dilutions		469			288	
Underlying operating expenses	**(4,462)**	(4,118)	(8)	**(4,462)**	(4,027)	(11)
Underlying cost efficiency ratio	**67.1%**	56.7%		**67.1%**	70.1%	

Reconciliation of reported and underlying profit/(loss) before tax

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported profit before tax	**3,354**	606	453	**3,354**	(506)	
Constant currency		(16)			(2)	

Own credit spread	**559**	66		**559**	(1,036)
Acquisitions, disposals and dilutions	**(3,892)**	(173)		**(3,892)**	(386)
Underlying profit/(loss) before tax	**21**	483	(96)	**21**	(1,930)

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Latin America

30 June 2012 compared with 30 June 2011

	Half-year to 30 June 2012 (1H12) compared with half-year to 30 June 2011 (1H11)					
	1H11 as reported US$m	Currency translation[10] US$m	1H11 at 1H12 exchange rates US$m	1H12 as reported US$m	Reported change[11] %	Constant currency change[11] %
Net interest income	**3,517**	**(363)**	**3,154**	**3,542**	**1**	**12**
Net fee income	**902**	**(90)**	**812**	**843**	**(7)**	**4**
Other income[13]	**1,264**	**(148)**	**1,116**	**1,180**	**(7)**	**6**
Net operating income[14]	**5,683**	**(601)**	**5,082**	**5,565**	**(2)**	**10**
Loan impairment charges and other credit risk provisions	**(820)**	**97**	**(723)**	**(1,136)**	**(39)**	**(57)**
Net operating income	**4,863**	**(504)**	**4,359**	**4,429**	**(9)**	**2**
Operating expenses	**(3,712)**	**384**	**(3,328)**	**(3,285)**	**12**	**1**
Operating profit	**1,151**	**(120)**	**1,031**	**1,144**	**(1)**	**11**
Share of profit in associates and joint ventures		**1**	**1**	**1**		
Profit before tax	**1,151**	**(119)**	**1,032**	**1,145**	**(1)**	**11**

30 June 2012 compared with 31 December 2011

	Half-year to 30 June 2012 (1H12) compared with half-year to 31 December 2011 (2H11)					
	2H11 as reported US$m	Currency translation[10] US$m	2H11 at 1H12 exchange rates US$m	1H12 as reported US$m	Reported change[11] %	Constant currency change[11] %
Net interest income	3,439	(184)	3,255	3,542	3	9
Net fee income	879	(46)	833	843	(4)	1
Other income[13]	1,452	(95)	1,357	1,180	(19)	(13)
Net operating income[14]	5,770	(325)	5,445	5,565	(4)	2
Loan impairment charges and other credit risk provisions	(1,063)	67	(996)	(1,136)	(7)	(14)
Net operating income	4,707	(258)	4,449	4,429	(6)	(0)
Operating expenses	(3,543)	191	(3,352)	(3,285)	7	2

Operating profit	1,164	(67)	1,097	1,144	(2)	4
Share of profit in associates and joint ventures		(1)	(1)	1		
Profit before tax	1,164	(68)	1,096	1,145	(2)	4

For footnotes, see page 100.

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Reconciliation of reported and underlying revenue[15]

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported revenue	**5,565**	5,683	(2)	**5,565**	5,770	(4)
Constant currency		(601)			(325)	
Own credit spread						
Acquisitions, disposals and dilutions	**(102)**	(25)		**(102)**	(88)	
Underlying revenue	**5,463**	5,057	8	**5,463**	5,357	2

Reconciliation of reported and underlying loan impairment charges and other credit risk provisions (LIC s)

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported LICs	**(1,136)**	(820)	(39)	**(1,136)**	(1,063)	(7)
Constant currency		97			67	
Acquisitions, disposals and dilutions						
Underlying LICs	**(1,136)**	(723)	(57)	**(1,136)**	(996)	(14)

Reconciliation of reported and underlying operating expenses

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported operating expenses	**(3,285)**	(3,712)	12	**(3,285)**	(3,543)	7
Constant currency		384			191	
Acquisitions, disposals and dilutions		9			1	
Underlying operating expenses	**(3,285)**	(3,319)	1	**(3,285)**	(3,351)	2
Underlying cost efficiency ratio	**60.1%**	65.6%		**60.1%**	62.6%	

Reconciliation of reported and underlying profit before tax

	Half-year to					
	30 June 2012 US$m	30 June 2011 US$m	Change %	**30 June 2012 US$m**	31 December 2011 US$m	Change %
Reported profit before tax	**1,145**	1,151	(1)	**1,145**	1,164	(2)
Constant currency		(119)			(68)	

Own credit spread						
Acquisitions, disposals and dilutions	**(102)**	(16)		**(102)**	(87)	
Underlying profit before tax	**1,043**	1,016	3	**1,043**	1,009	3

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HSBC HOLDINGS PLC

Interim Management Report (continued)

Disposals, held for sale and run-off portfolios

In implementing our strategy, we have sold or agreed to sell a number of businesses across the Group. We expect these disposals to have a significant adverse effect on both the revenue and the profitability of the geographical regions in the

future, especially on North America due to the sale of the profitable US Card and Retail Services business. In addition, two significant portfolios are being run down. We expect the losses on these

portfolios to continue to adversely affect North America and the other geographical regions in the future.

The table below presents the historical results of these businesses. We do not expect the historical results to be indicative of future results because of disposal or run-off. Fixed allocated costs, included in total operating costs, will not necessarily be removed upon disposal and have been separately identified on page 38.

Summary income statements for disposals, held for sale and run-off portfolios[43,44]

	Half-year to 30 June 2012					
	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	MENA US$m	North America US$m	Latin America US$m
Net interest income	**2**	**8**	**34**	**6**	**2,666**	**203**
Net fee income/(expense)	**(9)**	**(30)**	**7**	**3**	**431**	**(3)**
Net trading income/(expense)	**(36)**	**(3)**	**4**	**37**	**(213)**	**14**
Net income/(expense) from financial instruments designated at fair value	**5**		**2**		**(513)**	**1**
Gains less losses from financial investments	**(39)**				**12**	**6**
Dividend income					**2**	
Net earned insurance premiums		**144**	**46**		**107**	**164**
Other operating income			**6**		**(7)**	**6**
Total operating income/(expense)	**(77)**	**119**	**99**	**46**	**2,485**	**391**
Net insurance claims incurred and movement in liabilities to policyholders		**(71)**	**(30)**		**(71)**	**(81)**
Net operating income/(expense)[14]	**(77)**	**48**	**69**	**46**	**2,414**	**310**
Loan impairment (charges)/recoveries and other credit risk provisions	**(268)**		**2**		**(1,900)**	**(30)**
Net operating income/(expense)	**(345)**	**48**	**71**	**46**	**514**	**280**
Total operating expenses	**(24)**	**(27)**	**(68)**	**(11)**	**(1,186)**	**(213)**
Operating profit/(loss)	**(369)**	**21**	**3**	**35**	**(672)**	**67**

Share of profit in associates and joint ventures			1			1
Profit/(loss) before tax	**(369)**	**21**	**4**	**35**	**(672)**	**68**
By global business						
Retail Banking and Wealth Management		**19**	**2**	**10**	**(159)**	**28**
Commercial Banking			**4**		**9**	**23**
Global Banking and Markets	**(369)**	**2**	**(1)**	**25**	**(9)**	**26**
Global Private Banking			**(2)**			
Other			**1**		**(513)**	**(9)**
Profit/(loss) before tax	**(369)**	**21**	**4**	**35**	**(672)**	**68**
Gain on sale			**305**		**3,892**	**102**

For footnotes, see page 100.

Interim Management Report (continued)

Other information

Funds under management and assets held in custody

	Half-year to		
	30 June 2012 US$bn	30 June 2011 US$bn	31 December 2011 US$bn
Funds under management			
At beginning of period	**847**	925	948
Net new money	**10**	16	(14)
Value change	**9**	3	(43)
Exchange and other	**(9)**	4	(44)
At end of period	**857**	948	847
Funds under management by business			
HSBC Global Asset Management	**405**	449	396
Global Private Banking	**263**	297	259
Affiliates	**3**	3	3
Other	**186**	199	189
	857	948	847

Funds under management (FuM) at 30 June 2012 amounted to US$857bn, an increase of 1% compared with 31 December 2011. Both Global Asset Management and GPB fund holdings increased in the first half of 2012, reflecting net new money inflows and favourable equity market movements, partly offset by adverse foreign exchange movements. This improvement in FuM only partly reversed the reduction experienced in the second half of 2011, as a result of the fall in equity markets and movements in foreign exchange in the latter part of 2011.

Global Asset Management funds, including emerging market funds, increased by 2% to US$405bn compared with 31 December 2011. Net inflows during the first half of 2012 of US$13bn were mainly from sales of long-term funds, notably fixed income and multi-asset products, in Rest of Asia-Pacific, Hong Kong and Latin America. They also benefited from favourable equity market movements in Asia and Europe, partly offset by unfavourable foreign exchange movements during the first half of 2012.

GPB funds increased by 2% on 31 December 2011 to US$263bn, mainly as a result of favourable market performance and net inflows during the period originating from emerging markets. This was partly offset by negative foreign exchange movements, net outflows in Europe and the reduction of assets following the sale of the Private Banking business in Japan. Client assets, which include FuM and cash deposits and provide an indicator of overall GPB volumes, decreased by US$2.5bn to US$375bn due to the sale of the Japan business and net outflows in Europe.

Other FuM, decreased by 2% to US$186bn, primarily due to the disposal of the private client services business in North America.

Assets held in custody and under administration

Custody is the safekeeping and servicing of securities and other financial assets on behalf of clients. At 30 June 2012, we held assets as custodian of US$5.4 trillion, 4% higher than the US$5.2 trillion held at 31 December 2011. This was mainly driven by favourable market and 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 30 June 2012, the value of assets held under administration by the Group amounted to US$2.7 trillion, compared with US$2.6 trillion at 31 December 2011.

Review of transactions with related parties

The FSA s Disclosure Rules and Transparency Rules require the disclosure of related party transactions that have taken place in the first six months of the current financial year and any changes in the related party transactions described in the *Annual Report and Accounts 2011*, that have or could have materially affected the financial position or performance of HSBC. A fair review has been undertaken and any such related party transactions have been disclosed in the Notes on the Financial Statements.

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Footnotes to pages 2 to 99

Financial highlights

1 *Dividends recorded in the financial statements are dividends per ordinary share declared in the first six months of 2012 and are not dividends in respect of, or for, the period.*
2 *Restated for change in disclosure convention for the presentation of impaired loans and advances as described on page 147.*
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 *Return on invested capital is based on the profit attributable to ordinary shareholders. Average invested capital is measured as average total shareholders equity after:*
adding back the average balance of goodwill amortised before the transition to IFRSs or subsequently written off directly to reserves;
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 amount 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.
5 *The cost efficiency ratio is defined as total operating expenses divided by net operating income before loan impairment charges and other credit risk provisions.*
6 *Each ADS represents five ordinary shares.*
7 *Total shareholder return is defined as the growth in share value and declared dividend income during the relevant period.*
8 *The Financial Times Stock Exchange 100 Index.*
9 *The Morgan Stanley Capital International World Index and The Morgan Stanley Capital International World Banks Index.*

Reconciliations of constant currency profit before tax

10 *Currency translation is the effect of translating the results of subsidiaries and associates for the previous half-years at the average rates of exchange applicable in the current half-year.*
11 *Positive numbers are favourable: negative numbers are unfavourable.*
12 *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.*
13 *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.*
14 *Net operating income before loan impairment charges and other credit risk provisions, also referred to as revenue.*
15 *Underlying performance eliminates the effects of acquisitions, disposals and changes of ownership levels of subsidiaries, associates and businesses so we can view results on a like-for-like basis. We achieve this by eliminating gains and losses on disposal or dilution in the period incurred and by adjusting material results of operations in the previous period so that equivalent time periods are reflected. For example, if a disposal was made in the current year after four months of operations, the results of the previous year would be adjusted to also reflect four months of operations.*
16 *Underlying changes to profit before tax are due to constant currency (as detailed in the tables Reconciliation of constant currency profit before tax on pages 16 and 17), own credit spread (included in Other) and acquisitions, disposals and dilution. Individual reconciliations by global businesses are provided in the Form 6-K filed with the SEC, which is available on www.hsbc.com.*
17 *Underlying changes to profit before tax are due to constant currency (as detailed in the tables Reconciliation of constant currency profit before tax on pages 16 and 17), own credit spread, the largest amounts of which are in Europe (loss of US$1,605m, loss of US$71m and gain of US$3,018m for the half-years ended 30 June 2012, 30 June 2011 and 31 December 2011, respectively) and North America (loss of US$559m, loss of US$66m and gain of US$1,036m for the half-years ended 30 June 2012, 30 June 2011 and 31 December 2011, respectively) and acquisitions, disposals and dilution. Individual reconciliations by geographical regions are provided in the Form 6-K filed with the SEC, which is available on www.hsbc.com.*

Financial summary

18 *Net interest income includes the cost of internally funding trading assets, while the related revenues are reported in net trading income. In our global business results, the total cost of funding trading assets is included within Global Banking and Markets net trading income as an interest expense.*

19 *Gross interest yield is the average annualised interest rate earned on average interest-earning assets (AIEA).*

20 *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 payable on average interest-bearing funds.*

21 *Net interest margin is net interest income expressed as an annualised percentage of AIEA.*

22 *The cost of internal funding of trading assets was US$375m (first half of 2011: US$516m; second half of 2011: US$645m) 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.*

23 *Net trading income includes a charge of US$330m (first half of 2011: income of US$60m; second half of 2011: income of US$398m) associated with changes in the fair value of issued structured notes and other hybrid instrument liabilities derived from movements in HSBC issuance spreads.*

24 *The change in fair value related to movements in the Group s credit spread on long-term debt resulted in an expense of US$2.2bn in the first half of 2012 (first half of 2011: expense of US$143m; second half of 2011: gain of US$4,076bn).*

25 *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.*

26 *Discretionary participation features.*

27 *The calculation of the PVIF asset was refined during the half-year to 30 June 2011 to bring greater comparability and consistency across the Group s insurance operations. This was achieved by incorporating explicit margins and allowances for certain risks and uncertainties in place of implicit adjustments to the discount rate. The change in calculation reflected explicit risk margins for*

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non-economic risks in the projection assumptions, and explicit allowances for financial options and guarantees using stochastic methods. Discount rates were reduced as a result of removing the implicit adjustments. In certain circumstances, the implicit adjustments were different from the explicit amounts, resulting in a gain of US$243m in the period which was included in Other adjustments .

28 *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

29 *Net of impairment allowances.*

30 *The calculation of capital resources, capital ratios and risk-weighted assets for 30 June 2012 and 30 December 2011 is on a Basel 2.5 basis. The 30 June 2011 comparative is on a Basel II basis.*

31 *Capital resources are total regulatory capital, the calculation of which is set out on page 201.*

32 *Includes perpetual preferred securities.*

33 *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.*

34 *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 period-end.*

35 *See Note 14 on the Financial Statements.*

36 *France primarily comprises the domestic operations of HSBC France, HSBC Assurances Vie and the Paris branch of HSBC Bank plc.*

Economic profit

37 *Expressed as a percentage of average invested capital.*

38 *Return on invested capital is based on the profit attributable to ordinary shareholders of the parent company (see Note 4 on the Financial Statements).*

Reconciliation of RoRWA measures

39 *Risk-weighted assets (RWA s).*

40 *Pre-tax return on average risk-weighted assets (RoRWA).*

41 *Underlying RoRWA is calculated using underlying pre-tax return and reported average RWAs at constant currency and adjusted for the effects of business disposals.*

42 *Other includes treasury services related to the US CML business and commercial operations in run-off.*

Disposals, held for sale and run-off portfolios

43 *The results of operations of disposed businesses are stated up to and including the date of disposal. The results of operations of businesses held for sale and run-off portfolios are for the half-year to 30 June 2012.*

44 *The summary income statements present the historical results of disposals, held-for-sale and run-off portfolios to provide information on trends. The historical results are those which appear in the Group IFRS income statement and include fixed allocated costs which will not necessarily be removed or reduced upon disposal or rundown. Fixed allocated costs included in total operating expenses are disclosed separately on page 38. The results of disposed businesses exclude gains on sale and post disposal income and expenditure items; for example, restructuring costs. The results of businesses held for sale exclude losses recognised upon reclassification to the held-for-sale category. These losses are disclosed in note 14.*

45 *RWAs for disposals and Held for sale are shown exclusive of operational risk RWAs, while those for run-off portfolios include operational risk RWAs.*

Analyses by global business and by geographical region

46 *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, 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 Group 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.*

47 *Assets by geographical region and global business include intra-HSBC items. These items are eliminated, where appropriate, under the headings Intra-HSBC items or Inter-segment elimination .*

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

49 *Loan impairment charges and other credit risk provisions.*

50 *Share of profit in associates and joint ventures.*

51 *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, related external and internal interest income and interest expense, and dividends received; in the statutory presentation internal interest income and expense are eliminated.*

52 *In the first half of 2012, Global Markets included an adverse fair value movement of US$330m on the widening of credit spreads on structured liabilities (first half of 2011: favourable fair value movement of US$60m; second half of 2011: favourable fair value movement of US$398m).*

53 *Total income earned on Payments and Cash Management products in the Group amounted to US$3.1bn (first half of 2011: US$2.6bn; second half of 2011: US$3bn), of which US$2.2bn was in CMB (first half of 2011: US$1.9bn; second half of 2011: US$2.1bn) and US$0.9bn was in GB&M (first half of 2011: US$0.7bn; second half of 2011: US$0.8bn).*

54 *Total income earned on other transaction services in the Group amounted to US$1.8bn (first half of 2011: US$1.5bn; second half of 2011: US$1.7bn), of which US$1.4bn was in CMB relating to trade and receivables finance (first half of 2011: US$1.3bn; second half of 2011: US$1.3bn) and US$0.4bn was in GB&M of which US$0.4bn related to trade and receivables finance (first half of 2011: US$0.3bn; second half of 2011: US$0.3bn) and US$11m related to banknotes and other (first half of 2011: US$20m; second half of 2011: US$13m).*

55 *Other in GB&M includes net interest earned on free capital held in the global business not assigned to products.*

56 *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.*

57 *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/(expense) 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.*

58 *Net insurance claims incurred and movement in liabilities to policyholders.*

59 *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 .*

60 *RWAs are non-additive across geographical regions due to market risk diversification effects within the Group.*

Interim Management Report (continued)

Risk

Risk profile

Managing our risk profile

A strong balance sheet is core to our philosophy.

We ensure that our portfolios remain aligned to our risk appetite and strategy.

We actively manage 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 11.3%.

We have sustained our strong liquidity position throughout the first half of 2012.

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.

Our global risk operating model supports adherence to globally consistent standards and risk management policies across the Group.

Our top and emerging risks

Macroeconomic and geopolitical risk.

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

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

Managing risk

The continued growth in our business in the first half of 2012 was achieved while ensuring risks were assumed in a measured manner and in line with our risk appetite. Risks were mitigated when they exceeded our risk appetite, particularly reputational and operational risks.

Balance sheet assets grew by 4% and our credit risk-weighted assets decreased by 3% during the period.

During the first six months of 2012, financial markets were dominated by concerns over sovereign debt default risk and its contagion effects, the Middle East and the perception that the world economic recovery remained fragile. This created volatility in financial markets. In the face of this changeable economic and financial environment, we maintained our conservative risk profile by reducing exposure to the most likely areas of stress. Stress tests are run regularly to evaluate the potential impact of emerging scenarios and, where applicable and necessary, we adjusted our risk appetite accordingly.

We continued to manage selectively our exposure to sovereign debt and bank counterparties, 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.

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. Our geographical diversification also supported our strategies for growth in faster-growing markets and those with international connectivity.

In the first half of 2012 we increased our gross loans and advances in all regions except Latin America, where we classified certain lending balances to held for sale. On a constant currency basis, our loan impairment charges and other credit risk provisions in the first half of 2012 were 6% below the first half of 2011, at US$4.8bn. The US accounted for a significant proportion of the decline, with a reduction in the CML portfolio and the sale of the Card and Retail Services business on 1 May 2012.

For details of HSBC s policies and practices regarding risk management and governance see the Appendix to Risk on page 183.

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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 198, 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 183.

We continue to maintain a very strong liquidity position and are well positioned for the emerging new regulatory landscape.

Top and emerging risks

Details of the top and emerging risks identified through our risk management processes are set out below:

Macroeconomic and geopolitical risk

- Severe economic slowdown in mature economies impacting global growth
- Eurozone member departing from the currency union or a split into two different monetary regions
- Increased geopolitical risk in certain regions

Severe economic slowdown in mature economies impacting global growth

World growth is slowing as demand in mature economies is subdued and credit availability and investment activity remain very limited. A number of mature economies are implementing austerity measures in order to reduce their deficits and public debt. This is expected to help resolve the sovereign and banking crisis in the medium term, but in the short term it is limiting growth, increasing unemployment and restricting taxation revenues severely. This is affecting the rest of the world through lower trade, reduced international financing as banks are deleveraging and potential disruption to capital flows.

Potential impact on HSBC

- Trade and capital flows may contract as a result of banks deleveraging, the introduction of protectionist measures 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 economic crisis in mature economies will constrain, through spread compression and low returns on assets, the interest income we earn from investing our excess deposits.

During the first half of 2012, we continued to reduce our sovereign and financial institution counterparty credit positions in peripheral eurozone countries. In addition, we actively sought to identify and reduce exposures to 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 ongoing viability in the event of an unfavourable conclusion to the current crisis.

Eurozone member departing from the currency union or a split into two different monetary unions

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, and beyond to trading partners.

There is a significant risk of one or more countries leaving the euro. This would place further pressure on banks within the core European countries through their exposures to banks in these countries. In the current context of very low growth due to austerity measures, this could further aggravate the economic crisis and could push European countries into a vicious circle of economic and sovereign debt defaults. 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 or currency crisis. Our eurozone exposures are described in more detail on pages 121 to 131.

Potential impact on HSBC

We could incur significant losses stemming from the exit of one or more countries from the eurozone and the redenomination of their currencies.

Our exposures to European banks may come under stress, heightening the potential for credit and market risk losses, if the sovereign debt and banking system crisis in the region increases the need to recapitalise parts of the sector.

In the event of contagion from stress in the peripheral eurozone sovereign and financial sectors, our ability to borrow from other

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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 the first half of 2012 by reducing exposures and other measures. In addition, should such an event happen without the co-ordinated intervention to protect the rest of the eurozone, 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.

Increased geopolitical risk in certain regions

We are subject to geopolitical risks in the countries in which we operate. During the first half of 2012, these risks remained heightened in the Middle East.

In Egypt, the political transition process is still ongoing with the risk of instability remaining. In addition the political instability in Syria could spread across the region and become very disruptive for global international relations.

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 among our staff and physical damage to our assets.

We have increased our monitoring of the geopolitical and 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, fines, sanctions 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

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 .

In June 2011, the Basel Committee issued a revision to the former document setting out the finalised capital treatment for counterparty credit risk in bilateral trades.

In July 2011, the European Commission published proposals for a new Regulation and Directive, known collectively as CRD IV, to give effect to the Basel III framework in the EU.

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 levels: CRD IV proposals would require banks to hold common equity tier 1 capital

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equal to at least 4.5% of RWAs with an additional capital conservation buffer of 2.5%, which could be used in periods of stress, subject to certain restrictions, for example, on bonus payments and dividends. Banks may also be required to hold a further countercyclical capital buffer to protect against potential future losses, when excess credit growth in the financial system as a whole is associated with an increase in system-wide risk. The level of bank capital will also need to exceed a minimum leverage requirement of 3% of total assets, currently subject to supervisory monitoring and review, prior to becoming a binding requirement from 1 January 2018.

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 credit 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.

Derivatives and central counterparty clearing: measures have been introduced to give effect to the commitments from the G20 leading group of countries 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 traded on exchanges or electronic trading platforms, where appropriate, and centrally cleared by the end of 2012. They are to be reported to trade repositories. Higher capital requirements under Basel III will be imposed for bilateral (uncleared) transactions to incentivise the use of clearing.

UK Independent Commission on Banking: the UK government issued its White Paper in June 2012 setting out its proposed implementation of the recommendations of the ICB. It is likely that we will be required to make major changes to our corporate structure and the business activities we conduct in

the UK through our major banking subsidiary, HSBC Bank, as:

at a minimum retail banking activities for most personal customers and smaller businesses currently carried out within that entity will have to be spun-off into a ring-fenced retail bank. These changes will take some time to implement with a significant effect on costs from both implementing the changes and running the ongoing operations as restructured;

significant banks, such as HSBC Bank, will be required to have core tier 1 capital of at least 10% of RWAs and over 3% of total assets, which is a leverage requirement; and

UK-incorporated banks will be required to hold equity and debt capable of absorbing losses if the bank is non-viable, together with primary loss-absorbing capacity (PLAC) of at least 17% of RWAs.

The framework for defining products, services and customers which are either required to be within the ring-fenced bank or prohibited from it are subject to a consultation, and will then be incorporated into draft legislation. Detailed rule making will also be required which will take place over an extended period, probably into 2015.

The Volcker Rule : the so called Volcker Rule proposed under section 619 of the Dodd-Frank Wall Street Reform & Consumer Protection Act (the Dodd-Frank Act) could affect HSBC in North America and across the Group. The Volcker Rule placed restrictions on proprietary trading activities and on investing in and sponsoring hedge fund and private equity funds. In October 2011, a proposed rule was published which generated extensive public comment including submissions from foreign governments and other bodies on, inter alia, the overall scope and extra-territorial effects of the proposed rule. As yet, revised rules to implement the provisions of the Volcker Rule have not been published. On 19 April 2012, the Federal Reserve Board (FRB) clarified that banking entities covered by the Volcker Rule, have the full two-year period provided by the Volcker Rule until 21 July 2014 to fully conform their activities and investments, unless the FRB extends the period.

There is a continued risk of further changes to regulation relating to remuneration and other taxes.

G-SIBs: the capital impact of being designated a global systemically important bank (G-SIB) is discussed on page 200.

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Potential impact on HSBC

The proposals relating to capital and liquidity are likely to result in increased minimum capital and liquidity requirements, although the nature, timing and effect of many of the changes remain unclear, as is the extent to which entities within the Group may already comply with these requirements. Higher requirements in capital and liquidity have an effect on our future financial condition and the results of our operations. There is also the risk of secondary effects as the overall flow of credit to the economy is constrained and economic activity and opportunities for banking income slows.

As an institution with a relatively low-risk portfolio, the proposed leverage ratio could cause HSBC to either accept lower returns on equity than competitors or 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 198. 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.

Proposed changes relating to remuneration and 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, the Volcker Rule and the Foreign Account Tax Compliance Act (FATCA) 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.

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, fines, sanctions 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.

HSBC Holdings and certain of its affiliates are the subject of ongoing investigations by bank regulatory and law enforcement agencies in the US relating to their compliance with anti-money laundering laws and regulations, the US Bank Secrecy Act and sanctions programmes administered by the US Office of Foreign Assets Control. 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 including through preliminary discussions with relevant authorities. The resolution of at least some of these matters is likely to involve the filing of corporate criminal as well as civil charges and the imposition of significant fines and penalties. The prosecution of corporate criminal charges in these types of cases has most often been deferred through an agreement with the relevant authorities; however, the US authorities have substantial discretion, and prior settlements can provide no assurance as to how the US authorities will proceed in these matters. In the event of a filing of criminal charges the prosecution of which is not deferred, there could be significant consequences to HSBC and its affiliates, including loss of business, withdrawal of funding and harm to our reputation, all of which could have a material adverse effect on our business, liquidity, financial condition, results of operations and prospects.

Various regulators and competition and enforcement authorities around the world including in the UK, the US, Canada, the EU, Switzerland and Asia are conducting investigations related to certain

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past submissions made by panel banks in connection with the setting of London interbank offered rates (LIBOR), European interbank offered rates (EURIBOR) and other interest 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 those investigations.

Potential impact on HSBC

We are subject to a number of regulatory actions and investigations, see Note 25 on the Financial Statements. It is inherently difficult to predict the outcome of the regulatory proceedings involving our businesses. Unfavourable outcomes are having and may continue to have a material adverse effect on our reputation, brand and results, including loss of business and withdrawal of funding.

In response to this risk, we are progressing a number of initiatives which seek to address the issues identified, including creating our new global management structure, enhancing our governance and oversight, increasing our compliance function resource, emphasising our values and designing and implementing new global standards as outlined elsewhere.

Dispute risk

The current economic environment has increased our exposure to actual and potential litigation against the Group. Further details are discussed in Note 25 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

Model 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 economic 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 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.

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

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organisation, given that these networks can be used as powerful broadcasting tools which can 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 unlawfully 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 stake-holders. 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. We have invested significantly in addressing the risk through increased training to raise staff awareness.

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 to simplify our business, involves the withdrawal from certain markets, which presents disposal risks which must be carefully managed. The implementation of organisational changes to support the Group s strategy also requires close management oversight.

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. Systems and controls could be degraded as a result of organisational effectiveness initiatives unless there is strong governance and an oversight framework to monitor the risk and control environment. We
seek to ensure that our critical systems infrastructure, including IT services, essential buildings, offshore processes and key vendors, 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. Steps taken 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.

Model risk

More stringent regulatory requirements governing the development, parameters applied to and controls around models used for measuring risk can give rise to changes, including increases in capital requirements. Furthermore, the changing external economic and legislative environment and changes in customer behaviour can lead to the assumptions we have made in our models becoming invalid.

Potential impact on HSBC

These model risks can result in a potentially increased and volatile capital requirement.

We continue to address these risks through enhanced model development, independent review and model oversight to ensure our models remain fit for purpose.

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Credit risk

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 holding of debt and other securities. Credit risk generates the largest regulatory capital requirement of the risks we incur.

There have been no material changes to our policies and practices for the management of credit risk as described in the *Annual Report and Accounts 2011.*

Net exposure to the sovereign, agency and bank debt of Spain, Ireland, Italy, Greece, Portugal and Cyprus was US$11.6bn at 30 June 2012.

A summary of our current policies and practices regarding credit risk is provided in the Appendix to Risk on page 183.

Credit risk in the first half of 2012

Exposure, impairment allowances and charges

	At		
	30 Jun 2012	30 Jun 2011	31 Dec 2011

	US$bn	US$bn	US$bn
Total gross loans and advances (A)	**1,174.4**	1,282.8	1,139.1
Impairment allowances	**17.3**	18.9	17.6
as a percentage of A	**1.47%**	1.47%	1.55%

		Half-year to	
	30 Jun 2012 US$m	30 Jun 2011 US$m	31 Dec 2011 US$m
Impairment charges	**4.5**	5.0	6.5

Loan impairment charges and other credit risk provisions

		Half-year to	
	30 Jun 2012 US$m	30 Jun 2011 US$m	31 Dec 2011 US$m
Loan impairment charges and other credit risk provisions	**4,799**	5,266	6,861
	%	%	%
Personal	**69**	81	73
Corporate and commercial	**26**	13	21
Financial			1
Impairment of available-for-sale debt securities	**5**	6	5
of which: Greek Government		2	2
	100	100	100

The Group s total reported gross loans and advances, which excludes lending balances transferred to held for sale, were US$1,174bn at 30 June 2012, an increase of 3% compared with 31 December 2011.

The following commentary is on a constant currency basis.

Total gross loans and advances rose by 3%, compared with the end of 2011. The increase reflected growth in corporate and commercial lending, mainly in Hong Kong and Rest of Asia-Pacific, as well as a rise in overdraft balances in the UK which did not meet netting criteria under current accounting rules. Financial lending also increased, reflecting an increase in reverse repos, while personal lending growth was attributable to an increase in mortgage lending. During the first half of 2012, we reclassified certain lending balances to assets held for sale. At 30 June 2012, lending balances reported as held for sale were US$6.7bn. These included US$4.7bn of balances associated with the disposal of our operations in certain countries in Latin America.

In the first half of 2012, we continued to reduce our sovereign agency and bank credit risk exposure

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in peripheral eurozone countries. At 30 June 2012, our net exposure to the sovereign, agency and bank debt of Spain, Ireland, Italy, Greece, Portugal and Cyprus was US$11.6bn. At 30 June 2012 our sovereign and agency exposures to these countries were not considered to be impaired. For further details on our exposure to the eurozone, see page 121.

At 30 June 2012, our personal lending balances were US$401bn, an increase of 2% on 31 December 2011 as residential mortgage balances rose while other categories of personal lending declined.

First lien residential mortgage lending at 30 June 2012 was US$287bn, 2% higher than at the end of 2011. It represented 29% of our total gross lending to customers, in line with the end of 2011. Our most significant exposure to residential mortgages was in the UK, the US and Hong Kong.

In the first half of 2012, we continued to grow our residential mortgage portfolios in the UK and Hong Kong. Average loan-to-value (LTV) ratios on new residential mortgage lending in the UK and Hong Kong were 58% and 50%, respectively, while LTV ratios on our total residential mortgage books were 51% in the UK and 34% in Hong Kong. Delinquency levels and loan impairment charges in our residential mortgage portfolios in both the UK and Hong Kong remained at low levels in the first half of 2012.

In the US, we continued to be affected by industry-wide foreclosure delays which have extended the period between when a loan goes 180-days past due and the realisation of cash proceeds from selling the property. There remains a significant backlog of foreclosures which will take time to resolve.

Total personal lending in the US was US$63bn at 30 June 2012, representing 16% of the Group s total personal lending. Balances in the portfolio declined by 5% compared with 31 December 2011, reflecting continued run-off in the CML portfolio. At 30 June 2012, lending balances in the CML portfolio were US$46bn, a decline of 8% compared with 31 December 2011, of which 44% was due to the write-off of balances. During the first half of 2012, we completed the sale of our US Card and Retail Services business. The lending balances associated with this transaction were reported as held for sale at 31 December 2011.

In US dollar terms, lending balances in the CML portfolio that were two months or more delinquent were US$8.3bn compared with US$8.9bn at the end of 2011, with reductions in both the real estate

secured and personal non-credit card sections of the portfolio. Reduced delinquency on real estate secured lending balances reflected a fall in early stage delinquency as the portfolio continued to run off, as well as seasonal improvements in collections, partly offset by higher late stage delinquency due to the temporary suspension of foreclosure activities.

In our *Annual Report and Accounts 2011*, we disclosed a quantification of the value of collateral we hold over a borrower s specific asset, in the event of the borrower failing to meet its contractual obligations. At 30 June 2012, there were no significant changes in the value of collateral compared with the end of 2011.

At 30 June 2012, renegotiated loan balances were US$46.2bn, broadly in line with the end of 2011. The majority of our renegotiated loan balances were in North America in the real estate secured portion of the CML portfolio, where 57% of the lending balances have been reaged, modified or reaged and modified.

Reclassification to assets held for sale

During the period, 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 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 114);

distribution of financial instruments by credit quality (page 139); and

ageing analysis of days past due but not impaired gross financial instruments (page 143).

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 differentiates them from those classified as held for sale.

Comparative data at 30 June 2011 have not been separately presented as the amounts are insignificant.

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Reported and held-for-sale loans[1]

	At 30 June 2012		At 31 December 2011	
	Total gross loans and advances US$m	Impairment allowances on loans and advances US$m	Total gross loans and advances US$m	Impairment allowances on loans and advances US$m
As reported	**1,174,449**	**17,273**	**1,139,052**	**17,636**
Assets held for sale	**6,721**	**106**	**37,273**	**1,614**
	1,181,170	**17,379**	**1,176,325**	**19,250**

For footnote, see page 180.

The table below analyses the amount of   Loan impairment charges and other credit risk provisions   arising from assets held for sale and other assets not held for sale. They primarily relate to the US Card and Retail Services businesses classified as held for sale at 31 December 2011. These assets had been disposed of by 30 June 2012.

Loan impairment charges and other credit risk provisions (LIC   s)

	Half-year to 30 June 2012 US$m
LICs arising from:	
assets held for sale	335
assets not held for sale	4,464
	4,799

Credit exposure

Maximum exposure to credit risk

Our credit exposure is well diversified across a broad range of asset classes.

Our maximum exposure to loans and advances at amortised cost increased compared with the end of 2011. The rise primarily reflected growth in corporate and commercial lending in Hong Kong and Rest of Asia-Pacific. In addition, lending in the manufacturing sector rose, mainly in the UK, reflecting a rise in overdraft balances which did not meet netting criteria under current accounting rules. Reverse repo balances also rose, largely reflecting the deployment of proceeds from the US disposals, while mortgage lending increased due to growth in the UK and Hong Kong, partly offset by continued run-off in the US.

The loans and advances offset adjustment in the table on page 114 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.

Maximum exposure to financial investments decreased moderately compared with the end of 2011. This largely reflected the disposal of available-for-sale securities in Europe, broadly offset by a rise in North America where excess liquidity was used to purchase government debt securities.

In the first half of 2012, our exposure to trading assets rose reflecting increased client activity compared with the subdued levels seen in the second half of 2011. This resulted in higher reverse repo and settlement account balances which vary proportionately with levels of trading activity.

The Group s maximum exposure to cash and balances at central banks increased as we continued to place excess liquidity in Europe with central banks. In North America, we reduced balances at central banks as we repaid debt and increased our purchases of government debt securities.

Maximum exposure to credit risk table (page 114)

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.

Our maximum exposure to derivatives at 30 June 2012 increased compared with the end of 2011. This primarily reflected a rise in the fair value of interest rate and, to a lesser extent foreign exchange derivative contracts in Europe following movements in yield curves.

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The derivative offset amount in the table overleaf 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 30 June 2012, the total amount of such offsets was US$340bn (30 June 2011: US$208bn; 31 December 2011: US$306bn), of which US$301bn (30 June 2011: US$188bn; 31 December 2011: US$272bn) were offsets under a master netting arrangement, US$38.5bn (30 June 2011: US$20.1bn; 31 December 2011: US$33.0bn) was collateral received in cash and US$1.1bn (30 June 2011: US$0.2bn; 31 December 2011: US$0.7bn) was other collateral. These amounts do not qualify for net presentation for accounting purposes, as settlement may not actually be made on a net basis.

While not considered as offset in the table overleaf, 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.

Concentration of exposure

Concentrations of credit risk are described in the Appendix to Risk on page 183.

Securities held for trading

Total securities held for trading within trading assets were US$192bn at 30 June 2012 (30 June 2011: US$269bn; 31 December 2011: US$186bn). The largest concentration of these assets was in government and government agency securities. Our most significant exposures were to US Treasury and government agency securities (US$21bn) and UK (US$11bn) and Hong Kong (US$7bn) government securities. A detailed analysis of securities held for trading is set out in Note 7 on the Financial Statements and an analysis of credit quality is provided on page 139.

Debt securities, treasury and other eligible bills

Our holdings of corporate debt, ABSs and other securities were spread across a wide range of issuers and geographical regions, with 15% invested in securities issued by banks and other financial institutions. A more detailed analysis of financial investments is set out in Note 13 on the Financial

Statements and an analysis by credit quality is provided on page 139.

At 30 June 2012, our insurance businesses held diversified portfolios of debt and equity securities designated at fair value of US$31.5bn (30 June 2011: US$31.3bn; 31 December 2011: US$28.9bn) and debt securities classified as financial investments of US$40.2bn (30 June 2011: US$41.7bn; 31 December 2011: US$40.1bn). A more detailed analysis of securities held by the insurance businesses is set out on page 178.

Derivatives

Derivative assets at 30 June 2012 were US$356bn, (30 June 2011: US$261bn; 31 December 2011: US$346bn) of which the largest concentrations of exposure were in interest rate and foreign exchange derivatives. For an analysis of derivatives see Note 12 on the Financial Statements.

Loans and advances

Gross loans and advances to customers (excluding the financial sector) at 30 June 2012 increased by US$26bn or 3% from 31 December 2011. On a constant currency basis the increase was 3%. In the first half of 2012, we increased our exposure to personal lending and most industry sectors, with growth in Asia and Europe.

Summary of gross loans and advances to customers

The following commentary is on a constant currency basis:

Personal lending of US$401bn in the first half of 2012 was higher than at 31 December 2011. At US$287bn, first lien residential mortgage lending continued to represent the Group s largest concentration in a single exposure type, the most significant balances being in the UK (41%), the US (18%) and Hong Kong (17%).

Corporate and commercial lending was 50% of gross lending to customers at 30 June 2012.

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Maximum exposure to credit risk

	At 30 June 2012			At 30 June 2011			At 31 December 2011		
	Maximum exposure US$m	Offset US$m	Exposure to credit risk (net) US$m	Maximum exposure US$m	Offset US$m	Exposure to credit risk (net) US$m	Maximum exposure US$m	Offset US$m	Exposure to credit risk (net) US$m
Cash and balances at central banks	**147,911**		**147,911**	68,218		68,218	129,902		129,902
Items in the course of collection from other banks	**11,075**		**11,075**	15,058		15,058	8,208		8,208
Hong Kong Government certificates of indebtedness	**21,283**		**21,283**	19,745		19,745	20,922		20,922
Trading assets	**361,352**	**(12,665)**	**348,687**	438,232	(10,491)	427,741	309,449	(4,656)	304,793
Treasury and other eligible bills	**30,098**		**30,098**	23,899		23,899	34,309		34,309
Debt securities	**131,563**		**131,563**	208,805		208,805	130,487		130,487
Loans and advances:									
to banks	**94,830**		**94,830**	100,134		100,134	75,525		75,525
to customers	**104,861**	**(12,665)**	**92,196**	105,394	(10,491)	94,903	69,128	(4,656)	64,472
Financial assets designated at fair value	**14,535**		**14,535**	19,977		19,977	12,926		12,926
Treasury and other eligible bills	**91**		**91**	207		207	123		123
Debt securities	**14,238**		**14,238**	18,496		18,496	11,834		11,834
Loans and advances:									
to banks	**127**		**127**	355		355	119		119
to customers	**79**		**79**	919		919	850		850
Derivatives	**355,934**	**(340,442)**	**15,492**	260,672	(208,471)	52,201	346,379	(305,616)	40,763
Loans and advances held at amortised cost:	**1,157,176**	**(93,044)**	**1,064,132**	1,263,931	(103,876)	1,160,055	1,121,416	(87,978)	1,033,438
to banks	**182,191**	**(7,092)**	**175,099**	226,043	(3,173)	222,870	180,987	(3,066)	177,921
to customers	**974,985**	**(85,952)**	**889,033**	1,037,888	(100,703)	937,185	940,429	(84,912)	855,517
Financial investments	**387,050**		**387,050**	408,650		408,650	392,834		392,834
Treasury and other similar bills	**71,552**		**71,552**	61,664		61,664	65,223		65,223
Debt securities	**315,498**		**315,498**	346,986		346,986	327,611		327,611
Assets held for sale[1]	**10,541**	**(4)**	**10,537**				37,808	(204)	37,604
disposal groups	**10,383**	**(4)**	**10,379**				37,746	(204)	37,542
non-current assets held for sale	**158**		**158**				62		62
Other assets	**34,397**		**34,397**	36,789	(3)	36,786	32,992		32,992

Endorsements and acceptances	**12,782**		**12,782**	11,338	(3)	11,335	11,010		11,010
Other	**21,615**		**21,615**	25,451		25,451	21,982		21,982
Financial guarantees and similar contracts	**39,190**		**39,190**	52,232		52,232	39,324		39,324
Loan and other credit-related commitments[2]	**564,113**		**564,113**	660,175		660,175	654,904		654,904
	3,104,557	**(446,155)**	**2,658,402**	3,243,679	(322,841)	2,920,838	3,107,064	(398,454)	2,708,610

For footnotes, see page 180.

International trade and services was the biggest portion of the corporate and commercial lending category, increasing by 3% compared with 31 December 2011. The most significant concentrations of international trade and services lending were in the UK, Hong Kong and Rest of Asia-Pacific.

Commercial real estate lending, which represented 8% of total gross lending to customers, was broadly in line with 31 December 2011. The main concentrations of commercial real estate lending were in the UK and Hong Kong. See Areas of special interest for further discussion on commercial real estate lending.

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Our exposure in the financial category was US$95bn, an increase of 10% compared with 31 December 2011, due to a redeployment of short-term liquidity in North America from central banks to reverse repos. The largest exposure was to non-bank financial institutions and was spread across a range of institutions, with the most significant concentration in France, the UK and the US.

Loans and advances to banks were US$182bn, broadly in line with the end of 2011, and remained widely dispersed across many countries.

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 Limited, HSBC Bank, HSBC Bank Middle East Limited and HSBC Bank USA, by the location of the lending branch.

Gross loans and advances by industry sector

	At 31 December 2011 US$m	Currency effect US$m	Movement US$m	At 30 June 2012 US$m
Personal	393,625	**1,166**	**6,011**	**400,802**
First lien residential mortgages[3]	278,963	**1,643**	**6,174**	**286,780**
Other personal[4]	114,662	**(477)**	**(163)**	**114,022**
Corporate and commercial	472,816	**230**	**19,155**	**492,201**
Manufacturing	96,054	**(169)**	**12,165**	**108,050**
International trade and services	152,709	**22**	**3,964**	**156,695**
Commercial real estate	73,941	**178**	**595**	**74,714**
Other property-related	39,539	**50**	**369**	**39,958**
Government	11,079	**62**	**(1,631)**	**9,510**
Other commercial[5]	99,494	**87**	**3,693**	**103,274**
Financial	86,219	**(321)**	**8,657**	**94,555**
Non-bank financial institutions	85,275	**(313)**	**7,569**	**92,531**
Settlement accounts	944	**(8)**	**1,088**	**2,024**
Asset-backed securities reclassified	5,280	**62**	**(698)**	**4,644**
Total gross loans and advances to customers (TGLAC[6])	957,940	**1,137**	**33,125**	**992,202**
Gross loans and advances to banks	181,112	**(1,434)**	**2,569**	**182,247**
Total gross loans and advances	1,139,052	**(297)**	**35,694**	**1,174,449**
Impaired loans and advances to customers	41,584	**(52)**	**(788)**	**40,744**
as a percentage of TGLAC	4.3%			**4.1%**
Impairment allowances on loans and advances to customers	17,511	**(71)**	**(223)**	**17,217**
as a percentage of TGLAC	1.8%			**1.7%**

	Half-year to 30 June 2011 US$m			**Half-year to 30 June 2012 US$m**
Charge for impairment losses in the period	4,973	**912**	**(1,360)**	**4,525**
New allowances net of allowance releases	5,703	**879**	**(1,489)**	**5,093**
Recoveries	(730)	**33**	**129**	**(568)**

For footnotes, see page 180.

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Gross loans and advances to customers by industry sector and by geographical region

	Gross loans and advances to customers							
	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 30 June 2012								
Personal	**173,650**	**65,669**	**45,409**	**6,015**	**91,611**	**18,448**	**400,802**	**40.4**
First lien residential mortgages[3]	**125,729**	**48,951**	**33,636**	**1,937**	**71,582**	**4,945**	**286,780**	**28.9**
Other personal[4]	**47,921**	**16,718**	**11,773**	**4,078**	**20,029**	**13,503**	**114,022**	**11.5**
Corporate and commercial	**214,423**	**96,164**	**81,029**	**22,216**	**43,540**	**34,829**	**492,201**	**49.6**
Manufacturing	**55,245**	**10,235**	**17,550**	**3,888**	**8,594**	**12,538**	**108,050**	**10.9**
International trade and services	**64,843**	**31,631**	**30,777**	**8,574**	**11,471**	**9,399**	**156,695**	**15.8**
Commercial real estate	**32,563**	**21,510**	**9,544**	**940**	**6,706**	**3,451**	**74,714**	**7.5**
Other property-related	**7,506**	**17,079**	**6,849**	**2,060**	**6,120**	**344**	**39,958**	**4.0**
Government	**2,073**	**2,906**	**390**	**1,514**	**774**	**1,853**	**9,510**	**1.0**
Other commercial[5]	**52,193**	**12,803**	**15,919**	**5,240**	**9,875**	**7,244**	**103,274**	**10.4**
Financial	**58,322**	**3,907**	**3,897**	**1,438**	**25,237**	**1,754**	**94,555**	**9.5**
Non-bank financial institutions	**57,460**	**3,413**	**3,492**	**1,433**	**25,186**	**1,547**	**92,531**	**9.3**
Settlement accounts	**862**	**494**	**405**	**5**	**51**	**207**	**2,024**	**0.2**
Asset-backed securities reclassified	**4,243**				**401**		**4,644**	**0.5**
TGLAC[6]	**450,638**	**165,740**	**130,335**	**29,669**	**160,789**	**55,031**	**992,202**	**100.0**
Percentage of TGLAC by geographical region	**45.5%**	**16.7%**	**13.1%**	**3.0%**	**16.2%**	**5.5%**	**100.0%**	
Impaired loans	**10,881**	**555**	**1,148**	**2,514**	**22,186**	**3,460**	**40,744**	
as a percentage of TGLAC	**2.4%**	**0.3%**	**0.9%**	**8.5%**	**13.8%**	**6.3%**	**4.1%**	
Total impairment allowances	**5,193**	**536**	**846**	**1,773**	**6,798**	**2,071**	**17,217**	
as a percentage of TGLAC	**1.2%**	**0.3%**	**0.6%**	**6.0%**	**4.2%**	**3.8%**	**1.7%**	
At 30 June 2011								
Personal	172,383	61,704	44,300	5,196	131,676	24,091	439,350	41.6
First lien residential mortgages[3]	119,993	45,496	32,224	1,791	76,690	5,897	282,091	26.7
Other personal[4]	52,390	16,208	12,076	3,405	54,986	18,194	157,259	14.9
Corporate and commercial	221,361	94,566	74,726	20,786	38,761	41,147	491,347	46.5
Manufacturing	59,550	9,015	17,350	3,281	6,294	14,806	110,296	10.4
International trade and services	66,118	33,572	28,778	9,035	10,472	12,338	160,313	15.2
Commercial real estate	31,066	20,379	9,728	1,037	7,673	3,449	73,332	6.9
Other property-related	7,189	16,097	5,643	1,897	5,391	840	37,057	3.5
Government	2,126	3,252	430	1,251	311	2,055	9,425	0.9
Other commercial[5]	55,312	12,251	12,797	4,285	8,620	7,659	100,924	9.6
Financial	92,799	3,673	3,231	1,281	16,563	2,712	120,259	11.4

Non-bank financial institutions	91,636	3,042	2,794	1,267	16,563	2,654	117,956	11.2
Settlement accounts	1,163	631	437	14		58	2,303	0.2
Asset-backed securities reclassified	5,120				544		5,664	0.5
TGLAC[6]	491,663	159,943	122,257	27,263	187,544	67,950	1,056,620	100.0
Percentage of TGLAC by geographical region	46.6%	15.1%	11.6%	2.6%	17.7%	6.4%	100.0%	
Impaired loans[7]	10,878	510	1,208	2,293	25,657	3,663	44,209	
as a percentage of TGLAC	2.2%	0.3%	1.0%	8.4%	13.7%	5.4%	4.2%	
Total impairment allowances	5,332	573	828	1,569	8,282	2,148	18,732	
as a percentage of TGLAC	1.1%	0.4%	0.7%	5.8%	4.4%	3.2%	1.8%	

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	Gross loans and advances to customers							
	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
First lien residential mortgages[3]	119,902	46,817	32,136	1,837	73,278	4,993	278,963	29.1
Other personal[4]	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	45,632	9,004	16,909	3,517	7,888	13,104	96,054	10.0
International trade and services	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[5]	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[6]	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	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%	

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Gross loans and advances to customers by country

	First lien residential mortgages US$m	Other personal US$m	Property-related US$m	Commercial, international trade and other US$m	Total US$m
At 30 June 2012					
Europe	**125,729**	**47,921**	**40,069**	**236,919**	**450,638**
UK	**116,949**	**21,807**	**30,021**	**165,913**	**334,690**
France	**3,244**	**9,436**	**8,067**	**49,885**	**70,632**
Germany	**8**	**355**	**104**	**5,108**	**5,575**
Malta	**1,710**	**546**	**480**	**1,563**	**4,299**
Switzerland	**1,859**	**11,945**	**160**	**1,966**	**15,930**
Turkey	**989**	**3,550**	**296**	**3,665**	**8,500**
Other	**970**	**282**	**941**	**8,819**	**11,012**
Hong Kong	**48,951**	**16,718**	**38,589**	**61,482**	**165,740**
Rest of Asia-Pacific	**33,636**	**11,773**	**16,393**	**68,533**	**130,335**
Australia	**9,528**	**1,415**	**2,477**	**6,504**	**19,924**
India	**866**	**436**	**584**	**4,818**	**6,704**
Indonesia	**83**	**479**	**85**	**5,048**	**5,695**
Mainland China	**3,021**	**302**	**5,425**	**17,092**	**25,840**
Malaysia	**4,630**	**2,076**	**1,592**	**5,871**	**14,169**
Singapore	**8,745**	**4,448**	**3,921**	**9,938**	**27,052**
Taiwan	**3,189**	**581**	**123**	**3,381**	**7,274**
Vietnam	**43**	**205**	**44**	**1,537**	**1,829**
Other	**3,531**	**1,831**	**2,142**	**14,344**	**21,848**
Middle East and North Africa (excluding Saudi Arabia)	**1,937**	**4,078**	**3,000**	**20,654**	**29,669**
Egypt	**2**	**466**	**100**	**2,900**	**3,468**
Qatar	**11**	**423**	**466**	**1,244**	**2,144**
UAE	**1,573**	**1,830**	**1,556**	**11,452**	**16,411**
Other	**351**	**1,359**	**878**	**5,058**	**7,646**
North America	**71,582**	**20,029**	**12,826**	**56,352**	**160,789**
US	**50,773**	**12,405**	**8,015**	**39,241**	**110,434**
Canada	**19,071**	**7,214**	**4,160**	**16,072**	**46,517**
Bermuda	**1,738**	**410**	**651**	**1,039**	**3,838**
Latin America	**4,945**	**13,503**	**3,795**	**32,788**	**55,031**
Argentina	**31**	**1,459**	**105**	**2,239**	**3,834**
Brazil	**1,678**	**8,479**	**1,220**	**18,024**	**29,401**
Mexico	**1,898**	**2,531**	**1,360**	**8,906**	**14,695**
Panama	**1,307**	**1,015**	**1,049**	**2,550**	**5,921**
Other	**31**	**19**	**61**	**1,069**	**1,180**
	286,780	**114,022**	**114,672**	**476,728**	**992,202**

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	First lien residential mortgages US$m	Other personal US$m	Property-related US$m	Commercial, international trade and other US$m	Total US$m
At 30 June 2011					
Europe	119,993	52,390	38,255	281,025	491,663
UK	110,768	25,666	26,486	189,926	352,846
France	3,864	10,233	9,316	66,192	89,605
Germany	11	339	51	4,929	5,330
Malta	1,850	645	585	1,740	4,820
Switzerland	1,502	12,043	165	2,250	15,960
Turkey	858	3,053	253	3,799	7,963
Other	1,140	411	1,399	12,189	15,139
Hong Kong	45,496	16,208	36,476	61,763	159,943
Rest of Asia-Pacific	32,224	12,076	15,371	62,586	122,257
Australia	9,418	1,384	2,375	5,192	18,369
India	949	446	732	3,989	6,116
Indonesia	84	511	112	4,283	4,990
Mainland China	2,441	307	4,332	14,115	21,195
Malaysia	4,158	2,125	1,344	6,289	13,916
Singapore	7,799	4,035	3,700	9,155	24,689
Taiwan	3,261	578	129	3,997	7,965
Vietnam	45	211	78	1,457	1,791
Other	4,069	2,479	2,569	14,109	23,226
Middle East and North Africa (excluding Saudi Arabia)	1,791	3,405	2,934	19,133	27,263
Egypt	3	407	135	2,644	3,189
Qatar	9	455	417	1,323	2,204
UAE	1,500	1,915	1,451	11,386	16,252
Other	279	628	931	3,780	5,618
North America	76,690	54,986	13,064	42,804	187,544
US	55,118	46,396	7,865	26,443	135,822
Canada	19,824	8,095	4,674	15,864	48,457
Bermuda	1,748	495	525	497	3,265
Latin America	5,897	18,194	4,289	39,570	67,950
Argentina	30	1,140	119	2,405	3,694
Brazil	1,554	12,156	1,781	20,219	35,710
Mexico	2,214	2,650	1,424	9,600	15,888
Panama	1,186	1,011	669	4,389	7,255
Other	913	1,237	296	2,957	5,403
	282,091	157,259	110,389	506,881	1,056,620

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Gross loans and advances to customers by country (continued)

	First lien 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
	278,963	114,662	113,480	450,835	957,940

Loans and advances to banks by geographical region

	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$m	Impairment allowances[8] US$m
At 30 June 2012	**58,652**	**29,673**	**50,228**	**9,512**	**14,528**	**19,654**	**182,247**	**(56)**
At 30 June 2011	83,153	37,334	50,331	7,786	19,865	27,736	226,205	(162)
At 31 December 2011	54,406	35,159	47,309	8,571	14,831	20,836	181,112	(125)

For footnote, see page 180.

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Interim Management Report (continued)

Areas of special interest

Eurozone exposures

Eurozone countries are members of the EU and part of the euro single currency bloc. The peripheral eurozone countries are those that exhibited levels of market volatility that exceeded other eurozone countries, demonstrating fiscal or political uncertainty which may persist through the second half of 2012. In the first half of 2012, the peripheral eurozone countries of Greece, Ireland, Italy, Portugal, Spain and Cyprus continued to exhibit a high ratio of sovereign debt to GDP or short to medium-term maturity concentration of their liabilities, with Greece, Spain and Cyprus seeking assistance to meet sovereign liabilities or direct support for banking sector recapitalisations.

The selected other eurozone countries analysed in the table on page 128 are those that HSBC has a net on-balance sheet exposure to exceeding 5% of the Group s total equity at 30 June 2012.

Risk reduction in the first half of 2012

At 30 June 2012, our net exposure to the peripheral eurozone countries was US$37bn including a net exposure to sovereign, agencies and banks of US$12bn. During the period we continued to reduce our overall net exposure to sovereign, agencies and banks of peripheral eurozone countries. In addition, we continued to actively reduce exposures to counterparties domiciled in other eurozone 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 an analysis of publicly available information, reviews of external analyst reports, and meetings with the counterparties officials. Vulnerable counterparties were identified and subjected to enhanced monitoring, and our exposure was managed in a similar manner to the monitoring and management of direct exposures to the peripheral eurozone countries. One of the primary issues underpinning this process was the management of our surplus liquidity resulting in the placement of funds directly with central banks in the most highly-rated countries.

Our businesses in peripheral eurozone countries are funded from a mix of local deposits, local wholesale funding and intra-Group loans extended from HSBC operations with surplus funds. Intra-Group funding carries the risk that a member country might exit the eurozone and redenominate its national currency, which could result in a significant

currency devaluation. A description of risks relating to currency redenomination in the event of the exit of a eurozone member is provided on page 129.

Exposures to countries in the eurozone

The tables in this section summarise our exposures to selected eurozone countries, including:

- governments and central banks along with quasi government agencies;
- banks;

other financial institutions and corporates; and

personal lending.

Exposures to banks, other financial institutions, other corporates and personal lending are based upon the counterparty s country of domicile.

Basis of preparation

The gross balance sheet exposure before risk mitigation represents the on-balance sheet carrying amounts recorded in accordance with IFRSs.

The net on-balance sheet exposure is stated after taking into account mitigating offsets that are incorporated into the risk management view of the exposure but do not meet accounting offset requirements. These risk mitigating offsets include:

short positions managed together with trading assets;

derivative liabilities for which a legally enforceable right of offset with derivative assets exists; and

collateral received on derivative assets.

Short positions managed together with trading assets mitigate risk to which HSBC is exposed at the balance sheet date where, in the event of default, the trading asset and related short position crystallise gains and losses simultaneously. Where such relationships exist, an element of the risk will remain where the short and long positions do not match exactly, for example, where the maturity of the short position is less than the trading asset or where it does not represent an identical security. The remaining risk is reflected in the gross balance sheet exposure shown before risk mitigation. However, as the net position best reflects the effects of a credit event should it occur at the balance sheet date we consider that this measure is a key view of risk at that date.

Credit risk mitigation includes derivative liabilities with the same counterparty, where 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. These amounts do not qualify for net presentation for accounting purposes as settlement may not actually be made on a net basis, though we consider the net presentation more accurately reflects the risk exposure.

The effect of the transfer of risk to policyholders under unit linked insurance contracts, as well as trading assets which represent collateral to support associated liabilities, are separately disclosed in the detailed peripheral country exposures, but are not deducted from the total net exposure.

Credit default swaps (CDS s) reported in the detailed peripheral eurozone country tables are not included in the derivative exposure line as they are typically transacted with counterparties incorporated or domiciled outside of the country whose exposure they reference.

Credit default swaps and off-balance sheet exposures

The CDSs were transacted with banks with investment grade credit ratings, and would pay out in the event of the default of the referenced security

and certain other credit events. CDS contracts disclosed in the tables below were principally entered into for customer facilitation 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 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 amounts shown in the tables represent the amounts that could be drawn down by the counterparties. In some instances, limitations are imposed on a counterparty s ability to draw down on a facility. These limitations are governed by the documentation, which differs from counterparty to counterparty. In the majority of cases, we are bound to fulfil commitments made to third parties.

Summary of net exposures to peripheral eurozone countries

	At 30 June 2012				
	Sovereign and agencies US$bn	Banks US$bn	Other financial institutions and corporates US$bn	Personal US$bn	Total US$bn
Gross balance sheet exposure before risk mitigation	**9.8**	**21.8**	**18.3**	**1.2**	**51.1**
Risk mitigation	**6.4**	**15.4**	**1.4**		**23.2**
Net on-balance sheet exposure	**3.4**	**6.4**	**16.9**	**1.2**	**27.9**
Off-balance sheet exposures	**1.0**	**0.8**	**7.4**		**9.2**

Total net exposure	**4.4**	**7.2**	**24.3**	**1.2**	**37.1**
Total net exposure by country					
Spain (page 123)	**1.3**	**2.7**	**8.4**		**12.4**
Ireland (page 124)	**0.2**	**2.0**	**6.0**	**0.1**	**8.3**
Italy (page 125)	**2.1**	**1.6**	**4.3**	**0.1**	**8.1**
Greece (page 126)	**0.1**	**0.2**	**4.0**	**0.9**	**5.2**
Portugal (page 127)	**0.7**	**0.7**	**1.2**		**2.6**
Cyprus (page 128)			**0.4**	**0.1**	**0.5**
	4.4	**7.2**	**24.3**	**1.2**	**37.1**

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Exposures to peripheral eurozone countries

Exposures to Spain

	At 30 June 2012				
	Sovereign and agencies US$bn	Banks US$bn	Other financial institutions and corporates US$bn	Personal US$bn	Total US$bn
Cash and balances at central banks					
Loans and advances		0.1	5.2		5.3
gross		0.1	5.2		5.3
impairment allowances					
Financial investments held to maturity					
fair value					
Financial investments available for sale[9]	0.4	0.4	0.1		0.9
cumulative impairment					
amortised cost	0.4	0.4	0.1		0.9
available-for-sale reserve					
Financial assets designated at fair value					
Trading assets	1.5	1.9	0.2		3.6
Derivative assets	0.2	4.1	0.7		5.0
Gross balance sheet exposure before risk mitigation	2.1	6.5	6.2		14.8
Risk mitigation	1.8	4.2	0.5		6.5
short trading positions	1.7	0.2	0.1		2.0
collateral and derivative liabilities	0.1	4.0	0.4		4.5
Net on-balance sheet exposure	0.3	2.3	5.7		8.3
Off-balance sheet exposures	1.0	0.4	2.7		4.1
commitments	1.0		2.0		3.0
guarantees and others		0.4	0.7		1.1
Total net exposure	1.3	2.7	8.4		12.4
Of which:					
net trading assets representing cash collateral posted	0.1	1.1			1.2
on-balance sheet exposures held to meet DPF insurance liabilities	0.2	0.3			0.5
Total credit default swaps					
CDS asset positions	0.7	0.2	0.1		1.0
CDS liability positions	(0.7)	(0.1)	(0.1)		(0.9)
CDS asset notionals	4.8	2.1	1.2		8.1

CDS liability notionals	**4.8**	**2.0**	**1.1**		**7.9**

For footnote, see page 180.

At 30 June 2012, our total net exposure to Spain was US$12.4bn, similar to the amount of our exposure at the end of 2011.

At 30 June 2012, our total net exposure to Spanish sovereign and agencies was US$1.3bn, US$0.9bn lower than at the end of 2011. The reduction was primarily due to higher amounts of short trading positions.

At 30 June 2012, our total net exposure to Spanish banks was US$2.7bn, US$0.8bn lower than at the end of 2011. The reduction was primarily due to increased risk mitigation from higher collateral

and derivative liabilities in respect of derivative assets.

At 30 June 2012, our total net exposure to Spanish other financial institutions and corporates was US$8.4bn, an increase of US$1.8bn primarily due to higher off-balance sheet commitments. Our exposure to Spanish other financial institutions and corporates mainly comprised large multinational companies and other financial institutions with significant operations outside Spain, which mitigates the risk. Exposure to the commercial real estate sector in Spain remained insignificant.

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Interim Management Report (continued)

Exposures to Ireland

	At 30 June 2012				
	Sovereign and agencies US$bn	Banks US$bn	Other financial institutions and corporates US$bn	Personal US$bn	Total US$bn
Cash and balances at central banks					
Loans and advances		0.1	2.3	0.1	2.5
gross		0.1	2.3	0.2	2.6
impairment allowances				0.1	0.1
Financial investments held to maturity		0.2			0.2
fair value		0.2			0.2
Financial investments available for sale	0.1		0.7		0.8
cumulative impairment					
amortised cost	0.1		0.8		0.9
available-for-sale reserve			(0.1)		(0.1)
Financial assets designated at fair value			0.1		0.1
Trading assets	0.2	1.6	1.0		2.8
Derivative assets	0.5	8.3	1.0		9.8
Gross balance sheet exposure before risk mitigation	**0.8**	**10.2**	**5.1**	**0.1**	**16.2**
Risk mitigation	0.6	8.2	0.3		9.1
short trading positions	0.1				0.1
collateral and derivative liabilities	0.5	8.2	0.3		9.0
Net on-balance sheet exposure	0.2	2.0	4.8	0.1	7.1
Off-balance sheet exposures			1.2		1.2
commitments			1.0		1.0
guarantees and others			0.2		0.2
Total net exposure	**0.2**	**2.0**	**6.0**	**0.1**	**8.3**
Of which:					
net trading assets representing cash collateral posted	0.1	1.6	0.3		2.0
on-balance sheet exposures held to meet DPF insurance liabilities	0.1	0.3			0.4
Total credit default swaps					
CDS asset positions	0.2		0.1		0.3
CDS liability positions	(0.2)				(0.2)
CDS asset notionals	1.3	0.3	0.3		1.9
CDS liability notionals	1.3		0.3		1.6

At 30 June 2012, our total net exposure to Ireland was US$8.3bn, US$2.6bn higher than at the end of 2011. The majority of the increase was in respect of exposures to other financial institutions and corporates.

At 30 June 2012, our total net exposure to Irish other financial institutions and corporates was US$6.0bn, US$2.5bn higher than at the end of 2011. The increase was primarily due to higher amounts of trading assets and off-balance sheet commitments. A significant portion of our exposure relates to foreign owned entities incorporated in Ireland.

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Exposures to Italy

	At 30 June 2012				
	Sovereign and agencies US$bn	Banks US$bn	Other financial institutions and corporates US$bn	Personal US$bn	Total US$bn
Cash and balances at central banks					
Loans and advances		0.2	1.3	0.1	1.6
gross		0.2	1.3	0.1	1.6
impairment allowances					
Financial investments held to maturity	0.1	0.2			0.3
fair value	0.1	0.2			0.3
Financial investments available for sale[9]	0.3	0.3	0.3		0.9
cumulative impairment					
amortised cost	0.3	0.3	0.2		0.8
available-for-sale reserve					
Financial assets designated at fair value			0.1		0.1
Trading assets	5.0	0.6	0.3		5.9
Derivative assets	0.3	2.2	1.1		3.6
Gross balance sheet exposure before risk mitigation	5.7	3.5	3.1	0.1	12.4
Risk mitigation	3.6	2.1	0.6		6.3
short trading positions	3.6		0.1		3.7
collateral and derivative liabilities		2.1	0.5		2.6
Net on-balance sheet exposure	2.1	1.4	2.5	0.1	6.1
Off-balance sheet exposures		0.2	1.8		2.0
commitments			1.0		1.0
guarantees and others		0.2	0.8		1.0
Total net exposure	2.1	1.6	4.3	0.1	8.1
Of which:					
net trading assets representing cash collateral posted		0.5			0.5
on-balance sheet exposures held to meet DPF insurance liabilities	0.3	0.4	0.2		0.9
Total credit default swaps					
CDS asset positions	0.7	0.5	0.3		1.5
CDS liability positions	(0.7)	(0.5)	(0.2)		(1.4)
CDS asset notionals	5.0	5.4	3.8		14.2
CDS liability notionals	5.2	5.3	3.7		14.2

For footnote, see page 180.

At 30 June 2012, our total net exposure to Italy was US$8.1bn, similar to the amount of our exposure at the end of 2011.

At 30 June 2012, our total net exposure to Italian banks was US$1.6bn, US$0.5bn lower than at the end of 2011. The reduced exposure was primarily due to lower amounts of loans and advances and increased risk mitigation from higher

collateral and derivative liabilities in respect of derivative assets.

Our total net exposure to other financial institutions and corporates at 30 June 2012 of US$4.3bn mainly comprised large multinational companies and other financial institutions with significant operations outside Italy, which mitigates the risk.

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Exposures to Greece

	At 30 June 2012				
	Sovereign and agencies US$bn	Banks US$bn	Other financial institutions and corporates US$bn	Personal US$bn	Total US$bn
Cash and balances at central banks	0.1				0.1
Loans and advances		0.1	3.5	0.9	4.5
gross		0.1	3.7	0.9	4.7
impairment allowances			0.2		0.2
Financial investments held to maturity					
fair value					
Financial investments available for sale					
cumulative impairment					
amortised cost					
available-for-sale reserve					
Financial assets designated at fair value					
Trading assets					
Derivative assets		0.7			0.7
Gross balance sheet exposure before risk mitigation	0.1	0.8	3.5	0.9	5.3
Risk mitigation		0.7			0.7
short trading positions					
collateral and derivative liabilities		0.7			0.7
Net on-balance sheet exposure	0.1	0.1	3.5	0.9	4.6
Off-balance sheet exposures		0.1	0.5		0.6
commitments			0.1		0.1
guarantees and others		0.1	0.4		0.5
Total net exposure	0.1	0.2	4.0	0.9	5.2
Of which:					
net trading assets representing cash collateral posted					
on-balance sheet exposures held to meet DPF insurance liabilities					
Total credit default swaps					
CDS asset positions			0.1		0.1
CDS liability positions			(0.1)		(0.1)
CDS asset notionals			0.2		0.2
CDS liability notionals			0.2		0.2

At 30 June 2012, our total net exposure to Greece was US$5.2bn, US$2.4bn lower that at the end of 2011. Although there was a reduction in exposure levels to all Greek counterparties in the first half of 2012, the majority of the reduction was in respect of exposures to banks and other financial institutions and corporates.

At 30 June 2012, our total net exposure to Greek sovereign and agencies was US$0.1bn, US$0.3bn lower than at the end of 2011. Our Greek sovereign exposure decreased significantly as a result of the debt restructuring in March 2012 and the associated settlement of CDS contracts.

At 30 June 2012, our total net exposure to Greek banks was US$0.2bn, US$0.7bn lower than at the end of 2011. The decrease was primarily due to the maturity of trading balances in the first half of 2012.

At 30 June 2012, our total net exposure to Greek other financial institutions and corporates was US$4.0bn, US$1.3bn lower than at the end of 2011. The reduction was primarily due to lower level of off-balance sheet exposures, including commitments and guarantees. At 30 June 2012, 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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Interim Management Report (continued)

Exposures to Portugal

	At 30 June 2012 Sovereign and agencies US$bn	Banks US$bn	Other financial institutions and corporates US$bn	Personal US$bn	Total US$bn
Cash and balances at central banks					
Loans and advances		0.5	0.2		0.7
gross		0.5	0.2		0.7
impairment allowances					
Financial investments held to maturity					
fair value					
Financial investments available for sale	0.1				0.1
cumulative impairment					
amortised cost	0.1				0.1
available-for-sale reserve					
Financial assets designated at fair value					
Trading assets	0.7	0.1			0.8
Derivative assets	0.3	0.2			0.5
Gross balance sheet exposure before risk mitigation	1.1	0.8	0.2		2.1
Risk mitigation	0.4	0.2			0.6
short trading positions	0.1				0.1
collateral and derivative liabilities	0.3	0.2			0.5
Net on-balance sheet exposure	0.7	0.6	0.2		1.5
Off-balance sheet exposures		0.1	1.0		1.1
commitments			1.0		1.0
guarantees and others		0.1			0.1
Total net exposure	0.7	0.7	1.2		2.6
Of which:					
net trading assets representing cash collateral posted	0.4				0.4
on-balance sheet exposures held to meet DPF insurance liabilities	0.1				0.1
Total credit default swaps					
CDS asset positions	0.3	0.1	0.1		0.5
CDS liability positions	(0.3)	(0.1)	(0.1)		(0.5)
CDS asset notionals	1.5	0.6	0.7		2.8
CDS liability notionals	1.4	0.6	0.8		2.8

At 30 June 2012, our total net exposure to Portugal was US$2.6bn, US$1.5bn higher than at the end of 2011. The increase was primarily in respect of other financial institutions and corporates for which there were higher amounts of off-balance sheet

commitments in the first half of 2012. These increases were predominantly in support of internationally active corporates with significant operations outside Portugal, which reduces the risk.

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Exposures to Cyprus

	At 30 June 2012				
	Sovereign and agencies US$bn	Banks US$bn	Other financial institutions and corporates US$bn	Personal US$bn	Total US$bn
Cash and balances at central banks					
Loans and advances			0.2	0.1	0.3
gross			0.2	0.1	0.3
impairment allowances					
Financial investments held to maturity					
fair value					
Financial investments available for sale					
cumulative impairment					
amortised cost					
available-for-sale reserve					
Financial assets designated at fair value					
Trading assets					
Derivative assets					
Gross balance sheet exposure before risk mitigation			0.2	0.1	0.3
Risk mitigation					
short trading positions					
collateral and derivative liabilities					
Net on-balance sheet exposure			0.2	0.1	0.3
Off-balance sheet exposures			0.2		0.2
commitments			0.1		0.1
guarantees and others			0.1		0.1
Total net exposure			0.4	0.1	0.5
Of which:					
net trading assets representing cash collateral posted					
on-balance sheet exposures held to meet DPF insurance liabilities					
Total credit default swaps					
CDS asset positions					
CDS liability positions					
CDS asset notionals					
CDS liability notionals					

Exposures to selected other eurozone countries

Summary of net on-balance sheet exposures to selected other eurozone countries

	At 30 June 2012			
	France US$bn	Germany US$bn	The Netherlands US$bn	Total US$bn
Sovereign and agencies	**50**	**27**	**15**	**92**
Banks	**34**	**15**	**6**	**55**
Other financial institutions and corporates	**37**	**18**	**10**	**65**
Personal	**14**			**14**

At 30 June 2012, our net on-balance sheet exposure to France, Germany and the Netherlands was US$226bn, US$9bn lower than at the end of 2011.

At 30 June 2012, our net on-balance sheet exposure to the sovereign and agency debt of France, Germany and the Netherlands was US$92bn, US$5bn

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higher than at the end of 2011. Our exposure to France and Germany was commensurate with the size of our operations in these countries. In 2012, cash balances held with the Dutch Central Bank were reduced and redirected to the French Central Bank to align more closely with our underlying operations. The cash placements continued to be put into the euro clearing system managed by the ECB.

At 30 June 2012, our exposure to the bank debt of France, Germany, and the Netherlands was US$55bn, US$28bn lower than at the end of 2011. The decrease reflected our ongoing efforts to reduce exposure to counterparties domiciled in these countries with exposures to sovereigns and/or banks in peripheral eurozone countries of sufficient size to threaten the counterparties on-going viability in the event of an unfavourable conclusion to the current crisis.

At 30 June 2012, our exposure to the corporate and other financial institution debt of France, Germany and the Netherlands was US$65bn, US$14bn higher than at the end of 2011. Our exposure in Germany and France was commensurate with the size of our operations and was well diversified across portfolios, sectors and products.

Our relationships in these countries are mostly with large global entities that have significant operations outside their respective domestic markets. This mitigates our risk as these corporates have diversified the sources of their revenue and, more importantly, their ability to raise finance internationally should their domestic markets become strained.

In France, our exposure to personal lending at 30 June 2012 was US$14bn, similar to the amount of our exposure at the end of 2011. The exposure was mainly in residential mortgages, loans secured by a national guarantee scheme and unsecured personal loans, and both delinquency and impairment changes remained low.

Exposure to other eurozone countries

In addition to the countries disclosed above, HSBC had net on-balance sheet exposures to other eurozone countries that were not significant to the Group. Of these, the largest exposure was represented by our retail and corporate banking operations in Malta, which held assets of approximately US$4bn. Our second largest exposure was in Luxembourg with approximately US$2bn of exposure to sovereign, agencies and banks (mostly money market placements) and approximately US$2bn to other financial institutions and corporates (mostly loans and advances). We also

had approximately US$2bn of exposure to sovereign and agencies in Austria. Our remaining net on-balance sheet exposure to the eurozone is less than 5% of the Group s total equity.

Redenomination risk

As a result of the continuing distressed conditions experienced by the peripheral eurozone countries, there is an increased possibility of a member state exiting from the eurozone. There is currently no established legal framework within the European treaties to facilitate such an event; consequently, it is not possible to accurately predict the course of events and legal consequences that would ensue.

Our current view is that there would be a greater impact on HSBC from a euro exit of Greece, Italy or Spain than from Ireland, Portugal or Cyprus, where our exposures are substantially lower.

Key risks associated with an exit by a eurozone member include:

Foreign exchange losses: an exit would probably be accompanied by the passing of laws in the country concerned establishing a new local currency and providing for a redenomination of euro-denominated assets into the new local currency. The value of assets and liabilities in the country would immediately fall assuming the value of the redenominated currency is less than the original euros when translated into the carrying amounts. It is not possible to predict what the total consequential loss might be as it is uncertain which assets and liabilities would be legally re-denominated or what the extent of the devaluation would be. However, in order to provide an indication of one part of the possible exposure, the table below identifies assets and liabilities booked in our banking operations in Greece, Italy and Spain (described as in-country). These assets and liabilities predominantly comprise loans and deposits arising from our commercial banking operations in these countries. The net assets represent our net funding exposure to those countries which we consider most likely to be affected by a redenomination event. The table also identifies in-country off-balance sheet exposures as these are at risk of redenomination should they be called, giving rise to a balance sheet exposure. It is to be noted that this analysis can only be an indication as it does not include euro-denominated exposures booked by HSBC outside the countries at risk which are connected with those countries (see external contracts below).

External contracts redenomination risk: contracts entered into between HSBC businesses based outside a country exiting the euro with in-country

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counterparties or those otherwise closely connected with the relevant country, may be affected by redenomination. The effect is subject to a high level of uncertainty. Factors such as the country law under which the contract is documented, the HSBC entity involved and the payment mechanism may all be relevant to this assessment, as will the precise exit scenario as the consequences on external contracts of a disorderly exit or one sanctioned under EU law may be different. In addition, capital controls could be introduced which may affect the ability to repatriate funds including currencies not affected by the redenomination event.

We have been actively identifying and monitoring potential redenomination risks and, where possible, taking steps with the potential to mitigate them and/or reduce our overall exposure to losses that might arise in the event of a redenomination. We would emphasise, however, that a euro exit could take the form of a number of different scenarios giving rise to distinct legal consequences which could significantly alter the potential effectiveness of any steps taken, and it is accordingly not possible to predict how effective particular measures may be until they are tested against the precise circumstances of a redenomination event.

In-country funding exposure at 30 June 2012

	Denominated in:			
	Euros US$bn	US dollars US$bn	other currencies US$bn	Total US$bn
Greece				
In-country assets	2.2	0.1	0.1	2.4
In-country liabilities	(1.4)	(0.8)	(0.1)	(2.3)
Net in-country funding exposure	0.8	(0.7)		0.1
Off-balance sheet exposure/hedging	(0.3)	0.4	0.1	0.2
Italy				
In-country assets	1.3			1.3
In-country liabilities[10]	(2.0)			(2.0)
Net in-country funding exposure	(0.7)			(0.7)
Off-balance sheet exposure	0.3			0.3
Spain				
In-country assets	3.3	0.7	0.1	4.1
In-country liabilities	(2.0)	(0.5)		(2.5)
Net in-country funding exposure	1.3	0.2	0.1	1.6
Off-balance sheet exposure	1.1	0.2		1.3

For footnote, see page 180.

Risk management and contingency planning

There is an established framework for dealing with counterparty and systemic crisis situations, both regionally and globally, which is complemented by regular specific and enterprise-wide stress testing and scenario planning. The framework functions both at pre and in-crisis situations and ensures that we have detailed operational plans in case an adverse scenario materialises.

The main focus continues to be Greece and Spain although we also consider additional scenarios including contagion risk or the exit of a higher impact country. This includes the setting up of a Eurozone Major Incident Group which meets regularly, complemented by a regional eurozone contingency plan covering all global businesses and

functions. The plan has been tested and considers payments, legal, client account, internal and external communication and regulatory and compliance issues associated with eurozone breakup.

Stress testing

Our stress testing programme is described in the *Annual Report and Accounts 2011* (page 188), and is a tool used to assess the impact of potential scenarios on regulatory capital.

In the course of 2012, we have examined several scenarios reflecting potential developments, both in the eurozone and more widely. Scenarios examined and reported to senior management in the course of the first half of 2012 included the following.

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Two global stress scenarios were considered, taking into account the market turmoil that may arise from an orderly or a disorderly Greek default. The analysis generated by the enterprise-wide stress testing informs and shapes ongoing and future management actions which the Group would need to take to mitigate the impact of the stress scenario. The analysis demonstrated that HSBC would remain satisfactorily capitalised under the mild and severe scenarios after taking account of assumed management actions. The assumptions which were applied in each scenario are set out below:

Mild scenario assumptions:

- the situation in Greece worsens and there is an orderly default in Greece;
- Greek banks also default and, with support from the EU and International Monetary Fund, they are bailed out;
- increasing bond yields in Portugal, Ireland, Spain and Italy trigger further fiscal austerity measures, and governments strive to disassociate their countries from Greece;
- through financial and trade linkages, an orderly default of Greece results in the spread of contagion to the rest of the world;
- the UK, US and emerging markets are adversely affected, albeit to varying degrees; and
- slower global demand curbs growth and increases the risk premium on interest rates as well as commodity prices.

Severe scenario assumptions:

- a disorderly default of Greece, where the eurozone governments are unable to ring-fence peripheral countries and their banks;
- default of Portugal and Ireland with increases in bond yields for high debt countries;
- the ensuing credit crunch together with declining business and consumer confidence more than offset any relief gained from the depreciation of the euro;
- investors become increasingly uncomfortable with the US and the UK s fiscal positions, with the severe scenario resulting in a global slowdown; and

emerging economies are less affected by the financial shock.
In addition, our reverse stress test takes into consideration the eurozone crisis as one of its constituent scenarios.

Wholesale lending

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.

Middle East and North Africa

In the first half of 2012, significant unrest and political changes in the Middle East and North Africa were mainly confined to Syria and Egypt. Potential future risks arise from the threat to regional stability caused by the potential for the deteriorating internal situation in Syria to affect its neighbours. In Egypt, there is a risk that social unrest and the concomitant disruption to the management of the economy may persist if the recent presidential elections fail to defuse the threat of sustained political intervention by the Egyptian military.

The Group s exposures in the region remain concentrated in our associate investment in Saudi Arabia and in the UAE, where the political landscapes remained stable. Economic growth in these countries is, however, showing signs of slowing as oil prices are affected by the weakening in the world economy. In the countries in which we have a presence we continue to carefully monitor and respond to developments while assisting customers in managing their own risks in the volatile environment.

We continued to work closely with the various entities related to the Government of Dubai to address their prevailing issues. In the first half of 2012, an agreement was reached between Dubai International Capital and its creditors for the restructuring of US$2.4bn of debt which has been extended for five years.

Commercial real estate

In 2012, credit quality across this sector showed some deterioration and there remains a risk of stress in certain markets. Our exposure to commercial real estate lending continued to be concentrated in Hong Kong, the UK and North America. The market in Hong Kong, after relative buoyancy in 2011, began to stabilise in 2012, partly due to initiatives taken by supervisory authorities. In the UK, many regions were negatively affected by weak growth in the economy, though London and the South East continued to exhibit relative strength. We are closely monitoring re-financing requirements in the UK market over the next two to three years. In North

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America, the market continued to be relatively stable, in part supported by the continued low levels of interest rates.

The aggregate of our commercial real estate and other property-related lending was US$115bn at 30 June 2012, broadly in line with 31 December 2011, representing 12% of total loans and advances to customers.

Personal lending

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 range is not standard across all countries but is tailored to meet the demands of individual markets 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.

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 the parameters must comply with Group policy, strategy and risk appetite, they differ in the various locations in which we operate in order to reflect the local economic and housing market conditions, regulations, portfolio performance, pricing and other product features.

In the first half of 2012, the credit quality of most of our personal lending portfolios improved, reflecting the continued low levels of interest rates and strong customer repayments in many markets, as well as actions taken in previous periods to tighten our lending criteria. Delinquency levels and loan impairment charges reduced in most markets while lending balances in our higher risk portfolios continued to be managed down.

In the US, the origination of new personal lending was limited as we have discontinued all new consumer finance real estate lending following the closure of the consumer finance distribution network. Customer lending balances across HSBC Finance portfolios continued to decline and, in May

2012, we completed the sale of the US Card and Retail Services business. In addition, in the first half of 2012, we engaged an adviser to assist us in exploring options to accelerate the liquidation of the CML portfolio and identified certain loan pools that we are targeting to sell in the future as market conditions permit.

The commentary that follows is on a constant currency basis.

At 30 June 2012, the Group s exposure to personal lending was US$401bn, 2% higher than at 31 December 2011 reflecting a rise in first lien residential mortgage lending, mainly in the UK and Hong Kong, partly offset by a reduction in other personal lending. Loan impairment allowances on our personal lending portfolios were US$9.4bn, compared with US$9.7bn at the end of 2011, while the ratio of loan impairment allowances to total personal lending reduced from 2.5% at 31 December 2011 to 2.3% at 30 June 2012.

Loan impairment charges in our personal lending portfolios were US$3.2bn in the first half of 2012, 23% lower than in the first half of 2011 and representing 69% of the overall Group charge for loan impairment charges and other credit risk provisions. The decline was predominantly in the US and mainly reflected the reduction in balances in the CML portfolio, as well as an improvement in two-months-and-over contractual delinquency on balances less than 180 days past due. The decrease also reflected the sale of the Card and Retail Services business on 1 May 2012.

At 30 June 2012, total personal lending in the UK was US$139bn, representing a small increase from 31 December 2011, mainly due to growth in first lien residential mortgage balances following the success of marketing campaigns and competitive pricing. (UK mortgage lending is discussed in greater detail on page 135).

In Hong Kong, total personal lending grew by 4% compared with the end of 2011 to US$66bn, mainly due to a rise in first lien residential mortgage lending as our mortgage pricing remained competitive backed by a resilient property market.

In Rest of Asia-Pacific, we increased our personal lending following growth in first lien residential mortgage lending in Singapore, Malaysia and Australia, which reflected successful marketing efforts. This was partly offset by the transfer of personal lending balances in Korea to assets held for sale following the announcement of the disposal of our RBWM business there.

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Total personal lending balances in the US at 30 June 2012 were US$63bn, a decrease of 5% compared with the end of 2011. The decline reflected the run-off of our CML portfolio, as well as the seasonal improvements in our collections as customers used tax refunds received in the first half of the year to repay debt.

In Latin America, personal lending decreased by 5% compared with 31 December 2011, following the transfer of balances to assets held for sale, as well as a reduction in other personal lending, in Brazil where we managed down our exposure to non-

strategic portfolios, including vehicle finance and certain other lending products and focused on higher quality lending including first lien residential mortgage lending. This complemented the range of corrective actions, including improving our collections capabilities, reducing third party originations and improving credit scoring models, that were implemented to limit our exposure to further market weakness following a rise in delinquency in 2011 which continued into the first half of 2012.

Total personal lending

	UK US$m	Rest of Europe US$m	US[11] US$m	Rest of North America US$m	Other regions[11] US$m	Total US$m
At 30 June 2012						
First lien residential mortgages	**116,949**	**8,780**	**50,773**	**20,809**	**89,469**	**286,780**
Other personal lending	**21,807**	**26,114**	**12,405**	**7,624**	**46,072**	**114,022**
motor vehicle finance		**29**	**15**	**24**	**3,852**	**3,920**
credit cards	**10,961**	**2,640**	**791**	**1,188**	**13,543**	**29,123**
second lien residential mortgages	**644**		**6,352**	**424**	**144**	**7,564**
other	**10,202**	**23,445**	**5,247**	**5,988**	**28,533**	**73,415**
Total personal lending	**138,756**	**34,894**	**63,178**	**28,433**	**135,541**	**400,802**
Impairment allowances on personal lending						
First lien residential mortgages	**(441)**	**(59)**	**(4,463)**	**(38)**	**(248)**	**(5,249)**
Other personal lending	**(609)**	**(400)**	**(1,425)**	**(121)**	**(1,581)**	**(4,136)**
motor vehicle finance		**(4)**		**(1)**	**(166)**	**(171)**
credit cards	**(165)**	**(189)**	**(35)**	**(33)**	**(417)**	**(839)**
second lien residential mortgages	**(33)**		**(634)**	**(9)**		**(676)**
other	**(411)**	**(207)**	**(756)**	**(78)**	**(998)**	**(2,450)**
Total	**(1,050)**	**(459)**	**(5,888)**	**(159)**	**(1,829)**	**(9,385)**
as a percentage of total personal lending	**0.8%**	**1.3%**	**9.3%**	**0.6%**	**1.3%**	**2.3%**

At 30 June 2011

First lien residential mortgages	110,768	9,225	55,118	21,572	85,408	282,091
Other personal lending	25,666	26,724	46,396	8,590	49,883	157,259
motor vehicle finance		29	60	38	5,918	6,045
credit cards	11,122	2,007	30,670	1,282	14,048	59,129
second lien residential mortgages	795	1	8,509	553	288	10,146
other	13,749	24,687	7,157	6,717	29,629	81,939
Total personal lending	136,434	35,949	101,514	30,162	135,291	439,350
Impairment allowances on personal lending						
First lien residential mortgages	(336)	(61)	(3,980)	(24)	(323)	(4,724)
Other personal lending	(920)	(475)	(3,299)	(131)	(1,681)	(6,506)
motor vehicle finance		(4)			(233)	(237)
credit cards	(237)	(220)	(1,670)	(35)	(466)	(2,628)
second lien residential mortgages	(51)		(697)	(12)		(760)
other	(632)	(251)	(932)	(84)	(982)	(2,881)
Total	(1,256)	(536)	(7,279)	(155)	(2,004)	(11,230)
as a percentage of total personal lending	0.9%	1.5%	7.2%	0.5%	1.5%	2.6%

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Total personal lending (continued)

	UK US$m	Rest of Europe US$m	US[11] US$m	Rest of North America US$m	Other regions[11] US$m	Total US$m
At 31 December 2011						
First lien 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 residential 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 on personal lending						
First lien 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 residential mortgages	(42)	(1)	(740)	(9)		(792)
other	(526)	(213)	(873)	(65)	(968)	(2,645)
Total	(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%

For footnotes, see page 180.

Mortgage lending

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 30 June 2012, total mortgage lending, comprising both first lien and second lien residential mortgages, was US$294bn, an increase of 2% compared with the end of 2011.

US mortgage lending

In the US, total mortgage lending balances were US$57bn at 30 June 2012, a decline of 4% compared with the end of 2011. Overall, US mortgage lending represented 14% of our total personal lending and 19% of our total mortgage lending, compared with 15% and 21%, respectively, at 31 December 2011.

At 30 June 2012, mortgage lending balances at HSBC Finance were US$41bn, a decline of 7% compared with the end of 2011 due to the continued run-off of the CML portfolio. The reduction in balances also reflected seasonal improvements in collections as customers used tax refunds to make repayments. During the first half of 2012, we engaged an adviser to assist us in exploring options to accelerate the liquidation of this portfolio.

The rate at which balances in the CML portfolio are declining continues to be affected by the lack of refinancing opportunities available to our customers

and the temporary suspension of foreclosure activities. We have now resumed foreclosure processing in substantially all states, though it will take time to work through the backlog of loans that have not yet been referred to foreclosure. In addition, our loan modification programmes, which are designed to improve cash collections and avoid foreclosure, are contributing to slower loan repayment rates.

See below for a breakdown of mortgage lending in HSBC Finance.

HSBC Finance US Consumer and Mortgage Lending[12] *residential mortgages*

	At 30 Jun 2012 US$m	At 30 Jun 2011 US$m	At 31 Dec 2011 US$m
Residential mortgages			
First lien	**37,188**	42,276	39,608
Second lien	**4,042**	4,996	4,520
Total (A)	**41,230**	47,272	44,128
Impairment allowances	**4,884**	4,504	5,088
as a percentage of (A)	**11.8%**	9.5%	11.5%

For footnotes, see page 180.

In HSBC Bank USA, we continued to sell the majority of new originations to the secondary market as a means of managing our interest rate risk and improving structural liquidity. Mortgage lending balances were US$16bn at 30 June 2012, an increase of 3% compared with the end of 2011, driven by increased origination to our Premier customers.

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A discussion of credit trends in the US mortgage lending portfolio and the steps taken to mitigate risk is provided in US personal lending credit quality on page 136.

Mortgage lending rest of the world

Mortgage lending in the UK was US$118bn at 30 June 2012, representing the Group s largest concentration of mortgage exposure, an increase of 4% compared with the end of 2011. In the first half of 2012, house prices in parts of the UK remained under pressure, with sentiment among potential buyers remaining cautious given economic uncertainty and high levels of unemployment.

The credit quality of our UK mortgage portfolio remained high, reflecting actions taken in previous periods including the restrictions on lending to

purchase residential property for the purpose of rental. Almost all lending is originated through our own salesforce, and the self-certification of income is not permitted. The majority of our mortgage lending in the UK is to existing customers that hold current or savings accounts with HSBC. The average LTV ratio for new business was 58% at 30 June 2012, while loan impairment charges and delinquency levels in our UK mortgage book remained low, aided by the continued low levels of interest rates. In Hong Kong, mortgage lending was US$49bn, an increase of 4% compared with the end of 2011. The quality of our mortgage book was very strong with loan impairment charges at very low levels. The average LTV ratio on new mortgage sales was 50%.

The following table shows the levels of mortgage lending products in the various portfolios in the US, the UK and the rest of the HSBC Group.

Mortgage lending products

	UK US$m	Rest of Europe US$m	US[11] US$m	Rest of North America US$m	Other regions[11] US$m	Total US$m
At 30 June 2012						
First lien residential mortgages	116,949	8,780	50,773	20,809	89,469	286,780
Second lien residential mortgages	644		6,352	424	144	7,564
Total mortgage lending	117,593	8,780	57,125	21,233	89,613	294,344
Second lien as percentage of total mortgage lending	0.5%		11.1%	2.0%	0.2%	2.6%
Impairment allowances on mortgage lending	(474)	(59)	(5,097)	(47)	(248)	(5,925)
First lien residential mortgages	(441)	(59)	(4,463)	(38)	(248)	(5,249)
Second lien residential mortgages	(33)		(634)	(9)		(676)
Interest-only (including offset) mortgages	47,605	48		582	1,225	49,460
Affordability mortgages, including adjustable-rate mortgages (ARM s)	35	480	16,424	276	6,014	23,229
Other	102				201	303
Total interest-only and affordability mortgages	47,742	528	16,424	858	7,440	72,992
as a percentage of total mortgage lending	40.6%	6.0%	28.8%	4.0%	8.3%	24.8%

Negative equity mortgages[13]	**2,291**		**13,782**	**166**	**155**	**16,394**
Other loan to value ratios greater than 90%[14]	**5,039**	**186**	**7,131**	**1,378**	**958**	**14,692**
Total negative equity and other mortgages	**7,330**	**186**	**20,913**	**1,544**	**1,113**	**31,086**
as a percentage of total mortgage lending	**6.2%**	**2.1%**	**36.6%**	**7.3%**	**1.2%**	**10.6%**

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Mortgage lending products (continued)

	UK US$m	Rest of Europe US$m	US[11] US$m	Rest of North America US$m	Other regions[11] US$m	Total US$m
At 30 June 2011						
First lien residential mortgages	110,768	9,225	55,118	21,572	85,408	282,091
Second lien residential mortgages	795	1	8,509	553	288	10,146
Total mortgage lending	111,563	9,226	63,627	22,125	85,696	292,237
Second lien as percentage of total mortgage lending	0.7%		13.4%	2.5%	0.3%	3.5%
Impairment allowances on mortgage lending	(387)	(61)	(4,677)	(36)	(323)	(5,484)
First lien residential mortgages	(336)	(61)	(3,980)	(24)	(323)	(4,724)
Second lien residential mortgages	(51)		(697)	(12)		(760)
Interest-only (including offset) mortgages	45,730	54		810	1,362	47,956
Affordability mortgages, including ARMs	692	572	17,789	276	7,816	27,145
Other	118				195	313
Total interest-only and affordability mortgages	46,540	626	17,789	1,086	9,373	75,414
as a percentage of total mortgage lending	41.7%	6.8%	28.0%	4.9%	10.9%	25.8%
Negative equity mortgages[13]	2,365		16,368	86	317	19,136
Other loan to value ratios greater than 90%[14]	5,925	265	9,168	1,648	1,193	18,199
Total negative equity and other mortgages	8,290	265	25,536	1,734	1,510	37,335
as a percentage of total mortgage lending	7.4%	2.9%	40.1%	7.8%	1.8%	12.8%
	US$m	US$m	US$m	US$m	US$m	US$m
At 31 December 2011						
First lien residential mortgages	111,224	8,678	52,484	20,794	85,783	278,963
Second lien residential 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 percentage of total mortgage lending	0.6%		11.9%	2.2%	0.3%	2.9%
Impairment allowances on mortgage lending	(425)	(59)	(5,291)	(36)	(302)	(6,113)
First lien residential mortgages	(383)	(58)	(4,551)	(27)	(302)	(5,321)
Second lien residential mortgages	(42)	(1)	(740)	(9)		(792)
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%
Negative equity mortgages[13]	2,149		14,401	64	823	17,437
Other loan to value ratios greater than 90%[14]	4,845	210	7,964	1,430	1,469	15,918
Total negative equity and other mortgages	6,994	210	22,365	1,494	2,292	33,355
as a percentage of total mortgage lending	6.2%	2.4%	37.6%	7.0%	2.7%	11.6%

For footnotes, see page 180.

US personal lending

Credit quality

During the first half of 2012, the muted improvement in US economic conditions continued. In the second quarter, GDP growth was revised down to 1.9%, while consumer spending growth remained moderate. Serious threats to economic growth remain, including high energy costs,

uncertainty in the housing market and unemployment levels, which declined from the end of 2011 but remained high at 8.2%

Mortgage lending

In the first half of 2012, we further reduced our mortgage exposure in the US as balances continued to run off in our CML portfolio as discussed on

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page 134. At 30 June 2012, first lien residential mortgage lending balances were US$51bn, a decline of 3% compared with the end of 2011.

In our CML first lien residential mortgage portfolio, two-months and over delinquent balances were US$7.7bn, compared with US$7.9bn at December 2011 over the same period. The decline reflected seasonal improvements in our collections in the first half of 2012. In addition, the improvement reflected a decrease in delinquency on accounts less than 180 days contractually delinquent as lending balances continued to run off and economic conditions improved. The reduction was partly offset by the increase in late stage delinquency driven by the temporary suspension of foreclosure activities which began in late 2010, although this has now resumed in substantially all states. In our HSBC Bank USA portfolio, two-months and over delinquent balances remained unchanged at US$1.1bn.

Second lien residential 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 residential mortgages are taken up by customers who 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 residential mortgages, where the first lien residential 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 residential 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 10% to US$6.4bn at 30 June 2012, representing 11% of the overall US mortgage lending portfolio. Two months or more delinquent balances were US$515m at 30 June 2012 compared with US$674m at 31 December 2011.

Valuation of foreclosed properties in the US

We obtain real estate by foreclosing on the collateral pledged as security for residential mortgages. 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 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 or increases recognised through changes to impairment allowances.

As previously reported, beginning 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. We have now resumed the processing of suspended foreclosures and initiating new foreclosures in substantially all states. There remains a significant backlog of foreclosures which will take time to resolve. Any additional delays in the processing of foreclosures could result in an increase in loss severity.

The number of foreclosed properties at HSBC Finance at 30 June 2012 decreased compared with the end of December 2011 due to the suspension of foreclosures discussed above, as well as continuing sales of foreclosed properties. We expect the number of foreclosed properties added to the inventory will begin to increase in the second half of 2012, but this will continue to be affected by ongoing refinements to our processes and extended foreclosure timelines.

The average total loss on foreclosed properties and the average loss on sale of foreclosed properties decreased compared with the second half of 2011. This reflected a lower mix of properties sold which we had held for longer periods of time. Generally the length of time a property is held is reflected in the condition and ultimately the sale price. In addition, a greater proportion of properties sold where we had accepted a deed-in-lieu, partly offset by lower house prices in the first half of 2012. Typically, losses on a deed-in-lieu are lower than losses from properties acquired through a standard foreclosure process and provide quicker resolution to the delinquent account.

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HSBC Finance: foreclosed properties in the US

	Half-year to		
	30 June 2012	30 June 2011	31 December 2011
Number of foreclosed properties at end of period	**2,836**	6,982	3,511
Number of properties added to foreclosed inventory in the half year	**3,615**	8,071	3,116
Average loss on sale of foreclosed properties[15]	**7%**	8%	9%
Average total loss on foreclosed properties[16]	**55%**	55%	57%
Average time to sell foreclosed properties (days)	**179**	168	200

Forfootnotes, see page 180.

Credit cards

In the first half of 2012 we completed the sale of our US Card and Retail Services business, transferring the related general and private label credit card lending balances to the purchaser. The residual balances in the US related to HSBC Bank USA s credit card programme.

Personal non-credit card lending

Personal non-credit card lending balances in the US fell, largely due to run-off. Two months or more delinquent balances declined reflecting the run-off and seasonal improvement in collections.

Loan delinquency

The table below sets out the trends in two months and over contractual delinquencies.

Trends in two months and over contractual delinquency in the US

	At 30 June	At 30 June	At 31 December 2011

	2012 US$m	2011 US$m	US$m
In Personal lending in the US			
First lien residential mortgages	**8,851**	7,864	9,065
Consumer and Mortgage Lending	**7,662**	6,852	7,922
Other mortgage lending	**1,189**	1,012	1,143
Second lien residential mortgages	**515**	646	674
Consumer and Mortgage Lending	**372**	478	501
Other mortgage lending	**143**	168	173
Credit card	**29**	628	714
Private label		285	316
Personal non-credit card	**339**	517	513
Total	**9,734**	9,940	11,282
	%[17]	%[17]	%[17]
First lien residential mortgages	**17.4**	14.3	17.1
Second lien residential mortgages	**7.9**	7.6	8.5
Credit card	**3.7**	3.3	3.8
Private label		2.4	2.5
Personal non-credit card	**6.3**	7.2	8.3
Total	**15.3**	9.8	11.4

For footnote, see page 180.

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Credit quality of financial instruments

The five classifications describing the credit quality of our lending, debt securities portfolios and derivatives are set out in the Appendix to Risk on page 183 and defined on page 191 of the *Annual Report and Accounts 2011.* Additional credit quality information in respect of our consolidated holdings of ABSs is provided on page 154.

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 146.

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 146), are not disclosed within the expected loss (EL) grade to which they relate, but are separately classified as past due but not impaired.

Distribution of financial instruments by credit quality

	Neither past due nor impaired				Past due			
	Strong	Good	Satisfactory	Sub-standard	but not impaired	Impaired	Impairment allowances[18]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m	US$m
At 30 June 2012								
Cash and balances at central banks	146,337	1,364	210					147,911
Items in the course of collection from other banks	10,628	173	274					11,075
Hong Kong Government certificates of indebtedness	21,283							21,283
Trading assets[19]	242,618	68,646	49,377	711				361,352
treasury and other eligible bills	26,256	2,726	1,116					30,098
debt securities	97,559	14,196	19,458	350				131,563
loans and advances:								
to banks	60,832	26,423	7,474	101				94,830
to customers	57,971	25,301	21,329	260				104,861
Financial assets designated at fair value[19]	8,356	5,438	608	133				14,535
treasury and other eligible bills	77		14					91
debt securities	8,228	5,359	520	131				14,238
loans and advances:								

to banks	**51**		**74**	**2**				**127**
to customers		**79**						**79**
Derivatives[19]	**271,850**	**53,347**	**27,875**	**2,862**				**355,934**
Loans and advances held at amortised cost	**611,942**	**259,989**	**217,188**	**26,981**	**17,517**	**40,832**	**(17,273)**	**1,157,176**
to banks	**142,693**	**28,284**	**10,531**	**639**	**12**	**88**	**(56)**	**182,191**
to customers[20]	**469,249**	**231,705**	**206,657**	**26,342**	**17,505**	**40,744**	**(17,217)**	**974,985**
Financial investments	**330,781**	**27,343**	**23,265**	**3,456**		**2,205**		**387,050**
treasury and other similar bills	**62,669**	**4,691**	**4,093**	**99**				**71,552**
debt securities	**268,112**	**22,652**	**19,172**	**3,357**		**2,205**		**315,498**
Assets held for sale	**4,677**	**1,365**	**3,125**	**665**	**449**	**366**	**(106)**	**10,541**
disposal groups	**4,632**	**1,365**	**3,125**	**665**	**447**	**255**	**(106)**	**10,383**
non-current assets held for sale	**45**				**2**	**111**		**158**
Other assets	**11,908**	**7,672**	**12,403**	**1,604**	**290**	**520**		**34,397**
endorsements and acceptances	**2,172**	**4,807**	**4,849**	**945**	**5**	**4**		**12,782**
accrued income and other	**9,736**	**2,865**	**7,554**	**659**	**285**	**516**		**21,615**
	1,660,380	**425,337**	**334,325**	**36,412**	**18,256**	**43,923**	**(17,379)**	**2,501,254**

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Distribution of financial instruments by credit quality (continued)

	Neither past due nor impaired				Past due			
	Strong US$m	Good US$m	Satisfactory US$m	Sub-standard US$m	but not impaired US$m	Impaired[7] US$m	Impairment allowances[18] US$m	Total US$m
At 30 June 2011								
Cash and balances at central banks	66,860	999	229	130				68,218
Items in the course of collection from other banks	14,107	658	291	2				15,058
Hong Kong Government certificates of indebtedness	19,745							19,745
Trading assets[19]	318,456	51,432	62,735	5,609				438,232
treasury and other eligible bills	21,488	1,197	1,214					23,899
debt securities	173,233	10,726	22,215	2,631				208,805
loans and advances:								
to banks	73,490	20,773	4,347	1,524				100,134
to customers	50,245	18,736	34,959	1,454				105,394
Financial assets designated at fair value[19]	7,856	5,356	6,700	65				19,977
treasury and other eligible bills	207							207
debt securities	6,660	5,085	6,686	65				18,496
loans and advances:								
to banks	70	271	14					355
to customers	919							919
Derivatives[19]	211,625	34,718	11,096	3,233				260,672
Loans and advances held at amortised cost	695,086	302,837	186,904	31,426	22,166	44,406	(18,894)	1,263,931
to banks	182,273	35,168	7,666	785	116	197	(162)	226,043
to customers[20]	512,813	267,669	179,238	30,641	22,050	44,209	(18,732)	1,037,888
Financial investments	351,940	24,373	25,631	4,103		2,603		408,650
treasury and other similar bills	54,771	3,370	3,479	44				61,664
debt securities	297,169	21,003	22,152	4,059		2,603		346,986
Other assets	11,982	7,285	15,106	1,525	637	254		36,789
endorsements and acceptances	1,801	4,228	4,776	499	16	18		11,338
accrued income and other	10,181	3,057	10,330	1,026	621	236		25,451
	1,697,657	427,658	308,692	46,093	22,803	47,263	(18,894)	2,531,272

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	Neither past due nor impaired							
	Strong	Good	Satisfactory	Sub-standard	Past due but not impaired	Impaired	Impairment allowances[18]	Total
	US$m	US$m	US$m	US$m	US$m	US$m	US$m	US$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[19]	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
to customers	46,211	7,448	15,233	236				69,128
Financial assets designated at fair value[19]	7,176	4,728	830	192				12,926
treasury and other eligible bills	123							123
debt securities	6,148	4,728	767	191				11,834
loans and advances:								
to banks	55		63	1				119
to customers	850							850
Derivatives[19]	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
to banks	144,815	28,813	6,722	568	39	155	(125)	180,987
to customers[20]	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
	1,649,457	379,818	296,351	37,538	22,954	45,968	(19,250)	2,412,836

For footnotes, see page 180.

We assess credit quality on all financial instruments which are subject to credit risk. The balance of these financial instruments at 30 June 2012 was US$2,501bn, of which US$1,661bn or 66% were classified as strong . This percentage was broadly in line with 31 December 2011. The proportion of financial instruments classified as good and satisfactory remained broadly stable at 17% and 13%, respectively. The proportion of sub-standard financial instruments remained low at 1% at 30 June 2012.

Loans and advances held at amortised cost on which credit quality has been assessed increased by 3% to US$1,157bn. At 30 June 2012, 75% of the Group s lending balances were classified as either strong or good , broadly in line with the end of 2011.

Financial investments on which credit quality is assessed were US$387bn at 30 June 2012, compared with US$393bn at 31 December 2011. The majority of the Group s exposure was in the form of available-for-sale debt securities issued by

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government and government agencies classified as strong and this proportion was broadly in line with the end of 2011.

Derivative assets on which credit quality has been assessed increased by 3% to US$356bn compared with 31 December 2011. This rise was mainly in Europe, driven by a significant rise in the fair value of interest rate contracts due to downward movements of yield curves in major currencies, reflecting the ongoing monetary response to the economic weakness and turmoil in the eurozone. The proportion of balances classified as strong declined marginally from 81% at the end of 2011 to 76% at 30 June 2012 and the proportion of satisfactory balances increased from 5% to 8%.

Trading assets on which credit quality has been assessed grew by 17% to US$361bn from 31 December 2011, as client activity increased from the subdued levels seen in the second half of 2011. This resulted in higher reverse repo and equity securities balances as well as a rise in settlement account balances, which vary significantly in proportion to the level of trading activity. The proportion of balances classified as strong declined despite an overall increase in total balances classified as strong . This reflected a rise in the reverse repo transactions with counterparties classified as good and satisfactory , as well as the downgrade of certain eurozone countries which resulted in the movement of related debt securities balances from strong to good .

Cash and balances at central banks, on which credit quality has been assessed, increased by 14% to US$148bn, reflecting the deposit of surplus liquidity in Europe with the local central bank. Substantially all of the Group s cash and balances at central banks were classified as strong , with the most significant concentrations in Europe and North America.

Assets held for sale on which credit quality has been assessed declined, with reductions across all classifications, following the completion of the sale of our Card and Retail Services business in the US.

Past due but not impaired gross financial instruments

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 past due up to 89 days 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 90 days or more 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 30 June 2012, US$17.5bn of loans and advances held at amortised cost were classified as past due but not impaired (31 December 2011: US$20.0bn; 30 June 2011: US$22.2bn). The largest concentration of these balances was in HSBC Finance. The decrease in 2012 was primarily due to lower lending balances resulting in a reduction in early stage delinquency in the CML portfolio.

Past due but not impaired gross loans and advances to customers and banks by geographical region

	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 30 June 2012	**2,259**	**1,084**	**2,548**	**980**	**7,874**	**2,772**	**17,517**
At 30 June 2011[7]	2,528	1,071	2,377	1,292	11,447	3,451	22,166
At 31 December 2011	1,990	1,107	2,319	1,165	10,216	3,212	20,009

For footnote, see page 180.

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Past due but not impaired gross loans and advances to customers and banks by industry sector

	At 30 June 2012 US$m	At 30 June 2011[7] US$m	At 31 December 2011 US$m
Banks	**12**	116	39
Customers	**17,505**	22,050	19,970
Personal	**12,153**	16,689	13,951
Corporate and commercial	**5,011**	5,047	5,855
Financial	**341**	314	164
	17,517	22,166	20,009

For footnote, see page 180.

Ageing analysis of days past due but not impaired gross financial instruments

	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 30 June 2012						
Loans and advances held at amortised cost	**13,137**	**2,903**	**1,307**	**79**	**91**	**17,517**
to banks	**12**					**12**
to customers	**13,125**	**2,903**	**1,307**	**79**	**91**	**17,505**
Assets held for sale[1]	**270**	**116**	**50**	**6**	**7**	**449**
disposal groups	**270**	**114**	**50**	**6**	**7**	**447**
non-current assets held for sale		**2**				**2**
Other assets	**168**	**39**	**30**	**10**	**43**	**290**
endorsements and acceptances	**3**	**1**			**1**	**5**
other	**165**	**38**	**30**	**10**	**42**	**285**
	13,575	**3,058**	**1,387**	**95**	**141**	**18,256**
At 30 June 2011						
Loans and advances held at amortised cost[7]	16,125	3,808	1,911	185	137	22,166
to banks	116					116
to customers	16,009	3,808	1,911	185	137	22,050
Other assets	317	166	72	30	52	637
endorsements and acceptances	13	1			2	16
other	304	165	72	30	50	621

	16,442	3,974	1,983	215	189	22,803
At 31 December 2011						
Loans and advances held at amortised cost	14,239	3,680	1,727	223	140	20,009
to banks	39					39
to customers	14,200	3,680	1,727	223	140	19,970
Assets held for sale[1]	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

For footnotes, see page 180.

Renegotiated loans and forbearance

Current policies and procedures regarding renegotiated loans and forbearance are described in the Appendix to Risk on page 183.

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.

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Renegotiated loans and advances to customers

	At 30 June 2012			
	Neither past due nor impaired US$m	**Past due but not impaired US$m**	**Impaired US$m**	**Total US$m**
Retail	**8,007**	**3,532**	**19,229**	**30,768**
First lien residential mortgages	**5,841**	**2,842**	**16,096**	**24,779**
Other personal	**2,166**	**690**	**3,133**	**5,989**
Commercial real estate	**2,392**	**30**	**3,216**	**5,638**
Corporate and commercial	**4,387**	**401**	**3,993**	**8,781**
Financial	**261**		**560**	**821**
Governments	**44**		**117**	**161**
	15,091	**3,963**	**27,115**	**46,169**
Total renegotiated loans and advances to customers as a percentage of total gross loans and advances to customers				**4.7%**

	At 30 June 2011				At 31 December 2011			
	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	8,504	4,074	20,454	33,032	8,133	4,401	19,125	31,659
First lien residential mortgages	5,595	3,123	16,872	25,590	5,916	3,560	15,932	25,408
Other personal	2,909	951	3,582	7,442	2,217	841	3,193	6,251
Commercial real estate	2,697	10	2,659	5,366	2,793	9	3,248	6,050
Corporate and commercial	4,092	342	3,141	7,575	3,432	461	3,376	7,269
Financial	341		552	893	249		491	740
Governments	116		21	137	113	2	132	247
	15,750	4,426	26,827	47,003	14,720	4,873	26,372	45,965
Total renegotiated loans and advances to customers as a percentage of total gross loans and advances to customers				4.4%				4.8%

Renegotiated loans and advances to customers by geography

	At 30 June 2012 US$m	At 30 June 2011 US$m	At 30 December 2011 US$m
Europe	**12,423**	11,250	11,464
Hong Kong	**419**	478	447
Rest of Asia-Pacific	**445**	608	448
Middle East and North Africa	**2,649**	2,095	2,655
North America	**27,528**	29,761	28,475
Latin America	**2,705**	2,811	2,476
	46,169	47,003	45,965
Total impairment allowances on renegotiated loans	**7,350**	8,899	7,670
Individually assessed	**2,422**	1,989	2,311
Collectively assessed	**4,928**	6,910	5,359

Renegotiated loans totalled US$46.2bn at 30 June 2012 (30 June 2011: US$47.0bn; 31 December 2011: US$46.0bn). The most significant portfolio of renegotiated loans remains in North America and, at 30 June 2012, amounted to US$27.5bn or 60% of total renegotiated loans

(30 June 2011: US$29.8bn or 63%; 31 December 2011: US$28.5bn or 62%), substantially all of which were retail loans held by HSBC Finance. Of the total renegotiated loans in North America, US$17.9bn were presented as impaired at 30 June 2012 (30 June 2011: US$19.2bn; 31 December 2011: US$17.8bn),

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and the ratio of total impairment allowances to impaired loans at 30 June 2012 was 27% (30 June 2011: 34%; 31 December 2011: 28%).

Europe is the next largest portfolio of renegotiated loans which, at 30 June 2012, amounted to US$12.4bn (30 June 2011: US$11.3bn; 31 December 2011: US$11.5bn), constituting 27% of total renegotiated loans (30 June 2011: 24%; 31 December 2011: 25%). Of the total renegotiated loans in Europe, US$6.2bn were presented as impaired at 30 June 2012 (30 June 2011: US$5.4bn; 31 December 2011: US$6.0bn), and the ratio of total impairment allowances to impaired loans at 30 June 2012 was 27% (30 June 2011: 30%; 31 December 2011: 30%). Renegotiated balances in Europe were largely concentrated in the commercial real estate sector 38% (30 June 2011: 40%; 31 December 2011: 41%) and the corporate and commercial sector 38% (30 June 2011: 34%; 31 December 2011: 32%). The commercial real estate sector, particularly in the UK, continued to face 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 minimum and reduce capital repayments if possible. 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.

The balance of renegotiated loans in the Middle East and North Africa and Latin America (primarily in Mexico and Brazil) remained predominately concentrated in the corporate and commercial sectors. Forbearance in Hong Kong and Rest of Asia-Pacific remained insignificant.

HSBC Finance loan modifications and re-ageing

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. For further details on HSBC Finance s loan renegotiation programmes, see page 131 of the *Annual Report and Accounts 2011*.

At 30 June 2012, renegotiated real estate secured accounts represented 85% (30 June 2011: 86%; 31 December 2011: 86%) of North America s total renegotiated loans, and US$15.6bn (30 June 2011: US$17.4bn; 31 December 2011: US$16.0bn) of renegotiated real estate secured loans in HSBC Finance were classified as impaired.

Gross loan portfolio of HSBC Finance real estate secured accounts

	Re-aged[21] US$m	Modified and re-aged US$m	Modified US$m	Total renegotiated loans US$m	Total non-renegotiated loans US$m	Total gross loans US$m	Total impairment allowances US$m	Impairment allowances/ gross loans %
30 June 2012	**9,906**	**12,171**	**1,293**	**23,370**	**17,860**	**41,230**	**4,884**	**12**

30 June 2011	10,507	13,460	1,757	25,724	21,548	47,272	4,504	10
31 December 2011	10,265	12,829	1,494	24,588	19,540	44,128	5,088	12

For footnote, see page 180.

Number of renegotiated real estate secured accounts remaining in HSBC Finance s portfolio

	Number of renegotiated loans			
	Re-aged (000s)	Modified and re-aged (000s)	Modified (000s)	Total (000s)
30 June 2012	**118**	**109**	**13**	**240**
30 June 2011	122	113	17	252
31 December 2011	121	112	14	246

During the half-year to 30 June 2012, 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 are not duplicated 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 30 June 2012, renegotiated

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loans were 57% (30 June 2011: 55%; 31 December 2011: 56%) of HSBC Finance s real estate secured accounts.

Corporate and commercial forbearance

For the current policies and procedures regarding forbearance in the corporate and commercial sector, see page 188 in the Annual Report and Accounts 2011.

In the corporate and commercial sector, the increase of US$1,512m in renegotiated loans for the half-year ended 30 June 2012 compared with the end of 2011 was a result of increased forbearance activity in Europe, Middle East and North Africa and Latin America. In Europe the increases primarily related to CMB customers in the UK. In Middle East and North Africa, the increase was due largely to two significant individual loan renegotiations for UAE based borrowers, the larger of the two being cash secured. In Latin America the increase was largely related to Brazil due to a small number of larger corporate restructurings and increased restructuring activity in Business Banking.

In the commercial real estate sector the balance of renegotiated loans decreased by US$412m, compared with the end of 2011, mainly in the Middle East and North Africa. This predominately related to a decrease in balances for a single CMB customer in Bahrain.

Impaired loans

During 2011 we adopted a revised disclosure convention for the presentation of impaired loans and advances for geographical regions with significant levels of forbearance. The previous impaired loans disclosure convention was that impaired loans and advances were those classified as customer risk rating (CRR) 9, CRR 10, EL 9 or EL 10 and all retail loans 90 days or more past due, unless individually they had been assessed as not impaired. Our current impaired loan disclosure convention is described below.

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 184);
- 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 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 143. Renegotiated loans and forbearance disclosures are subject to evolving industry practice and regulatory guidance.

Impaired loan comparative data at 30 June 2011 have been restated to reflect the revised impaired loans disclosure convention. The following table shows the effect of the restatement on 30 June 2011 total reported impaired loans and advances to customers.

The impaired loan comparative data at 31 December 2011 were previously published in accordance with the revised disclosure convention. For further details see page 133 of the *Annual Report and Accounts 2011*.

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Impaired loans and advances to customers

	At 30 June 2011 US$m
Previous disclosure convention	25,982
Reclassified from neither past due nor impaired	11,341
Europe	675
Middle East and North Africa	71
North America	9,602
Latin America	993
Reclassified from past due but not impaired	6,886
Europe	
Middle East and North Africa	28
North America	6,708
Latin America	150
Revised disclosure convention	44,209

Impairment of loans and advances

Impaired loans and advances to customers and banks by industry sector

	Impaired loans and advances at 30 June 2012			Impaired loans and advances at 30 June 2011[7]			Impaired loans and advances at 31 December 2011		
	Individually assessed US$m	**Collectively assessed US$m**	**Total US$m**	Individually assessed US$m	Collectively assessed US$m	Total US$m	Individually assessed US$m	Collectively assessed US$m	Total US$m
Banks	**88**		**88**	197		197	155		155
Customers	**16,973**	**23,771**	**40,744**	15,794	28,415	44,209	16,554	25,030	41,584
personal	**2,280**	**23,211**	**25,491**	2,198	27,144	29,342	2,473	24,070	26,543
corporate and commercial	**13,692**	**560**	**14,252**	12,396	1,268	13,664	12,898	960	13,858
financial	**1,001**		**1,001**	1,200	3	1,203	1,183		1,183
	17,061	**23,771**	**40,832**	15,991	28,415	44,406	16,709	25,030	41,739

For footnote, see page 180.

Impairment allowances

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

	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 30 June 2012							
Gross loans and advances to customers							
Individually assessed impaired loans[22]	9,680	475	1,035	2,309	1,946	1,528	16,973
Collectively assessed[23]	440,958	165,265	129,300	27,360	158,843	53,503	975,229
impaired loans[22]	1,201	80	113	205	20,240	1,932	23,771
non-impaired loans[24]	439,757	165,185	129,187	27,155	138,603	51,571	951,458
TGLAC	450,638	165,740	130,335	29,669	160,789	55,031	992,202
Total impairment allowances	5,193	536	846	1,773	6,798	2,071	17,217
individually assessed	3,709	250	564	1,324	439	368	6,654
collectively assessed	1,484	286	282	449	6,359	1,703	10,563
Net loans and advances	445,445	165,204	129,489	27,896	153,991	52,960	974,985

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Impairment allowances on loans and advances to customers by geographical region (continued)

	Europe	Hong Kong	Rest of Asia-Pacific	MENA	North America	Latin America	Total
	%	%	%	%	%	%	%
Allowances as a percentage of loans and advances:							
individually assessed (in each case)	**38.3**	**52.6**	**54.5**	**57.3**	**22.6**	**24.1**	**39.2**
collectively assessed (in each case)	**0.3**	**0.2**	**0.2**	**1.6**	**4.0**	**3.2**	**1.1**
total (in each case)	**1.2**	**0.3**	**0.6**	**6.0**	**4.2**	**3.8**	**1.7**
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
At 30 June 2011							
Gross loans and advances to customers[7]							
Individually assessed impaired loans[22]	9,584	489	1,081	1,949	1,826	865	15,794
Collectively assessed[23]	482,079	159,454	121,176	25,314	185,718	67,085	1,040,826
impaired loans[22]	1,294	21	127	344	23,831	2,798	28,415
non-impaired loans[24]	480,785	159,433	121,049	24,970	161,887	64,287	1,012,411
TGLAC	491,663	159,943	122,257	27,263	187,544	67,950	1,056,620
Total impairment allowances	5,332	573	828	1,569	8,282	2,148	18,732
individually assessed	3,607	297	518	1,098	384	339	6,243
collectively assessed	1,725	276	310	471	7,898	1,809	12,489
Net loans and advances	486,331	159,370	121,429	25,694	179,262	65,802	1,037,888
	%	%	%	%	%	%	%
Allowances as a percentage of loans and advances:							
individually assessed (in each case)	37.6	60.7	47.9	56.3	21.0	39.2	39.5
collectively assessed (in each case)	0.4	0.2	0.3	1.9	4.3	2.7	1.2
total (in each case)	1.1	0.4	0.7	5.8	4.4	3.2	1.8
	US$m	US$m	US$m	US$m	US$m	US$m	US$m
At 31 December 2011							
Gross loans and advances to customers							
Individually assessed impaired loans[22]	10,490	519	963	2,187	1,832	563	16,554
Collectively assessed[23]	429,088	157,727	123,687	25,402	148,096	57,386	941,386
impaired loans[22]	1,261	85	106	238	20,864	2,476	25,030
non-impaired loans[24]	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
Total 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
	%	%	%	%	%	%	%
Allowances as a percentage of loans and advances:							
individually assessed (in each case)	35.8	55.5	52.4	57.2	22.7	57.4	39.5
collectively assessed (in each case)	0.3	0.2	0.2	1.8	4.6	2.9	1.2
total (in each case)	1.2	0.4	0.6	6.2	4.8	3.5	1.8

For footnotes, see page 180.

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Movement in impairment allowances on loans and advances to customers and banks

	Banks individually assessed[7] US$m	Customers Individually assessed US$m	Collectively assessed US$m	Total US$m
At 1 January 2012	**125**	**6,537**	**10,974**	**17,636**
Amounts written off	**(70)**	**(963)**	**(4,110)**	**(5,143)**
Recoveries of loans and advances previously written off		**84**	**484**	**568**
Charge to income statement	**1**	**1,102**	**3,422**	**4,525**
Exchange and other movements		**(106)**	**(207)**	**(313)**
At 30 June 2012	**56**	**6,654**	**10,563**	**17,273**
Impairment allowances:				
on loans and advances to customers		**6,654**	**10,563**	**17,217**
personal		**700**	**8,686**	**9,386**
corporate and commercial		**5,341**	**1,809**	**7,150**
financial		**613**	**68**	**681**
as a percentage of loans and advances[26,27]	**0.04%**	**0.71%**	**1.12%**	**1.60%**
	US$m	US$m	US$m	US$m
At 1 January 2011	158	6,457	13,626	20,241
Amounts written off		(986)	(5,975)	(6,961)
Recoveries of loans and advances previously written off		107	623	730
Charge to income statement	1	637	4,335	4,973
Exchange and other movements	3	28	(120)	(89)
At 30 June 2011	162	6,243	12,489	18,894
Impairment allowances:				
on loans and advances to customers		6,243	12,489	18,732
personal		679	10,550	11,229
corporate and commercial		4,966	1,853	6,819
financial		598	86	684
as a percentage of loans and advances[26,27]	0.10%	0.64%	1.27%	1.66%
	US$m	US$m	US$m	US$m
At 1 July 2011	162	6,243	12,489	18,894
Amounts written off	(16)	(647)	(4,856)	(5,519)
Recoveries of loans and advances previously written off		84	612	696
Charge to income statement	(17)	1,294	5,255	6,532
Exchange and other movements[25]	(4)	(437)	(2,526)	(2,967)
At 31 December 2011	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[26,27]	0.09%	0.71%	1.20%	1.67%

For footnotes, see page 180.

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Impairment charge

Net loan impairment charge to the income statement by geographical region

	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
Half-year to 30 June 2012							
Individually assessed impairment allowances							
New allowances	**988**	**15**	**129**	**176**	**193**	**191**	**1,692**
Release of allowances no longer required	**(312)**	**(16)**	**(39)**	**(54)**	**(59)**	**(25)**	**(505)**
Recoveries of amounts previously written off	**(22)**	**(3)**	**(8)**	**(17)**	**(26)**	**(8)**	**(84)**
	654	**(4)**	**82**	**105**	**108**	**158**	**1,103**
Collectively assessed impairment allowances							
New allowances net of allowance releases	**371**	**54**	**179**	**54**	**2,103**	**1,145**	**3,906**
Recoveries of amounts previously written off	**(171)**	**(13)**	**(67)**	**(24)**	**(55)**	**(154)**	**(484)**
	200	**41**	**112**	**30**	**2,048**	**991**	**3,422**
Total charge for impairment losses	**854**	**37**	**194**	**135**	**2,156**	**1,149**	**4,525**
Banks	**1**						**1**
Customers	**853**	**37**	**194**	**135**	**2,156**	**1,149**	**4,524**
At 30 June 2012							
Impaired loans	**10,935**	**555**	**1,148**	**2,534**	**22,200**	**3,460**	**40,832**
Impairment allowances	**5,232**	**536**	**846**	**1,790**	**6,798**	**2,071**	**17,273**
Half-year to 30 June 2011							
Individually assessed impairment allowances							
New allowances	744	20	78	96	182	89	1,209
Release of allowances no longer required	(269)	(23)	(61)	(37)	(41)	(35)	(466)
Recoveries of amounts previously written off	(21)	(13)	(11)	(11)	(15)	(34)	(105)
	454	(16)	6	48	126	20	638
Collectively assessed impairment allowances							
New allowances net of allowance releases	684	52	188	81	3,004	951	4,960
Recoveries of amounts previously written off	(288)	(13)	(90)	(30)	(55)	(149)	(625)
	396	39	98	51	2,949	802	4,335
Total charge for impairment losses	850	23	104	99	3,075	822	4,973
Banks						1	1
Customers	850	23	104	99	3,075	821	4,972
At 30 June 2011							
Impaired loans[7]	10,985	514	1,210	2,313	25,719	3,665	44,406
Impairment allowances	5,412	573	828	1,586	8,346	2,149	18,894

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	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
Half-year to 31 December 2011							
Individually assessed impairment allowances							
New allowances	926	59	129	232	216	133	1,695
Release of allowances no longer required	(109)	(18)	(53)	(43)	(70)	(39)	(332)
Recoveries of amounts previously written off	(9)	(7)	(15)	(38)	(29)	12	(86)
	808	34	61	151	117	106	1,277
Collectively assessed impairment allowances							
New allowances net of allowance releases	497	74	178	66	3,890	1,160	5,865
Recoveries of amounts previously written off	(253)	(14)	(69)	(24)	(32)	(218)	(610)
	244	60	109	42	3,858	942	5,255
Total charge for impairment losses	1,052	94	170	193	3,975	1,048	6,532
Banks	(11)				(5)	(1)	(17)
Customers	1,063	94	170	193	3,980	1,049	6,549
At 31 December 2011							
Impaired loans	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

For footnote, see page 180.

Charge for impairment losses as a percentage of average gross loans and advances to customers by geographical region

	Europe %	**Hong Kong %**	**Rest of Asia-Pacific %**	**MENA %**	**North America %**	**Latin America %**	**Total %**
Half-year to 30 June 2012							
New allowances net of allowance releases	**0.55**	**0.07**	**0.42**	**1.26**	**2.89**	**4.59**	**1.12**
Recoveries	**(0.10)**	**(0.02)**	**(0.12)**	**(0.29)**	**(0.10)**	**(0.57)**	**(0.13)**
Total charge for impairment losses	**0.45**	**0.05**	**0.30**	**0.97**	**2.79**	**4.02**	**0.99**
Amount written off net of recoveries	**0.47**	**0.10**	**0.18**	**0.53**	**3.20**	**3.01**	**0.99**
Half-year to 30 June 2011							
New allowances net of allowance releases	0.57	0.07	0.36	1.04	3.27	3.20	1.20
Recoveries	(0.15)	(0.03)	(0.18)	(0.31)	(0.07)	(0.58)	(0.15)
Total charge for impairment losses	0.42	0.04	0.18	0.73	3.20	2.62	1.05
Amount written off net of recoveries	0.68	0.10	0.38	0.45	3.89	2.39	1.31
Half-year to 31 December 2011							

New allowances net of allowance releases	0.62	0.15	0.41	1.87	4.94	3.93	1.51
Recoveries	(0.12)	(0.03)	(0.14)	(0.46)	(0.07)	(0.65)	(0.14)
Total charge for impairment losses	0.50	0.12	0.27	1.41	4.87	3.28	1.37
Amount written off net of recoveries	0.38	0.11	0.24	0.18	3.61	2.42	1.00

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Reconciliation of reported and constant currency changes in impaired loans by geographical region

	31 Dec 11 as reported US$m	Constant currency effect US$m	31 Dec 11 at 30 Jun 12 exchange rates US$m	Movement on a constant currency basis US$m	30 Jun 12 as reported US$m	Reported change	Change on a constant currency basis
Europe	11,819	**59**	**11,878**	**(943)**	**10,935**	**(7)**	**(8)**
Hong Kong	608	**1**	**609**	**(54)**	**555**	**(9)**	**(9)**
Rest of Asia-Pacific	1,070		**1,070**	**78**	**1,148**	**7**	**7**
Middle East and North Africa	2,445	**(2)**	**2,443**	**91**	**2,534**	**4**	**4**
North America	22,758		**22,758**	**(558)**	**22,200**	**(2)**	**(2)**
Latin America	3,039	**(109)**	**2,930**	**530**	**3,460**	**14**	**18**
Total	41,739	**(51)**	**41,688**	**(856)**	**40,832**	**(2)**	**(2)**

Impaired loans and net loan impairment allowances

On a reported basis, loan impairment charges to the income statement of US$4.5bn in the first half of 2012 declined by 9% compared with the first half of 2011 and by 31% compared with the second half of 2011. Impaired loans were US$40.8bn, 2% lower than at 31 December 2011.

The following commentary is on a constant currency basis.

New loan impairment allowances were US$5.6bn, a decline of 6% compared with the first half of 2011, reflecting lower lending balances in our US run-off portfolios. Releases and recoveries of US$1.1bn were 6% lower, mainly in Europe.

Impaired loans were 3% of total gross loans and advances at 30 June 2012, in line with 31 December 2011.

In **Europe**, new loan impairment allowances were US$1.4bn, 1% lower than in the first half of 2011, primarily in the UK as we continued to focus our lending on higher quality assets. New collectively assessed loan impairment allowances declined, mainly in the UK due to lower delinquency rates in both the secured and unsecured lending portfolios in RBWM and the shortening of the write-off period for balances greater than 180 days in Marks and Spencer Retail Financial Services Holdings Limited (M&S Money) which resulted in an increase in allowances in 2011. New individually assessed loan impairment allowances increased, mainly in the UK, reflecting the challenging economic conditions. Impaired loans of US$10.9bn were 8% lower than at 31 December 2011 due to lower delinquency rates.

Releases and recoveries in Europe were US$507m, a decrease of 9% compared with the first half of 2011, mainly in the UK due to the shortening of the write-off period for balances greater than 180

days overdue in M&S Money which resulted in an increase in releases and recoveries last year.

In **Hong Kong**, new loan impairment allowances fell by 5% compared with the first half of 2011, reflecting lower loan impairment charges against specific exposures and a reduction in general provisions as a result of lower delinquency rates. Impaired loans declined by 9% from 31 December 2011, reflecting improved delinquency in the mortgage portfolio.

Releases and recoveries in Hong Kong were US$32m, 35% lower than in the first half of 2011 due to the non-recurrence of significant releases and recoveries from two GB&M customers.

New loan impairment allowances in **Rest of Asia-Pacific** increased by 20% to US$308m as a result of a specific impairment on a corporate exposure in Australia and a number of individual loan impairment charges in India and New Zealand. Impaired loans in the region increased by 7% from the end of 2011 to US$1.1bn at 30 June 2012, mainly in Malaysia.

Releases and recoveries in the region decreased by 26%, mainly due to lower releases for cards as we run-off the portfolio in India, and the non-recurrence of recoveries in Thailand following the sale of the RBWM business.

In the **Middle East and North Africa**, new loan impairment allowances increased by 30% to US$230m in the first half of 2012 due to an increase in individually assessed impairment charges in GB&M. New collectively assessed loan impairment allowances declined, primarily in RBWM due to lower delinquencies driven by stricter acquisition criteria which resulted in an improvement in credit quality. Impaired loans of US$2.5bn increased marginally at 30 June 2012 from US$2.4bn at 31 December 2011.

Interim Management Report (continued)

Releases and recoveries in the region increased by 23% to US$95m, compared with the first half of 2011.

In **North America**, new loan impairment allowances declined markedly, reducing by 28% to US$2.3bn. In our CML portfolio, the fall in new collectively assessed loan impairment allowances reflected a reduction in lending balances as the portfolio continued to run off, and an improvement in two-months-and-over contractual delinquency on balances less than 180 days past due. Loan impairment charges were adversely affected by delays in expected cash flows from mortgage loans due, in part, to the delays in foreclosure processing, though the effects were less pronounced than in the first half of 2011. Additionally, in the first half of 2012, we increased our loan impairment allowances having updated our assumptions regarding the timing of expected cash flows received from customers with loan modifications. Impaired loans decreased by 2% from the end of 2011 to US$22.2bn, driven by the continued run-off of the CML portfolio.

Releases and recoveries in North America increased by US$29m, due to higher customer repayments within the corporate and commercial sector, as well as a significant recovery in the first half of 2012.

In **Latin America**, new loan impairment allowances increased by 46% to US$1.3bn, driven by higher new collectively assessed loan impairment allowances in Brazil, primarily reflecting strong balance sheet growth in previous periods as a result of increased marketing, a focus on acquiring customers and strong customer demand in buoyant economic conditions which subsequently weakened, notably in the personal and corporate portfolios. We implemented a number of actions to address the increase in delinquencies including improving our collections capabilities reducing third-party originations and lowering credit limits where appropriate. New individually assessed loan impairment charges also rose, mainly in Brazil following a rise in individually assessed loan impairment charges and significantly increased loan impairment charges in Business Banking. Impaired loans increased by 18% compared with 31 December 2011, driven by worsening delinquency in Brazil.

Releases and recoveries in Latin America decreased by 3% from the first half of 2011 to US$187m, primarily in Brazil due to weaker economic conditions.

Securitisation exposures and other

structured products

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;
- monoline insurance companies (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 ABSs trading portfolios and derivative transactions with monolines. Further information in respect of Solitaire and the SICs is provided in Note 22 to the Financial Statements.

Business model

Balance Sheet Management holds ABSs primarily issued by government agency and sponsored enterprises as part of our investment portfolios.

Our investment portfolios include SICs and money market funds. 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.

Exposure in the first half of 2012

The first half of 2012 saw continued uncertainty and concerns over sovereign credit risk and continued challenges for the US housing market. Despite this, there was modest price appreciation across a range of ABSs asset classes. Unrealised losses in our available-for-sale portfolios reduced in the first half of 2012 from US$5.1bn to US$3.9bn, mainly as a result of this price appreciation.

Within the following tables are assets held in the GB&M legacy credit portfolio with a carrying value of US$33.3bn (30 June 2011: US$44.5bn; 31 December 2011: US$35.4bn).

A summary of the nature of HSBC s exposures is provided in the Appendix to Risk on page 183.

Interim Management Report (continued)

Overall exposure of HSBC

	At 30 June 2012 Carrying amount[28] US$bn	At 30 June 2012 Including sub-prime and Alt-A US$bn	At 30 June 2011 Carrying amount[28] US$bn	At 30 June 2011 Including sub-prime and Alt-A US$bn	At 31 December 2011 Carrying amount[28] US$bn	At 31 December 2011 Including sub-prime and Alt-A US$bn
Asset-backed securities (ABS s)	**60.5**	**6.6**	72.9	8.1	65.6	6.9
fair value through profit or loss	**3.2**	**0.2**	10.1	0.3	3.0	0.2
available for sale[29]	**50.3**	**5.5**	54.7	6.8	54.6	5.7
held to maturity[29]	**1.8**	**0.2**	2.1	0.2	2.0	0.2
loans and receivables	**5.2**	**0.7**	6.0	0.8	6.0	0.8
Direct lending at fair value through profit or loss	**1.1**	**0.8**	1.1	0.9	1.2	0.8
Total ABSs and direct lending at fair value through profit or loss	**61.6**	**7.4**	74.0	9.0	66.8	7.7
Less securities subject to risk mitigation from credit derivatives with monolines and other financial institutions	**(2.4)**	**(0.3)**	(8.4)	(0.3)	(1.9)	(0.2)
	59.2	**7.1**	65.6	8.7	64.9	7.5
Leveraged finance loans	**3.0**		3.7		3.6	
fair value through profit or loss	**0.1**		0.1		0.2	
loans and receivables	**2.9**		3.6		3.4	
	62.2	**7.1**	69.3	8.7	68.5	7.5
Exposure including securities mitigated by credit derivatives with monolines and other financial institutions	**64.6**	**7.4**	77.7	9.0	70.4	7.7

For footnotes, see page 180.

ABSs classified as available for sale

Our principal holdings of available-for-sale ABSs (see table below) 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 risk protection of US$1.2bn through credit enhancement and a liquidity facility.

Movement in the available-for-sale (AFS) reserve

	Half-year to 30 June 2012			Half-year to 30 June 2011			Half-year to 31 December 2011		
	Directly held/ Solitaire[30]	**SPEs**	**Total**	Directly held/ Solitaire[30]	SPEs	Total	Directly held/ Solitaire[30]	SPEs	Total
	US$m	**US$m**	**US$m**	US$m	US$m	US$m	US$m	US$m	US$m
AFS reserve at beginning of period	**(3,085)**	**(2,061)**	**(5,146)**	(4,102)	(2,306)	(6,408)	(3,099)	(1,744)	(4,843)
Increase/(decrease) in fair value of securities	**475**	**267**	**742**	618	355	973	4	(492)	(488)
Impairment charge:									
borne by HSBC	**79**	**108**	**187**	238		238	145	26	171
allocated to capital note holders[31]		**11**	**11**		137	137		176	176
Repayment of capital	**18**	**99**	**117**	142	94	236	20	89	109
Other movements	**148**	**22**	**170**	5	(24)	(19)	(155)	(116)	(271)
AFS reserve at end of period	**(2,365)**	**(1,554)**	**(3,919)**	(3,099)	(1,744)	(4,843)	(3,085)	(2,061)	(5,146)

For footnotes, see page 180.

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Interim Management Report (continued)

Securities investment conduits

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 first half of 2012 impairment charges in one SPE, Mazarin Funding Limited (Mazarin), exceeded the carrying value of the capital notes liability and a charge of US$108m (30 June 2011: nil; 31 December 2011: US$26m) 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

	SICs excluding Solitaire at		
	30 Jun 2012 US$m	30 Jun 2011 US$m	31 Dec 2011 US$m
Available-for-sale reserve	**(1,873)**	(1,973)	(2,701)
related to ABSs	**(1,554)**	(1,744)	(2,061)
Economic first loss protection	**2,286**	2,286	2,286
Carrying amount of capital notes liability	**167**	354	154
Impairment charge for the period:			
borne by HSBC	**108**		26
allocated to capital note holders[31]	**11**	137	176

For footnote, see page 180.

Impairment methodologies

The accounting policy for impairment and indicators of impairment is set out on page 301 of the *Annual Report and Accounts 2011*.

A summary of our impairment methodologies is provided in the Appendix to Risk on page 183.

Impairment and cash loss projections

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 30 June 2012 and the results remained consistent with this guidance.

For the purpose 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 purpose 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 occur 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 30 June 2012, 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.

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Interim Management Report (continued)

Carrying amount of HSBC s consolidated holdings of ABSs, and direct lending held at fair value through profit or loss

	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$m	Gross principal exposure[32] US$m	Credit default swap protection[33] US$m	Net principal exposure[34] US$m
At 30 June 2012										
Mortgage-related assets:										
Sub-prime residential	835	2,086			506	3,427	2,308	5,835	266	5,569
Direct lending	668					668	441	1,555		1,555
MBSs and MBS CDOs	167	2,086			506	2,759	1,867	4,280	266	4,014
US Alt-A residential	169	3,414	146		200	3,929	2,772	7,825	100	7,725
Direct lending	91					91		97		97
MBSs	78	3,414	146		200	3,838	2,772	7,728	100	7,628
US Government agency and sponsored enterprises:										
MBSs	214	23,103	1,656			24,973		23,401		23,401
Other residential	568	3,052			952	4,572	1,855	5,221	97	5,124
Direct lending	321					321		316		316
MBSs	247	3,052			952	4,251	1,855	4,905	97	4,808
Commercial property										
MBSs and MBS CDOs	295	7,107		107	1,450	8,959	5,898	10,440		10,440
	2,081	38,762	1,802	107	3,108	45,860	12,833	52,722	463	52,259
Leveraged finance-related assets:										
ABSs and ABS CDOs	389	5,322			317	6,028	4,306	6,837	758	6,079
Student loan-related assets:										
ABSs and ABS CDOs	172	4,651			151	4,974	4,036	6,505	99	6,406
Other assets:										
ABSs and ABS CDOs	1,455	1,598		65	1,586	4,704	1,716	6,593	1,326	5,267
	4,097	50,333	1,802	172	5,162	61,566	22,891	72,657	2,646	70,011

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Interim Management Report (continued)

	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$m	Gross principal exposure[32] US$m	Credit default swap protection[33] US$m	Net principal exposure[34] US$m
At 30 June 2011										
Mortgage-related assets:										
Sub-prime residential	1,022	2,556			598	4,176	2,696	6,783	305	6,478
Direct lending	830					830	560	1,854		1,854
MBSs and MBS CDOs	192	2,556			598	3,346	2,136	4,929	305	4,624
US Alt-A residential	163	4,231	177		255	4,826	3,417	9,232	100	9,132
Direct lending	80					80		90		90
MBSs	83	4,231	177		255	4,746	3,417	9,142	100	9,042
US Government agency and sponsored enterprises:										
MBSs	217	22,570	1,933			24,720	17	23,815		23,815
Other residential	800	3,801			990	5,591	2,332	6,322		6,322
Direct lending	188					188		187		187
MBSs	612	3,801			990	5,403	2,332	6,135		6,135
Commercial property										
MBSs and MBS CDOs	552	8,119		111	1,935	10,717	6,439	12,217	395	11,822
	2,754	41,277	2,110	111	3,778	50,030	14,901	58,369	800	57,569
Leveraged finance-related assets:										
ABSs and ABS CDOs	379	5,695			399	6,473	4,450	7,289	806	6,483
Student loan-related assets:										
ABSs and ABS CDOs	137	5,110			151	5,398	4,411	6,819	100	6,719
Other assets:										
ABSs and ABS CDOs	1,791	2,595		6,053	1,637	12,076	1,783	14,799	7,924	6,875
	5,061	54,677	2,110	6,164	5,965	73,977	25,545	87,276	9,630	77,646

Interim Management Report (continued)

Carrying amount of HSBC s consolidated holdings of ABSs, and direct lending held at fair value through profit or loss (continued)

	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$m	Gross principal exposure[32] US$m	Credit default swap protection[33] US$m	Net principal exposure[34] US$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

For footnotes, see page 180.

The above table excludes leveraged finance transactions, which are shown separately on page 161.

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Interim Management Report (continued)

Exposures and significant movements

Sub-prime residential mortgage-related assets

Sub-prime residential mortage-related assets included US$2.2bn (30 June 2011: US$2.8bn; 31 December 2011: US$2.4bn) relating to US-originated assets and US$0.8bn (30 June 2011: US$1.1bn; 31 December 2011: US$1.0bn) relating to UK non-conforming residential mortgage-related assets.

At 30 June 2012, 24% (US$0.8bn) of our sub-prime residential mortgage-related assets were rated AA or AAA (30 June 2011: 31%, US$1.3bn; 31 December 2011: 25%, US$0.9bn). Of the non-high grade assets held of US$2.6bn (30 June 2011: US$2.9bn; 31 December 2011: US$2.7bn), US$1.1bn (30 June 2011: US$1.5bn; 31 December 2011: US$1.2bn) related to US-originated assets.

There was an increase in market prices for subprime assets during the first half of 2012; this effect was coupled with principal paydowns. A further net writeback of US$29m on assets was recognised in the first half of 2012 (30 June 2011: writeback of US$2m; 31 December 2011: impairment of US$44m). Of the above, there were US$30m of writebacks (30 June 2011: writeback of US$41m; 31 December 2011: impairment of US$36m) in the SICs of which US$14m of writebacks (30 June 2011: writeback of US$41m; 31 December 2011: impairment of US$36m) was attributed to the capital note holders.

US Alt-A residential mortgage-related assets

During the first half of 2012, principal paydowns along with general spread tightening, contributed to an increase in the carrying values for Alt-A assets. Further impairments of US$144m (30 June 2011: US$364m; 31 December 2011: US$323m) were recorded as losses were incurred under the accounting rules. Of this impairment, US$149m (30 June 2011: US$168m; 31 December 2011: US$176m) occurred in the SICs, of which US$25m (30 June 2011: US$168m; 31 December 2011: US$150m) was borne by the capital note holders. At 30 June 2012, 8% (US$0.3bn) of these assets were rated AA or AAA (30 June 2011: 9%, US$0.5bn; 31 December 2011: 9%, US$0.4bn).

Commercial property mortgage-related assets

Of our total of US$9.0bn (30 June 2011: US$10.7bn; 31 December 2011: US$9.5bn) of commercial property mortgage-related assets, US$4.4bn related to US originated assets (30 June 2011: US$4.9bn; 31 December 2011: US$4.9bn). Spreads continued to tighten on both US and non-US commercial

property mortgage-related assets during the first half of 2012. Impairments of US$127m were recognised (30 June 2011: nil; 31 December 2011: US$36m).

Transactions with monoline insurers

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 the first half of 2012, the notional value of contracts with monolines reduced, primarily due to the maturity of a structured transaction. The table overleaf sets out the fair value, essentially the replacement cost of the derivative transactions at 30 June 2012, 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. The value of protection purchased is shown subdivided between those monolines that were rated by Standard and Poor s (S&P) at

BBB or above at 30 June 2012, 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. During the first half of 2012, the credit valuation adjustment on derivative contracts with monolines rose despite the overall decrease in exposure due to an increase in the estimates of loss against investment grade monolines.

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$71m (30 June 2011: US$117m;

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HSBC s exposure to derivative transactions entered into directly with monoline insurers

	Notional amount US$m	Net exposure before credit valuation adjustment[35] US$m	Credit valuation adjustment[36] US$m	Net exposure after credit valuation adjustment US$m
At 30 June 2012				
Derivative transactions with monoline counterparties				
Monolines investment grade (BBB or above)	**4,213**	**789**	**(118)**	**671**
Monolines sub-investment grade (below BBB)	**1,502**	**343**	**(216)**	**127**
	5,715	**1,132**	**(334)**	**798**
At 30 June 2011				
Derivative transactions with monoline counterparties				
Monolines investment grade (BBB or above)	5,269	846	(85)	761
Monolines sub-investment grade (below BBB)	2,224	539	(372)	167
	7,493	1,385	(457)	928
At 31 December 2011				
Derivative transactions with monoline counterparties				
Monolines investment grade (BBB or above)	4,936	873	(87)	786
Monolines sub-investment grade (below BBB)	1,552	370	(217)	153
	6,488	1,243	(304)	939

For footnotes, see page 180.

31 December 2011: US$76m). The net effect of utilising a methodology based on CDS spreads would be an increase in credit valuation adjustment of US$52m (30 June 2011: US$49m; 31 December 2011: US$178m).

Credit valuation adjustments for monolines

For highly-rated monolines, the standard credit valuation adjustment methodology (as described on page 232) 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 15% 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 monolines

We had no liquidity facilities to monolines at 30 June 2012 (30 June 2011: nil; 31 December 2011: 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 30 June 2012. For wrapped bonds held in our trading portfolio, the mark-to-market movement has been reflected through the income statement. For wrapped bonds held in the available-for-sale 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 10 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 30 June 2012, we had purchased from CDPCs credit protection with a notional value of US$4.3bn (30 June 2011: US$4.8bn; 31 December 2011: US$4.4bn) which had a fair value of US$0.3bn (30 June 2011: US$0.2bn; 31 December 2011: US$0.4bn), against which a credit valuation adjustment (a provision) of US$51m (30 June 2011: US$49m; 31 December 2011: US$93m) was held. At 30 June 2012, none of our exposure was to CDPCs with investment grade ratings (30 June 2011: nil; 31 December 2011: nil).

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Leveraged finance transactions

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 156.

We held leveraged finance commitments of US$3.0bn at 30 June 2012 (30 June 2011: US$3.8bn; 31 December 2011: US$3.7bn), of which US$2.7bn (30 June 2011: US$3.3bn; 31 December 2011: US$3.3bn) was funded. At 30 June 2012, our principal exposures were to companies in two sectors: US$0.8bn to data processing (30 June 2011: US$1.5bn; 31 December 2011: US$1.3bn) and US$1.9bn to communications and infrastructure (30 June 2011: US$1.8bn; 31 December 2011: US$1.9bn).

HSBC s exposure to leveraged finance transactions

	Exposures at 30 June 2012			Exposures at 30 June 2011			Exposures at 31 December 2011		
	Funded[37]	**Unfunded**[38]	**Total**	Funded[37]	Unfunded[38]	Total	Funded[37]	Unfunded[38]	Total
	US$m	**US$m**	**US$m**	US$m	US$m	US$m	US$m	US$m	US$m
Europe	**2,194**	**221**	**2,415**	2,761	289	3,050	2,795	253	3,048
North America	**443**	**126**	**569**	489	127	616	445	126	571
	2,637	**347**	**2,984**	3,250	416	3,666	3,240	379	3,619
Held within:									
loans and receivables	**2,593**	**323**	**2,916**	3,249	356	3,605	3,120	328	3,448
fair value through profit or loss	**44**	**24**	**68**	1	60	61	120	51	171

For footnotes, see page 180.

Representations and warranties related to mortgage sales and securitisation activities

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 details are provided in Note 25 on the Financial Statements.

At 30 June 2012, a liability of US$222m (30 June 2011: US$237m; 31 December 2011: 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. 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 are expected to become delinquent at an estimated conversion rate. Repurchase demands of US$167m were outstanding at 30 June 2012 (30 June 2011: US$103m; 31 December 2011: US$113m).

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Risk elements in the loan portfolio

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
- troubled debt restructurings not included in the above.

Impaired loans

In the following tables, we present information on our impaired loans and advances in accordance with the classification approach described on page 146.

Impaired loan comparative data for 30 June 2011 have been restated to reflect the change in the impaired loans disclosure convention made in 4Q11. For further detail on the impaired loans restatement, see page 146.

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. In accordance with IFRS, we recognise interest income on assets after they have been written down as a result of an impairment loss.

The balance of impaired loans at 30 June 2012 was US$40.8bn compared with US$41.7bn at 31 December 2011. This reduction occurred primarily in Europe due to lower delinquency rates, and in North America reflecting the continued run off of the CML portfolio, partly offset by an increase in Latin America resulting from higher loan delinquencies in Brazil.

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 to grant 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 161b. 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. TDR comparative data for 30 June 2011 has been restated to reflect the change in the impaired loans disclosure convention in 2011.

The balance of TDRs not included as impaired loans at 30 June 2012 was US$1.2bn higher than at 31 December 2011. The increase is mainly in North America and reflects the effect of certain loans 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.

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 121.

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, as set out on page 147, although 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 of the *Annual Report and Accounts 2011*.

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Renegotiated loans and forbearance on page 143 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 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.

Analysis of risk elements in the loan portfolio by geographical region

	At 30 June 2012 US$m	At 30 June 2011 US$m	At 31 December 2011 US$m
Impaired loans	**40,832**	44,406	41,739
Europe	**10,935**	10,985	11,819
Hong Kong	**555**	514	608
Rest of Asia-Pacific	**1,148**	1,210	1,070
Middle East and North Africa	**2,534**	2,313	2,445
North America	**22,200**	25,719	22,758
Latin America	**3,460**	3,665	3,039
Unimpaired loans contractually past due 90 days or more as to principal or interest	**170**	322	363
Europe	**30**	21	41
Hong Kong	**3**	3	3
Rest of Asia-Pacific	**16**	17	21
Middle East and North Africa	**80**	185	214
North America	**38**	93	74
Latin America	**3**	3	10
Troubled debt restructurings (not included in the classifications above)	**5,980**	4,907	4,764
Europe	**1,084**	867	753
Hong Kong	**123**	182	108
Rest of Asia-Pacific	**118**	160	122
Middle East and North Africa	**573**	407	444
North America	**2,860**	1,975	2,300
Latin America	**1,222**	1,316	1,037
Trading loans classified as in default			
North America	**183**	245	230
Risk elements on loans[1]	**47,165**	50,347	47,096
Europe	**12,049**	11,873	12,613
Hong Kong	**681**	699	719
Rest of Asia-Pacific	**1,282**	1,387	1,213
Middle East and North Africa	**3,187**	2,905	3,103

North America	**25,281**	28,032	25,362
Latin America	**4,685**	5,451	4,086
Assets held for resale[2]	**432**	976	502
Europe	**50**	49	60
Hong Kong	**14**	4	4
Rest of Asia-Pacific	**9**	7	10
Middle East and North Africa			
North America	**313**	797	359
Latin America	**46**	119	69
Total risk elements	**47,597**	51,323	47,598
Europe	**12,099**	11,922	12,673
Hong Kong	**695**	703	723
Rest of Asia-Pacific	**1,291**	1,394	1,223
Middle East and North Africa	**3,187**	2,905	3,103
North America	**25,594**	28,829	25,721
Latin America	**4,731**	5,570	4,155
	%	%	%
Loan impairment allowances as a percentage of risk elements on loans[3]	**36.8**	37.7	37.6

1 *In addition to the numbers presented there were US$0.3bn (31 December 2011: US$1.5bn) of impaired loans; and US$0.1bn (31 December 2011: US$0.1bn) of troubled debt restructurings (not included in the classifications above), all relating to disposal groups held for sale at 30 June 2012.*

2 *Assets held for resale represent assets obtained by taking possession of collateral held as security for financial assets.*

3 *Ratio excludes trading loans classified as in default.*

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Liquidity and funding

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.

There have been no material changes to our policies and practices for the management of liquidity and funding risks as described in the *Annual Report and Accounts 2011*.

Our liquidity and funding risk management framework

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

Our liquidity and funding risk management framework requires:

- liquidity to be managed by operating entities on a stand-alone basis with no implicit reliance on the Group or central banks;
- all operating entities to comply with their limits for the advances to core funding ratio; and
- all operating entities to maintain a positive stressed cash flow position out to three months under prescribed Group stress scenarios.

Further details of the metrics are provided in the Appendix to Risk on page 183.

A summary of our current policies and practices regarding liquidity and funding is provided in the Appendix to Risk on page 183.

Liquidity and funding in the first half of 2012

The liquidity and funding position of the Group remained strong in the first half of 2012, as demonstrated by the Group s key liquidity and funding metrics presented in the tables below and explained on the following pages.

During the first half of 2012, HSBC UK (see footnote 40) continued to fund the majority of growth in advances with growth in core deposits. The advances to core funding ratio increased, reflecting certain wholesale term debt becoming due within one year and therefore no longer meeting the definition of core funding.

The Hongkong and Shanghai Banking Corporation, with an advances to core funding ratio of 74%, continued to be well positioned from a funding perspective to implement the Group s business strategy across Asia-Pacific.

The completion of the sale of the US card business and branch network during the first half of 2012 improved the liquidity and funding position of both HSBC Finance and HSBC USA (see footnote 42), the latter recording a decrease in the advances to core funding ratio to 68% from 86% at 31 December 2011.

As shown in the sources and uses table below, customer deposits (excluding repo and liabilities held for sale) increased by US$29bn reflecting the Group s continued ability to attract new customer deposits. The increase was driven by growth in Europe across all global businesses, and in Hong Kong across RBWM and CMB, reflecting the success of deposit gathering initiatives. These increases were partly offset by declines in Latin America due to a managed reduction in GB&M term deposits in Brazil, together with a reduction in North America as short-term customer placements at the end of 2011 returned to more normal levels in a competitive market.

We also continued to have good access to senior debt capital markets during the first half of 2012, with Group entities issuing US$8bn of term debt securities with maturities in excess of one year in the public capital markets.

Sources of funding

Our primary sources of funding are current accounts and savings deposits payable on demand or short notice, and we do not rely on securitisations, covered bond issuance programmes or repurchase agreements as important sources of funding. Repurchase agreements entered into are generally short-term in nature, maturing in 90 days or less.

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We carry out short-term lending using reverse repurchase agreements in various markets. The majority of the counterparts to these transactions are of high credit quality. For all transactions we ensure that the collateral is accepted with an appropriate haircut reflecting counterparty and collateral credit quality.

The funding sources and uses table, which provides a consolidated view of how our balance sheet is funded, should be read in the light of our

risk management framework, which requires our operating entities to manage liquidity and funding risk on a stand-alone basis. The table analyses our consolidated balance sheet according to the assets that primarily arise from operating activities and the sources of funding primarily supporting these activities. The assets and liabilities that do not arise from operating activities are presented as a net balancing source or deployment of funds.

Funding sources and uses

	30 Jun 2012 US$m	30 Jun 2011 US$m	31 Dec 2011 US$m		**30 Jun 2012 US$m**	30 Jun 2011 US$m	31 Dec 2011 US$m
Sources				**Uses**			
Customer accounts	**1,278,489**	1,318,987	1,253,925	Loans and advances to customers	**974,985**	1,037,888	940,429
repos	**26,426**	64,192	30,785	reverse repos	**49,320**	74,123	41,419
cash deposits	**1,252,063**	1,254,795	1,223,140	loans or other receivables	**925,665**	963,765	899,010
Deposits by banks	**123,553**	125,479	112,822	Loans and advances to banks	**182,191**	226,043	180,987
repos	**17,054**	18,329	17,617	reverse repos	**42,429**	68,247	41,909
cash deposits	**106,499**	107,150	95,205	loans or other receivables	**139,762**	157,796	139,078
Debt securities issued	**125,543**	149,803	131,013	Assets held for sale	**12,383**	1,626	39,558
Liabilities of disposal groups held for sale	**12,599**	41	22,200	Trading assets	**391,371**	474,950	330,451
				reverse repos	**104,335**	111,373	79,848
				stock borrowing	**16,509**	19,826	9,459
Subordinated liabilities	**29,696**	32,753	30,606	other trading assets	**270,527**	343,751	241,144
Financial liabilities designated at fair value	**87,593**	98,280	85,724	Financial investments	**393,736**	416,857	400,044
Liabilities under insurance contracts	**62,861**	64,451	61,259	Cash and balances with central banks	**147,911**	68,218	129,902
Trading liabilities	**308,564**	385,824	265,192	Net deployment in other balance sheet assets and liabilities	**100,087**	117,573	107,463
repos	**112,628**	119,783	86,838				
stock lending	**6,013**	8,479	4,595				
other trading liabilities	**189,923**	257,562	173,759				

Total equity	**173,766**	167,537	166,093			
	2,202,664	2,343,155	2,128,834	**2,202,664**	2,343,155	2,128,834

Management of funding and liquidity risk

Our liquidity and funding risk framework employs two key measures to define, monitor and control the Group s liquidity and funding risk. For each operating entity, the advances to core funding ratio is used to monitor the structural long-term funding position and stressed coverage ratios incorporating Group defined stress scenarios are used to monitor the resilience to severe liquidity stresses.

Advances to core funding ratio

The three principal entities listed in the table below represented 61% of the total core deposits originated by operating entities at 30 June 2012 and overseen by the Risk Management Meeting (30 June 2011: 61%; 31 December 2011: 61%).

The table shows that loans and advances to customers in our principal banking entities were financed by reliable and stable sources of funding. We would meet any unexpected cash outflows primarily from our cash and balances at central banks, by selling or entering into repos with the securities assessed as liquid assets, and by running down interbank loans and reverse repos contractually. Additional sources of secured funding such as collateralised lending markets could also be accessed over the longer term.

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

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Advances to core funding ratios[39]

	30 Jun 2012 %	Half-year to 30 Jun 2011 %	31 Dec 2011 %
HSBC UK[40]			
Period-end	**104**	100	100
Maximum	**104**	103	102
Minimum	**100**	98	99
Average	**102**	101	100
The Hongkong and Shanghai Banking Corporation[41]			
Period-end	**74**	79	75
Maximum	**75**	79	79
Minimum	**71**	70	75
Average	**73**	75	77
HSBC USA[42]			
Period-end	**68**	81	86
Maximum	**86**	98	86
Minimum	**68**	80	81
Average	**80**	86	82
Total of HSBC s other principal entities[43]			
Period-end	**88**	89	86
Maximum	**88**	90	90
Minimum	**85**	88	86
Average	**86**	89	88

For footnotes, see page 180.

Funding of HSBC Finance

HSBC Finance historically raised term funding from the professional markets and, to a lesser extent, through securitising assets. At 30 June 2012, US$41bn (30 June 2011: US$59bn; 31 December 2011: US$51bn) of HSBC Finance s liabilities were drawn from professional markets, utilising a range of products, maturities and currencies.

HSBC Finance funding

	At 30 Jun 2012 US$bn	At 30 Jun 2011 US$bn	At 31 Dec 2011 US$bn
Maximum amounts of unsecured term funding maturing in any rolling:			
3-month period	**3.6**	5.1	5.1
12-month period	**9.4**	10.8	9.7
Unused committed sources of secured funding[44]		0.5	0.5
Committed backstop lines from non-Group entities in support of CP programmes	**2.0**	4.0	4.0

For footnote, see page 180.

HSBC Finance uses a range of measures to monitor funding risk, including stress 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 has in place committed backstop lines from non-Group entities 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. HSBC Finance plans to wind down its CP programme during 2012 and, to that end, did not renew a US$2bn credit facility that expired in April 2012.

The need for HSBC Finance to refinance maturing term funding is reduced by the continued run-down of its balance sheet.

We do not expect the professional markets to be a source of funding for HSBC Finance in the future in light of the sale of the Card and Retail Services business and the run-off of its remaining business. HSBC Finance will meet future funding needs by asset sales and affiliate funding. As a consequence, no new external third-party funding (including CP) is being originated by HSBC Finance.

Stressed coverage ratios

The stressed coverage ratios tabulated below express stressed cash inflows as a percentage of stressed cash outflows over a one month time horizon. Operating entities are required to maintain a ratio of 100% or greater out to three months.

At 30 June 2012, the one-month and three-month stressed coverage ratios for the three principal entities and the total of HSBC s other principal operating entities shown in the table below were in excess of the 100% target.

Inflows included in the numerator of the stressed coverage ratio are those that are assumed to be generated from the utilisation of liquid assets net of management assumed haircuts, and cash inflows related to assets contractually maturing within the stressed cash flow time period and not already reflected as a utilisation of a liquid asset.

In general, customer advances are assumed to be renewed and as a result are not assumed to generate a stressed cash inflow or represent a liquidity resource.

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Stressed one-month coverage ratio[39]

		Half-year to	
	30 Jun 2012	30 Jun 2011	31 Dec 2011
	%	%	%
HSBC UK[40]			
Period-end	**111**	116	116
Maximum	**117**	116	118
Minimum	**111**	109	110
Average	**114**	112	113
The Hongkong and Shanghai Banking Corporation[41]			
Period-end	**124**	117	123
Maximum	**134**	145	123
Minimum	**123**	117	116
Average	**130**	128	119
HSBC USA[42]			
Period-end	**134**	117	118
Maximum	**137**	128	123
Minimum	**115**	108	109
Average	**125**	122	116
Total of HSBC s other principal entities[43]			
Period-end	**118**	117	118
Maximum	**123**	121	119
Minimum	**118**	117	116
Average	**120**	119	117

For footnotes, see page 180.

The total shown for other principal HSBC operating entities represents the combined position of all the other operating entities overseen directly by the Risk Management Meeting.

Liquid assets of HSBC s principal operating entities

The table below shows the estimated liquidity value (before haircuts) of assets categorised as liquid assets used for the purposes of calculating the three month stressed coverage ratio, as defined under the HSBC Group framework.

Any unencumbered asset held as a consequence of a reverse repo transaction with a residual contractual maturity within three months is not reflected in the liquid assets values presented as these assets are reflected as contractual cash inflows. Unsecured interbank loans maturing within three months are also not reflected in the liquid asset values presented as these assets are also reflected as contractual cash inflows.

The decrease of US$8bn in level 1 and level 2 liquid assets and US$12bn in total liquid assets reported for HSBC USA in the first half of 2012 was offset by an increase of US$14bn in the amount of cash deployed in reverse repo transactions maturing within three months (the majority maturing within one week) which are excluded from the liquid asset values presented for HSBC USA.

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Liquid assets of HSBC s principal entities

	Estimated liquidity value[45]		
	30 Jun 2012 US$m	30 Jun 2011 US$m	31 Dec 2011 US$m
HSBC UK[40]			
Level 1 and Level 2	**121,165**	82,425	114,940
Level 3	**9,320**		
Non-government assets		28,468	23,007
	130,485	110,893	137,947
The Hongkong and Shanghai Banking Corporation[41]			
Level 1 and Level 2	**110,872**	94,401	107,056
Level 3	**4,889**		
Non-government assets		3,747	2,151
	115,761	98,149	109,208
HSBC USA[42]			
Level 1 and Level 2	**79,477**	78,587	87,429
Level 3	**8,405**		
Other	**6,238**		
Non-government assets		19,526	19,093
	94,120	98,113	106,522
Total of HSBC s other principal entities[43]			
Level 1 and Level 2	**155,329**	153,281	140,911
Level 3	**11,205**		
Other			
Non-government assets		37,155	23,584
	166,534	190,436	164,495

For footnotes, see page 180.

The Group s liquid asset policy was refined as at 1 January 2012 to apply a more granular definition of liquid assets, as set out in the Appendix to Risk on page 183. Under the previous framework, liquid assets were classified into two categories: central government, central bank and US agency MBS exposures; and all other non-government exposures. Central government, central bank and US agency MBS exposures qualify as Level 1 or Level 2 under the new policy and are shown as such in the comparatives. All other non-governmental liquid assets are separately presented in the comparatives. All assets within the liquid asset portfolio are unencumbered.

Contingent liquidity risk

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 256). HSBC-managed asset exposures are differentiated in that they relate to consolidated SICs which issue debt secured by ABSs (see page 255). Other conduit exposures relate to third-party sponsored conduits (see page 257). Single issuer liquidity facilities are provided directly to clients rather than via any form of conduit. Single issuer liquidity facilities provided in the table below represent the aggregate of the five largest facilities, and the largest market sector.

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The Group s contractual exposures monitored under the contingent liquidity risk limit structure

	HSBC UK			HSBC USA			HSBC Canada			The Hongkong and Shanghai Banking Corporation		
	At 30 Jun 2012 US$bn	At 30 Jun 2011 US$bn	At 31 Dec 2011 US$bn	**At 30 Jun 2012 US$bn**	At 30 Jun 2011 US$bn	At 31 Dec 2011 US$bn	**At 30 Jun 2012 US$bn**	At 30 Jun 2011 US$bn	At 31 Dec 2011 US$bn	**At 30 Jun 2012 US$bn**	At 30 Jun 2011 US$bn	At 31 Dec 2011 US$bn
Conduits												
Client-originated assets												
total lines	**10.0**	7.5	11.4	**1.7**	1.2	0.9	**0.9**	0.7	0.7			
largest individual lines	**0.6**	0.4	0.7	**0.5**	0.4	0.3	**0.8**	0.5	0.5			
HSBC-managed assets[46]												
total lines	**20.0**	23.6	22.1									
Other conduits[47]												
total lines				**1.0**	1.1	1.4						
Single-issuer liquidity facilities												
five largest[48]	**4.0**	4.2	3.4	**5.9**	6.6	5.7	**1.7**	2.2	1.8	**1.6**	1.9	1.9
largest market sector[49]	**8.4**	9.8	7.5	**7.1**	5.1	6.5	**4.2**	4.3	3.8	**2.5**	2.6	2.5

For footnotes, see page 180.

Comparatives for HSBC UK have been adjusted to reflect the reassessment of contingent liquidity risk exposures for certain entities.

Encumbered assets

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 19 on the Financial Statements. Assets not included in Note 19 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 178) 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$38m (30 June 2011: US$61m; 31 December 2011: US$33m) are considered encumbered.

Liquidity regulation

In December 2010, the Basel Committee on Banking Supervision (Basel Committee) published the International framework for liquidity risk measurement, standards and monitoring . The framework comprises two liquidity metrics: the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). The ratios are subject to an observation period that began in 2011, and are expected to become established standards by 2015 and 2018, respectively. During the observation period, the standards are under review by the Basel Committee with any revisions to the LCR expected by mid-2013 and to the NSFR by mid-2016.

Currently, the Basel Committee and the European Commission are debating the final calibration of the LCR and the NSFR. A significant level of interpretation is required in determining how to apply the definitions as currently drafted, in particular, the definition of operational deposits. It is therefore likely that the ratios will be subject to further change as exact requirements are finalised.

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Market risk

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.

There have been no material changes to our policies and practices for the management of market risk as described in the *Annual Report and Accounts 2011*.

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 including Balance Sheet Management, 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 176).

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 mainland China slowdown 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.

A summary of our current policies and practices regarding market risk is provided in the Appendix to Risk on page 183.

Market risk in the first half of 2012

The first quarter of the year began with a positive trend in the markets. This was reflected in a stock market rally, a sharp decrease in major volatility indices, credit spreads tightening and funding spreads improving across the board. The issuance of new debt and secondary trading activity benefited from the strong rally in credit. However, in the second quarter, the slowdown in global growth combined with the persistent challenges in the eurozone to re-introduce risk aversion, resulting in credit markets retracting, global stock markets retreating and the US dollar appreciating against the euro, sterling and emerging market currencies.

The eurozone sovereign debt crisis remained the centre of attention throughout the first half of the year. The difficulties in implementing the prescribed austerity measures and fiscal discipline, the possibility of counties exiting the eurozone, the escalating fears around high debt to GDP ratios and the need for aid to recapitalise banks weighed down on market sentiment. Against this backdrop, our response was to continue to manage down and, where possible, hedge our exposure to eurozone countries.

Trading and non-trading portfolios

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[50]
Interest rate	VAR	VAR[51]
Equity	VAR	Sensitivity
Credit spread	VAR	VAR

For footnotes, see page 180.

Value at risk of the trading and non-trading portfolios

Our Group VAR, both trading and non-trading, was as tabulated overleaf.

During the first half of 2012, the reduction in VAR mainly came from credit portfolios as a result of a reduction in the volatility of the historical market data in our VAR model.

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Value at risk

	30 June 2012 US$m	Half-year to 30 June 2011 US$m	31 December 2011 US$m
At period-end	**258.6**	249.7	367.0
Average	**292.4**	289.5	313.2
Minimum	**229.0**	241.1	231.5
Maximum	**383.9**	403.2	404.3

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 the first half of 2012, there were no loss exceptions at Group level. This was consistent with what is statistically expected from the model.

Daily distribution of Global Markets trading, Balance Sheet Management and other trading revenues[52,53]

	30 Jun 2012	Half-year to 30 Jun 2011	31 Dec 2011
	US$m	US$m	US$m
Average daily revenue	**55.5**	50.7	34.2
Standard deviation[54]	**29.7**	25.8	40.5
Ranges of most frequent daily revenues	**40 50**	30 40	30 40
	days	days	days
daily occurrences	**23**	25	17
Days of negative revenue		2	21

Half-year to 30 June 2012

Number of days

Revenues (US$m)

n Profit and loss frequency

Half-year to 30 June 2011

Number of days

Half-year to 31 December 2011

Number of days

Revenues (US$m)

n Profit and loss frequency

Revenues (US$m)

n Profit and loss frequency

For footnotes, see page 180.

Our Group daily VAR, both trading and non-trading, was as follows. For a description of HSBC s fair value and price verification controls, see page 230.

Daily VAR (trading and non-trading)

(US$m)

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Trading portfolios

VAR by risk type for trading intent activities[55]

	Foreign exchange and commodity US$m	Interest rate US$m	Equity US$m	Credit spread US$m	Portfolio diversification[56] US$m	Total[57] US$m
At 30 June 2012	**28.8**	**42.9**	**13.8**	**26.4**	**(42.7)**	**69.2**
At 30 June 2011	10.3	67.0	4.1	38.7	(28.5)	91.6
At 31 December 2011	18.6	49.4	7.4	75.2	(32.3)	118.3
Average						
First half of 2012	**30.0**	**45.0**	**5.9**	**37.4**	**(29.7)**	**88.7**
First half of 2011	15.0	52.0	9.2	46.2	(28.8)	93.6
Second half of 2011	18.6	56.3	6.7	67.9	(39.9)	109.7
Minimum						
First half of 2012	**14.4**	**33.3**	**2.7**	**22.4**		**62.0**
First half of 2011	7.6	30.1	3.6	34.7		62.2
Second half of 2011	9.2	44.4	2.5	34.8		77.9
Maximum						
First half of 2012	**46.0**	**60.0**	**13.8**	**77.9**		**130.9**
First half of 2011	26.8	80.2	17.2	56.2		143.9
Second half of 2011	31.9	78.2	14.9	103.2		138.4

For footnotes, see page 180.

The VAR for trading intent activity within Global Markets at 30 June 2012 (US$69.2m) was lower than at 31 December 2011 (US$118.3m) due to a reduction in positions, lower volatility of the historical market data in our VAR model, and an increase in portfolio diversification.

Credit spread risk

Credit spread risk arises on credit derivative transactions entered into by Global Banking in order to manage the risk concentrations within our corporate loan portfolio and enhance capital efficiency.

At 30 June 2012, the credit VAR on these transactions was US$5.5m (30 June 2011: US$3.7m; 31 December 2011: US$6.6m). The mark-to-market of these transactions is reflected in the income statement.

Gap risk

We did not incur any significant gap risk loss in the half-year to 30 June 2012.

Non-trading portfolios

Available-for-sale debt securities

At 30 June 2012, 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$212m (30 June 2011: US$220m; 31 December

2011: US$389m). This sensitivity is calculated before taking into account losses which would have been absorbed by the capital note holders.

At 30 June 2012, the capital note holders would absorb the first US$2.2bn (30 June 2011: US$2.2bn; 31 December 2011: US$2.3bn) of any losses incurred by the SICs before we incur any equity losses.

Equity securities classified as available for sale

Fair values of equity securities

	At 30 Jun 2012 US$bn	At 30 Jun 2011 US$bn	At 31 Dec 2011 US$bn
Private equity holdings[58]	**3.0**	2.9	3.0
Funds invested for short-term cash management	**0.1**	0.6	0.2
Investment to facilitate ongoing business[59]	**1.1**	1.1	1.1
Other strategic investments	**2.5**	3.6	2.9
Total	**6.7**	8.2	7.2

For footnotes, see page 180.

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.

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The fair value of the constituents of equity securities classified as available for sale can fluctuate considerably. A 10% reduction in the value of the available-for-sale equities at 30 June 2012 would have reduced equity by US$0.7bn (30 June 2011: US$0.8bn; 31 December 2011: US$0.7bn). Our policy for assessing impairment on available-for-sale equity securities is described on page 301 of the *Annual Report and Accounts 2011*.

Structural foreign exchange exposures

Our policies and procedures for managing structural foreign exchange exposures are described on page 201 in the *Annual Report and Accounts 2011*.

Sensitivity of net interest income

The table below sets out the effect on 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 July 2012. Assuming no management actions, a sequence of such rises would increase planned net interest income for the 12 months to 30 June 2013 by US$1,586m (to 31 December 2012: US$1,571m), while a sequence of such falls would decrease planned net interest income by US$1,685m (to 31 December 2012: US$1,909m). These figures incorporate the effect of any option features in the underlying exposures.

Sensitivity of projected net interest income[60]

	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 July 2012 to June 2013 projected net interest income arising from a shift in yield curves at the beginning of each quarter of:							
+ 25 basis points	**242**	**81**	**225**	**199**	**779**	**60**	**1,586**
25 basis points	**(394)**	**(69)**	**(325)**	**(142)**	**(719)**	**(36)**	**(1,685)**
Change in January 2012 to December 2012 projected net interest income arising from a shift in yield curves at the beginning of each quarter of:							
+ 25 basis points	209	62	263	232	729	76	1,571
25 basis points	(465)	(59)	(443)	(166)	(708)	(68)	(1,909)

For footnote, see page 180.

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 183.

The main driver of the changes between December 2011 and June 2012 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, resulting in reduced margin compression risk in a falling rate scenario.

We monitor the sensitivity of reported reserves before any tax adjustments to interest rate movements on a monthly basis. This is done by assessing the expected pre-tax 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 HSBC s reported reserves to these movements and the maximum and minimum month-end figures during the period:

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Sensitivity of reported reserves to interest rate movements[60]

		Impact in the preceding 6 months	
		Maximum	Minimum
	US$m	US$m	US$m
At 30 June 2012			
+ 100 basis point parallel move in all yield curves	**(5,199)**	**(5,748)**	**(5,199)**
As a percentage of total shareholders equity	**(3.1%)**	**(3.4%)**	**(3.1%)**
100 basis point parallel move in all yield curves	**4,879**	**5,418**	**4,879**
As a percentage of total shareholders equity	**2.9%**	**3.3%**	**2.9%**
At 30 June 2011			
+ 100 basis point parallel move in all yield curves	(5,889)	(6,178)	(5,889)
As a percentage of total shareholders equity	(3.7%)	(3.9%)	(3.7%)
100 basis point parallel move in all yield curves	6,081	6,329	6,081
As a percentage of total shareholders equity	3.8%	4.0%	3.8%
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%

For footnote, see page 180.

The sensitivities are illustrative only and are based on simplified scenarios. The table shows the potential sensitivity of reserves, as a proportion of total shareholders equity, 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 was due to a decrease in government bonds held in Balance Sheet Management, which are accounted for on an available-for-sale basis.

Balance Sheet Management

In each Group entity, Balance Sheet Management (BSM) is responsible for managing liquidity and funding under the supervision of the local Asset and Liability Management Committee (ALCO). It also manages the structural interest rate position of the entity within a Global Markets limit structure.

BSM reinvests excess liquidity into highly rated liquid assets. The majority of the liquidity is invested in central bank deposits, and government, supranational and agency securities with most of the remainder short-term interbank and central bank loans.

Central bank deposits are accounted for as cash balances. Interbank loans and loans to central banks are accounted for as loans and advances to banks. BSM s holdings of securities are accounted for as available-for-sale assets.

BSM is permitted to use derivatives as part of its mandate to manage interest rate risk. Derivative activity is predominantly through the use of vanilla interest rate swaps which are part of cash flow hedging relationships.

Credit risk in BSM is predominantly limited to short-term bank exposure created by interbank lending and exposure to central banks as well as high quality sovereigns, supranationals or agencies which constitute the majority of BSM s liquidity portfolio. BSM does not and is not mandated to manage the structural credit risk of any Group balance sheets. BSM only manages interest rate risk.

BSM is permitted to enter into single name and index credit derivatives activity, but it does so to manage credit risk on the exposure specific to its securities portfolio in limited circumstances only. The risk limits are extremely limited and closely monitored. BSM currently has no open credit derivative index risk.

Defined benefit pension schemes

Market risk arises within HSBC s defined benefit pension schemes to the extent that the obligations of the schemes are not fully matched by assets with determinable cash flows.

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HSBC s defined benefit pension schemes

	At 30 Jun 2012 US$bn	At 30 Jun 2011 US$bn	At 31 Dec 2011 US$bn
Liabilities (present value)	**35.9**	33.7	35.0
	%	%	%
Assets:			
Equity investments	**17**	20	15
Debt securities	**72**	69	73
Other (including property)	**11**	11	12
	100	100	100

For details of the latest actuarial valuation of the HSBC Bank (UK) Pension Scheme (the Scheme) funded defined benefit plan (the principal plan), see Note 7 on the Financial Statements in the *Annual Report and Accounts 2011.*

Additional market risk measures applicable only to the parent company

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 for interest rate risk.

Foreign exchange risk

Total foreign exchange VAR arising within HSBC Holdings in the first half of 2012 was as follows:

HSBC Holdings foreign exchange VAR

		Half-year to	
	30 Jun 2012 US$m	30 Jun 2011 US$m	31 Dec 2011 US$m
At period end	**39.4**	43.4	47.7
Average	**48.2**	40.7	43.3
Minimum	**39.4**	38.2	38.2
Maximum	**54.2**	43.4	48.3

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.

Interest 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. The change in the interest rate gap profile between 30 June 2011 and 30 June 2012 is primarily driven by part of the subordinated and Tier 1 debt approaching maturity.

Repricing gap analysis of HSBC Holdings

	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 30 June 2012						
Total assets	**125,392**	**26,223**	**1,450**	**1,010**	**612**	**96,097**
Total liabilities and equity	**(125,392)**	**(7,333)**	**(7,051)**	**(11,052)**	**(14,005)**	**(85,951)**
Off-balance sheet items attracting interest rate sensitivity		**(18,331)**	**4,632**	**8,575**	**4,200**	**924**
Net interest rate risk gap		**559**	**(969)**	**(1,467)**	**(9,193)**	**11,070**
Cumulative interest rate gap		**559**	**(410)**	**(1,877)**	**(11,070)**	
At 30 June 2011						
Total assets	123,004	27,224	1,175	1,021	624	92,960
Total liabilities and equity	(123,004)	(3,886)	(12,468)	(16,243)	(13,373)	(77,034)
Off-balance sheet items attracting interest rate sensitivity		(18,990)	10,033	6,315	3,535	(893)
Net interest rate risk gap		4,348	(1,260)	(8,907)	(9,214)	15,033
Cumulative interest rate gap		4,348	3,088	(5,819)	(15,033)	
At 31 December 2011						
Total assets	123,862	25,885	2,350	1,010	603	94,014
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)	

Operational risk

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

There were continuing enhancements to our operational risk management framework policies and procedures in the first half of 2012. This included the implementation of a Top Risk analysis process to enhance the quantification and management of material risks through scenario analysis. This provides a top down, forward-looking view to help determine whether the risks are being effectively managed within our risk appetite or whether further management action is required.

A summary of our current policies and practices regarding operational risk is provided in the Appendix to Risk on page 183.

Operational risk in the first half of 2012

During the first half of 2012, our top and emerging risk profile was dominated by compliance and legal risks. Other featured operational risks include:

- *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 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 reduce the level of losses in these areas;
- *social media risk*: compensating controls have been implemented by several Group companies in an attempt to reduce our exposure to these risks, including:
  - an HSBC presence in several of the larger social media networks; and
  - increased monitoring;
- *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 the use of the operational risk management framework, including investments made to further improve the resilience of our payments infrastructure.

Legal risks are discussed on page 194 and further details regarding compliance risk are set out below.

Compliance risk

All Group companies are required to observe the letter and spirit of all relevant laws, codes, rules, regulations and standards of good market practice. In 2012, we continued to experience increasing levels of compliance risk as regulators and other agencies pursued investigations into historic activities and as we continued to work with them in relation to already identified issues. These included:

- the mis-selling of interest rate derivative products to SMEs in the UK and the settlement of claims by HSBC Bank to provide appropriate redress;

- investigations related to certain past submissions made by panel banks in connection with the setting of LIBOR, EURIBOR and other interest rates. As certain HSBC entities are members of such panels, HSBC Holdings and certain of its subsidiaries have been the subject of regulatory demands for information;

- appearance before the US Senate Permanent Subcommittee on Investigations (PSI) about our compliance with US regulations including anti-money laundering laws, the BSA and OFAC sanctions. We have previously disclosed these matters and have co-operated with relevant US authorities since 2010; and

- ongoing investigations by US regulatory and law enforcement authorities into our compliance with anti-money laundering laws, the BSA and OFAC sanctions.

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It is clear from both our own and wider industry experience that there is a significantly increased level of activity from regulators and law enforcement agencies in pursuing investigations in relation to possible breaches of regulation. Coupled with a substantial increase in the volume of new regulation, much of which has some level of extra-territorial effect, and the geographical spread of our businesses, we believe that the level of inherent compliance risk that we face will continue to remain high for the foreseeable future. Many of the steps described in the reputational risk section below are intended to adapt to and address that ongoing increased compliance risk.

Reputational risk

The safeguarding of our reputation is paramount. It is the responsibility of all members of staff, who are supported by a global risk management structure underpinned by relevant policies and practices, readily available guidance, and regular training.

As noted in the compliance risk section above, we have acknowledged, in the context of the recent PSI hearing, that it was not enough to fix the specific issues that the PSI focused on and outlined additionally our implementation of a global strategy to tackle the root causes of these identified deficiencies.

With a new senior leadership team and a new strategy in place since 2011, HSBC has already taken concrete steps to augment the framework to address these issues including making significant changes to strengthen compliance, risk management and culture. These steps, which should also serve, over time, to enhance our reputational risk management, include the following:

- the creation of a new global structure, which will make HSBC easier to manage and control, by reorganising HSBC into four global businesses and ten global functions, including Compliance and Risk, allowing a coordinated and consistent approach;
- simplifying our business through the ongoing implementation of our organisational effectiveness programme and our five economic filters strategy and developing a sixth global risk filter which should help to standardise our approach to doing business in higher risk countries;
- a substantial increase in resources, doubling of global expenditure and significant strengthening of compliance as a control (and not only as an advisory) function;
- continuing to roll out an HSBC Values programme that seeks to define the way everyone in the Group should act. This makes all managers and senior executives accountable for ensuring that business decisions and activities are aligned to our Values and business principles and includes reviewing all products, services, policies and practices to ensure that the Values are embedded into our business as usual operations;
- the appointment of a new Chief Legal Officer, with particular expertise and experience in US law and regulation;
- designing and implementing new global standards by which we conduct our businesses. As a key principle in doing this, we will adopt and enforce a single standard globally that is determined by the highest regulatory standard we must apply anywhere. We will also maximise information sharing for risk management purposes across HSBC to the extent permitted by law and apply a globally consistent approach to knowing and retaining our customers; and

enforcing a consistent global sanctions policy.

Success in detecting and preventing illicit actors access to the global financial system calls for constant vigilance and HSBC will continue to work in close cooperation with all governments to achieve this. This is integral to the execution of HSBC s strategy, to our core values and to preserving and enhancing our reputation.

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Risk management of insurance operations

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 have been 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, as described in the *Annual Report and Accounts 2011*.

A summary of HSBC s policies and practices regarding insurance risk and the main contracts we manufacture, is provided in the Appendix to Risk on page 183.

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 via 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 the risk appetite and operational scale. This allows us to retain the risks and rewards associated 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 the first half of 2012

The principal insurance 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 discretionary participation (or bonus) features (DPF) within the policy.

The following tables analyse our insurance risk exposures by geographical region and by type of business. The insurance risk profile and related exposures remain largely consistent with those observed at 31 December 2011.

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Analysis of life insurance risk liabilities to policyholders[61]

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	North America[62] US$m	Latin America US$m	Total US$m
At 30 June 2012						
Life (non-linked)	**1,185**	**23,645**	**1,432**		**2,079**	**28,341**
Insurance contracts with DPF[63]	**329**	**22,028**	**395**			**22,752**
Credit life	**167**		**59**			**226**
Annuities	**547**		**110**		**1,512**	**2,169**
Term assurance and other long-term contracts	**142**	**1,617**	**868**		**567**	**3,194**
Life (linked)	**2,774**	**3,713**	**532**		**4,905**	**11,924**
Investment contracts with DPF[63,64]	**21,898**		**8**			**21,906**
Insurance liabilities to policyholders	**25,857**	**27,358**	**1,972**		**6,984**	**62,171**
At 30 June 2011						
Life (non-linked)	1,621	19,957	997	992	2,282	25,849
Insurance contracts with DPF[63]	364	18,875	316			19,555
Credit life	482		51	34	2	569
Annuities	473		72	749	1,699	2,993
Term assurance and other long-term contracts	302	1,082	558	209	581	2,732
Life (linked)	2,563	3,460	525		5,184	11,732
Investment contracts with DPF[63,64]	24,652		16			24,668
Insurance liabilities to policyholders	28,836	23,417	1,538	992	7,466	62,249
At 31 December 2011						
Life (non-linked)	1,163	21,460	1,227	982	2,094	26,926
Insurance contracts with DPF[63]	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[63,64]	21,477		11			21,488
Insurance liabilities to policyholders	25,148	24,853	1,714	982	6,927	59,624

For footnotes, see page 180.

Analysis of non-life insurance risk net written insurance premiums[61,65]

	Europe US$m	Hong Kong US$m	Rest of Asia-Pacific US$m	North America US$m	Latin America US$m	Total US$m

Half-year to 30 June 2012						
Accident and health	**3**	**99**	**5**		**18**	**125**
Motor		**8**	**12**		**134**	**154**
Fire and other damage		**17**	**7**	**23**	**13**	**60**
Liability		**11**	**2**		**1**	**14**
Credit (non-life)				**18**	**1**	**19**
Marine, aviation and transport		**5**	**2**		**11**	**18**
Other non-life insurance contracts	**1**	**18**	**1**	**2**	**27**	**49**
Total net written insurance premiums	**4**	**158**	**29**	**43**	**205**	**439**
Net insurance claims incurred and movement in liabilities to policyholders	**(2)**	**(69)**	**(15)**	**(13)**	**(95)**	**(194)**
Half-year to 30 June 2011						
Accident and health	19	91	5	1	20	136
Motor		8	15		160	183
Fire and other damage	9	14	5	12	13	53
Liability		10	3		1	14
Credit (non-life)	7			27	1	35
Marine, aviation and transport		5	2		12	19
Other non-life insurance contracts	6	18		4	46	74
Total net written insurance premiums	41	146	30	44	253	514
Net insurance claims incurred and movement in liabilities to policyholders	25	(67)	(14)	(7)	(115)	(178)

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Analysis of non-life insurance risk net written insurance premiums (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
Half-year to 31 December 2011						
Accident and health	4	95	3	(1)	19	120
Motor		9	10		168	187
Fire and other damage	(4)	15	8	18	16	53
Liability	1	6	2			9
Credit (non-life)	(1)			21		20
Marine, aviation and transport		5	1		13	19
Other non-life insurance contracts	1	21	1	3	45	71
Total net written insurance premiums	1	151	25	41	261	479
Net insurance claims incurred and movement in liabilities to policyholders	31	(60)	(12)	(15)	(116)	(172)

For footnotes, see page 180.

Our motor business was written predominantly in Argentina; this business was sold in May 2012. 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 by type of contract

A principal tool we use to manage our exposure to insurance risk, in particular for life insurance contracts, is asset and liability matching.

The table below shows the composition of assets and liabilities and demonstrates that there were sufficient assets to cover the liabilities to policyholders at 30 June 2012.

Balance sheet of insurance manufacturing subsidiaries by type of contract

	Insurance contracts					Investment contracts				
	With DPF US$m	Unit-linked US$m	Annuities US$m	Term assurance[66] US$m	Non-life US$m	With DPF[64] US$m	Unit-linked US$m	Other US$m	Other assets[67] US$m	Total US$m
At 30 June 2012										

Financial assets	**22,712**	**11,129**	**1,798**	**3,758**	**1,123**	**21,242**	**8,138**	**4,212**	**6,347**	**80,459**
trading assets			**4**							**4**
financial assets designated at fair value	**1,989**	**10,905**	**376**	**571**	**212**	**5,895**	**7,432**	**1,472**	**2,623**	**31,475**
derivatives	**20**	**1**				**216**	**5**	**91**	**5**	**338**
financial investments	**16,971**		**1,083**	**2,929**	**676**	**13,728**		**1,847**	**3,122**	**40,356**
other financial assets	**3,732**	**223**	**335**	**258**	**235**	**1,403**	**701**	**802**	**597**	**8,286**
Reinsurance assets	**13**	**826**	**464**	**166**	**102**				**73**	**1,644**
PVIF[68]									**4,426**	**4,426**
Other assets and investment properties	**422**	**8**	**19**	**175**	**145**	**664**	**30**	**28**	**2,924**	**4,415**
Total assets	**23,147**	**11,963**	**2,281**	**4,099**	**1,370**	**21,906**	**8,168**	**4,240**	**13,770**	**90,944**
Liabilities under investment contracts:										
designated at fair value							**8,057**	**3,679**		**11,736**
carried at amortised cost								**430**		**430**
Liabilities under insurance contracts	**22,752**	**11,924**	**2,169**	**3,420**	**690**	**21,906**				**62,861**
Deferred tax	**17**		**14**	**10**	**1**				**1,011**	**1,053**
Other liabilities									**4,587**	**4,587**
Total liabilities	**22,769**	**11,924**	**2,183**	**3,430**	**691**	**21,906**	**8,057**	**4,109**	**5,598**	**80,667**
Total equity									**10,277**	**10,277**
Total equity and liabilities[69]	**22,769**	**11,924**	**2,183**	**3,430**	**691**	**21,906**	**8,057**	**4,109**	**15,875**	**90,944**

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	Insurance contracts					Investment contracts				
	With DPF US$m	Unit-linked US$m	Annuities US$m	Term assurance[66] US$m	Non-life US$m	With DPF[64] US$m	Unit-linked US$m	Other US$m	Other assets[67] US$m	Total US$m
At 30 June 2011										
Financial assets	19,436	10,962	2,734	3,233	2,434	24,112	8,771	4,038	7,371	83,091
trading assets					34					34
financial assets designated at fair value	1,683	10,664	474	646	221	6,426	8,050	1,529	1,641	31,334
derivatives	54	1	1	10	1	279	11	1	2	360
financial investments	14,650		1,929	2,061	1,169	16,178		1,789	4,274	42,050
other financial assets	3,049	297	330	516	1,009	1,229	710	719	1,454	9,313
Reinsurance assets	13	802	395	243	424				59	1,936
PVIF[68]									4,186	4,186
Other assets and investment properties	216	10	26	363	208	557	23	51	697	2,151
Total assets	19,665	11,774	3,155	3,839	3,066	24,669	8,794	4,089	12,313	91,364
Liabilities under investment contracts:										
designated at fair value							8,762	3,429		12,191
carried at amortised cost								485		485
Liabilities under insurance contracts	19,555	11,732	2,993	3,301	2,202	24,668				64,451
Deferred tax	13		22	6	6			1	970	1,018
Other liabilities									2,213	2,213
Total liabilities	19,568	11,732	3,015	3,307	2,208	24,668	8,762	3,915	3,183	80,358
Total equity									11,006	11,006
Total equity and liabilities[69]	19,568	11,732	3,015	3,307	2,208	24,668	8,762	3,915	14,189	91,364
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[68]									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[69]	20,797	11,210	2,903	3,268	1,636	21,488	7,813	4,021	13,490	86,626

For footnotes, see page 180.

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Interim Management Report (continued)

Footnotes to Risk

Credit risk

1 *30 June 2011 comparative data have not been separately presented as the amounts are insignificant.*
2 *The amount of the loan commitments reflects, where relevant, the expected level of take-up of pre-approved loan offers made by mailshots to personal customers. In addition to those amounts, there is a further maximum possible exposure to credit risk of US$27.9bn (30 June 2011: US$159.5bn; 31 December 2011: US$171bn), reflecting the full take-up of such irrevocable loan commitments. The take-up of such offers is generally at modest levels.*
3 *First lien residential mortgages include Hong Kong Government Home Ownership Scheme loans of US$3.2bn at 30 June 2012 (30 June 2011: US$3.4bn; 31 December 2011: US$3.3bn).*
4 *Other personal loans and advances include second lien mortgages and other property-related lending.*
5 *Other commercial loans and advances include advances in respect of agriculture, transport, energy and utilities.*
6 *Included within Total gross loans and advances to customers (TGLAC) is credit card lending of US$29.1bn (30 June 2011: US$59.1bn; 31 December 2011: US$29.5bn).*
7 *During 2011 the Group adopted a more stringent treatment for the presentation of impaired loans for geographical regions with significant levels of forbearance. As a result loans and advances have been classified as impaired that under the previous disclosure convention would otherwise have been classified as neither past due nor impaired or past due but not impaired. The comparative balances for 30 June 2011 were restated to comply with the revised disclosure convention (see page 133 of the Annual Report and Accounts 2011 for further details).*
8 *The impairment allowances on loans and advances to banks at 30 June 2012 relate to the geographical regions, Europe and Middle East and North Africa (30 June 2011 and 31 December 2011: Europe, Middle East and North Africa and North America).*
9 *Our available-for-sale holdings in sovereign and agency debt of Italy and Spain include debt held to support insurance contracts which provide discretionary profit participation to policyholders. For such contracts, unrealised movements in liabilities are recognised in other comprehensive income, following the treatment of the unrealised movements on related available-for-sale assets. To the extent that the movements are matched, no movement in the available-for-sale reserve is recognised. For those available-for-sale debt instruments described above that are not held to support insurance contracts which provide discretionary profit participation to policyholders, the available-for-sale reserves at 30 June 2012 were insignificant.*
10 *In-country liabilities in Italy include liabilities issued under local law but booked outside the country.*
11 *The US includes residential mortgages of HSBC Bank USA and HSBC Finance. Other regions comprise Hong Kong, Rest of Asia-Pacific, Middle East and North Africa, and Latin America.*
12 *HSBC Finance lending is shown on a management basis and includes loans transferred to HSBC USA Inc. which are managed by HSBC Finance.*
13 *Negative equity arises when the value of the property used to secure a loan is below the balance outstanding on the loan, generally based on values at the balance sheet date.*
14 *Loan-to-value ratios are generally based on values at the balance sheet date.*
15 *Property acquired through foreclosure is initially recognised at the lower of the carrying amount of the loan or its fair value less estimated costs to sell (Initial Foreclosed Property Carrying Amount). The average loss on sale of foreclosed properties is calculated as the Initial Foreclosed Properties Carrying Amount less cash proceeds divided by the unpaid loan principal balance prior to write-down (excluding any accrued finance income) plus certain other ancillary disbursements that, by law, are reimbursable from the cash proceeds (e.g. real estate tax advances) and were incurred prior to our taking title to the property. This ratio represents the portion of our total loss on foreclosed properties that occurred after we took title to the property. The comparative data for 30 June 2011 are restated (previously divided by the Initial Foreclosed Property Carrying Amount).*
16 *The average total loss on foreclosed properties includes both the loss on sale of the foreclosed property as discussed in footnote 15 and the cumulative write-downs recognised on the loans up to the time we took title to the property. This calculation of the average total loss on foreclosed properties uses the unpaid loan principal balance prior to write-down (excluding any accrued finance income) plus certain other ancillary disbursements that, by law, are reimbursable from the cash proceeds (e.g. real estate tax advances) and were incurred prior to our taking title to the property.*
17 *Percentages are expressed as a function of the relevant gross loans and receivables balance.*
18 *Impairment allowances are not reported for financial instruments whereby the carrying amount is reduced directly for impairment and not through the use of an allowance account.*
19 *Impairment is not measured for assets held in trading portfolios or designated at fair value as assets in such portfolios are managed according to movements in fair value, and the fair value movement is taken directly to the income statement. Consequently, we report all such balances under Neither past due nor impaired .*
20 *Loans and advances to customers include asset-backed securities that have been externally rated as strong (30 June 2012: US$3.5bn; 30 June 2011: US$4.1bn; 31 December 2011: US$3.5bn), good (30 June 2012: US$564m; 30 June 2011: US$748m; 31 December 2011: US$476m), satisfactory (30 June 2012: US$205m; 30 June 2011: US$227m; 31 December 2011: US$428m), sub-standard (30 June 2012: US$649m; 30 June 2011: US$480m; 31 December*

2011: US$556m) and impaired (30 June 2012: US$227m; 30 June 2011: US$49m; 31 December 2011: US$229m).

21 *Included in this category are loans of US$2.5bn (30 June 2011: US$3.3bn; 31 December 2011: US$2.9bn) that have been re-aged once and were less than 60 days past due at the point of re-age. These loans are not classified as impaired following re-age due to the overall expectation that these customers will perform on the original contractual terms of their borrowing in the future.*

22 *Impaired loans and advances are those classified as CRR 9, CRR 10, EL 9 or EL 10, retail loans 90 days or more past due, unless individually they have been assessed as not impaired (see page 142, Past due but not impaired gross financial instruments) and renegotiated loans and advances meeting the criteria to be disclosed as impaired (see page 146).*

23 *Collectively assessed loans and advances comprise homogeneous groups of loans that are not considered individually significant, and loans subject to individual assessment where no impairment has been identified on an individual basis, but on which a collective impairment allowance has been calculated to reflect losses which have been incurred but not yet identified.*

24 *Collectively assessed loans and advances not impaired are those classified as CRR1 to CRR8 and EL1 to EL8 but excluding retail loans 90 days past due and renegotiated loans and advances meeting the criteria to be disclosed as impaired.*

25 *Included within Exchange and other movements is US$1.6bn of impairment allowances reclassified to held for sale.*

26 *Net of repo transactions, settlement accounts and stock borrowings.*

27 *As a percentage of loans and advances to banks and loans and advances to customers, as applicable.*

28 *Carrying amount of the net principal exposure.*

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29 *Total includes holdings of ABSs issued by The Federal Home Loan Mortgage Corporation (Freddie Mac) and The Federal National Mortgage Association (Fannie Mae).*
30 *Directly held includes assets held by Solitaire where we provide first loss protection and assets held directly by the Group.*
31 *Impairment charges allocated to capital note holders represent impairments where losses would be borne by external third-party investors in the structures.*
32 *The gross principal is the redemption amount on maturity or, in the case of an amortising instrument, the sum of the future redemption amounts through the residual life of the security.*
33 *A credit default swap (CDS) gross protection is the gross principal of the underlying instrument that is protected by CDSs.*
34 *Net principal exposure is the gross principal amount of assets that are not protected by CDSs. It includes assets that benefit from monoline protection, except where this protection is purchased with a CDS.*
35 *Net exposure after legal netting and any other relevant credit mitigation prior to deduction of the credit risk adjustment.*
36 *Cumulative fair value adjustment recorded against exposures to OTC derivative counterparties to reflect their creditworthiness.*
37 *Funded exposures represent the loan amount advanced to the customer, less any fair value write-downs, net of fees held on deposit.*
38 *Unfunded exposures represent the contractually committed loan facility amount not yet drawn down by the customer, less any fair value write-downs, net of fees held on deposit.*

Liquidity and funding

39 *The most favourable metrics are a smaller advances to core funding and a larger stressed one month coverage ratio.*
40 *The HSBC UK entity shown comprises three legal entities; HSBC Bank plc (including all overseas branches), Marks and Spencer Financial Services Limited and HSBC Trust Company (UK) Limited, managed as a single operating entity, in line with the application of UK liquidity regulation as agreed with the UK FSA.*
41 *The Hongkong and Shanghai Banking Corporation represents the bank in Hong Kong including all overseas branches. Each branch is monitored and controlled for liquidity and funding risk purposes as a stand-alone operating entity.*
42 *The HSBC USA principal entity shown represents the HSBC USA Inc consolidated group; predominantly HSBC USA Inc and HSBC Bank USA, NA. The HSBC USA Inc consolidated group is managed as a single operating entity.*
43 *The total shown for other principal HSBC operating entities represents the combined position of all the other operating entities overseen directly by the Risk Management Meeting of the GMB.*
44 *Unused committed sources of secured funding for which eligible assets were held.*
45 *Estimated liquidity value represents the expected realisable value of assets prior to management assumed haircuts.*
46 *HSBC-managed asset exposures related to consolidated securities investment conduits, primarily Solitaire and Mazarin (see page 255). These vehicles issue debt secured by ABSs which are managed by HSBC. HSBC had a total contingent liquidity risk of US$20.0 of which Solitaire represented US$9.7bn already funded on-balance sheet at 30 June 2012 (30 June 2011: US$8.9bn; 31 December 2011: US$9.3bn) leaving a net contingent exposure of US$10.3bn (30 June 2011: US$14.3bn; 31 December 2011: US$12.8bn). At 30 June 2012, US$5.6bn (30 June 2011: US$7.0bn; 31 December 2011: US$6.2bn) of the net contingent liability was on the commercial paper issued by Mazarin and entirely held by HSBC.*
47 *Other conduit exposures relate to third-party sponsored conduits (see page 257).*
48 *The undrawn balance for the five largest committed liquidity facilities provided to customers other than facilities to conduits.*
49 *The undrawn balance for the total of all committed liquidity facilities provided to the largest market sector, other than facilities to conduits.*

Market risk

50 *The structural foreign exchange risk is monitored using sensitivity analysis (see page 171). The reporting of commodity risk is consolidated with foreign exchange risk. There is no commodity risk in the non-trading portfolios.*
51 *The interest rate risk on the fixed-rate securities issued by HSBC Holdings is not included in the Group VAR. The management of this risk is described on page 173.*
52 *The effect of any month-end adjustments not attributable to a specific daily market move is spread evenly over the days in the month in question.*
53 *Revenues within the daily distribution graph include all revenues booked in Global Markets (gross of brokerage fees), Balance Sheet Management, and the trading element of revenues booked in the GPB and RBWM businesses.*
54 *The standard deviation measures the variation of daily revenues about the mean value of those revenues.*
55 *Trading intent portfolios include positions arising from market-making and position taking.*
56

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

57 *The total VAR is non-additive across risk types due to diversification effects.*

58 *Investments in private equity are primarily made through managed funds that are subject to limits on the amount of investment. Potential new commitments are subject to risk appraisal to ensure that industry and geographical concentrations remain within acceptable levels for the portfolio as a whole. Regular reviews are performed to substantiate the valuation of the investments within the portfolio.*

59 *Investments held to facilitate ongoing business include holdings in government-sponsored enterprises and local stock exchanges.*

60 *Instead of assuming that all interest rates move together, we group our interest rate exposures into currency blocs whose rates are considered likely to move together.*

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Risk management of insurance operations

61 *HSBC has no insurance manufacturing subsidiaries in the Middle East and North Africa.*
62 *The decline in life insurance liabilities in North America reflects the classification of the majority of this business as held for sale at 30 June 2012. At 30 June 2012, the held-for-sale North American life insurance liabilities by contract type comprised credit life contracts (US$21m), annuities (US$731m) and term assurance and other long-term contracts (US$203m).*
63 *Insurance contracts and investment contracts with discretionary participation features (DPF) can give policyholders the contractual right to receive, as a supplement to their guaranteed benefits, additional benefits that may be a significant portion of the total contractual benefits, but whose amount and timing are determined by HSBC. These additional benefits are contractually based on the performance of a specified pool of contracts or assets, or the profit of the company issuing the contracts.*
64 *Although investment contracts with DPF are financial instruments, HSBC continues to account for them as insurance contracts as permitted by IFRS 4.*
65 *Net written insurance premiums represent gross written premiums less gross written premiums ceded to reinsurers.*
66 *Term assurance includes credit life insurance.*
67 *The Other assets column shows shareholder assets as well as assets and liabilities classified as held for sale. The majority of the assets for insurance businesses classified as held for sale are reported as Other assets and investment properties and totalled US$2.4bn at 30 June 2012 (31 December 2011: US$0.1bn; 30 June 2011: nil). Assets classified as held for sale consist primarily of debt securities. All liabilities for insurance businesses classified as held for sale are reported in Other liabilities and totalled US$1.6bn at 30 June 2012 (31 December 2011: US$0.1bn; 30 June 2011: nil). The majority of these liabilities were life and non-life policyholder liabilities.*
68 *Present value of in-force long-term insurance contracts and investment contracts with DPF.*
69 *Does not include associated insurance companies, Ping An, SABB Takaful Company or Bao Viet Holdings, or joint venture insurance companies, Hana Life and Canara HSBC Oriental Bank of Commerce Life Insurance Company Limited.*

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Appendix to Risk

Risk policies and practices

This appendix describes the significant policies and practices employed by HSBC in managing our credit risk, liquidity and funding, market risk, operational risk, legal risk, compliance risk, reputational risk and insurance risk.

Managing risk

HSBC s approach to risk is encapsulated within our risk appetite framework. The risk appetite statement is approved by the Board, which is advised by the Group Risk Committee. For further details of the activities of the Group Risk Committee see pages 233 to 238 of the *Annual Report and Accounts 2011*.

The framework is maintained at Group, regional and global business levels, operating through governance bodies, processes and metrics designed to assist in risk management. Risk appetite statements define, at various levels of the business, the qualitative and quantitative expressions of the risks which HSBC is prepared to embrace in alignment with its strategy and business plans. Quantitative and qualitative metrics are assigned to nine key categories: earnings, capital, liquidity and funding, securitisations, cost of risk, intra-group lending, strategic investments, risk categories, and risk diversification and concentration. Measurement against the metrics serves to:

- guide underlying business activity, ensuring it is aligned to risk appetite statements;
- determine risk-adjusted remuneration;
- enable the key underlying assumptions to be monitored and, where necessary, adjusted through subsequent business planning cycles; and
- promptly identify business decisions needed to mitigate risk.

Risk governance

Our strong risk governance reflects the importance placed by the Board on shaping the Group s risk strategy and managing risks effectively. It is supported by a clear policy framework of risk ownership, by the cascading from the Group Management Board (GMB) of balanced scorecards that align business and risk objectives, and by the accountability of all staff for identifying, assessing and managing risks within the scope of their assigned responsibilities. This personal accountability, reinforced by the governance structure, experience and mandatory learning, helps to foster a disciplined and constructive culture of risk management and control throughout HSBC.

During the period we continued to implement a new operating model for the global risk function. The new model has integrated Compliance within the Global Risk function, established risk roles for RBWM and CMB in alignment with other global businesses and broadened the responsibility of Global Security and Fraud Risk. The model enables the end-to-end management of risk in a consistent manner.

Scenario stress testing

We conduct a range of Group stress testing scenarios including, but not limited to, severe global economic downturn, country, sector and counterparty failures and a variety of projected major operational risk events. The outcomes of the stress scenarios are used to assess the potential impact on demand for regulatory capital against its supply. We also participate, where appropriate, in scenario analyses requested by regulatory bodies.

In addition to the suite of risk scenarios considered for the Group, each major HSBC subsidiary conducts regular economic and event-driven scenario analyses specific to its region.

Stress testing is also used by the market risk discipline to evaluate the potential impact on portfolio values of events or movements in a set of financial variables.

Credit risk

Credit risk management

The role of an independent credit control unit is fulfilled by Group Risk which is part of the Global Risk function. Credit approval authorities are delegated by the Board to certain executive officers of HSBC Holdings plc. Similar credit approval authorities are delegated by the boards of subsidiary companies to executive officers of the relevant subsidiaries. In each major subsidiary, a Chief Risk Officer reports to the local Chief Executive Officer on credit-

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related issues, while maintaining a direct functional reporting line to the Group Chief Risk Officer in Global Risk. Full details of the roles and responsibilities of the credit risk management function and the policies and procedures for managing credit risk are set out on page 189 of the *Annual Report and Accounts 2011*. There were no significant changes during the first half of 2012.

Principal objectives of our credit risk management

to maintain across HSBC a strong culture of responsible lending and a robust risk policy and control framework;

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

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

Concentration of exposure (page 113)

Concentrations of credit risk arise when a number of counterparties or exposures have comparable economic characteristics, or such counterparties are engaged in similar activities or operate in the same geographical areas or industry sectors, so that their collective ability to meet contractual obligations is uniformly affected by changes in economic, political or other conditions. We use a number of controls and measures to minimise undue concentration of exposure in our portfolios across industry, country and global businesses. These include portfolio and counterparty limits, approval and review controls, and stress testing.

Wrong-way risk is an aggravated form of concentration risk and arises when there is a strong correlation between the counterparty s probability of default and the mark-to-market value of the underlying transaction. We use a range of procedures to monitor and control wrong-way risk, including requiring entities to obtain prior approval before undertaking wrong-way risk transactions outside pre-agreed guidelines.

Credit quality of financial instruments (page 139)

The five credit quality classifications defined on page 191 of the *Annual Report and Accounts 2011* describe the credit quality of our lending, debt securities portfolios and derivatives. These classifications each encompass a range of more granular, internal credit rating grades assigned to wholesale and retail lending business, as well as the external ratings attributed by external agencies to debt securities.

There is no direct correlation between the internal and external ratings at the granular level, except to the extent each falls within a single quality classification.

Credit quality classification

	Debt securities and other bills	Wholesale lending and derivatives		Retail lending	
	External	Internal	Probability of	Internal	Expected

	credit rating	credit rating	default %	credit rating[1]	loss %
Quality classification					
Strong	**A and above**	**CRR1 to CRR2**	**0 0.169**	**EL1 to EL2**	**0 0.999**
Good	**BBB+ to BBB**	**CRR3**	**0.170 0.740**	**EL3**	**1.000 4.999**
Satisfactory	**BB+ to B+ and unrated**	**CRR4 to CRR5**	**0.741 4.914**	**EL4 to EL5**	**5.000 19.999**
Sub-standard	**B and below**	**CRR6 to CRR8**	**4.915 99.999**	**EL6 to EL8**	**20.000 99.999**
Impaired	**Impaired**	**CRR9 to CRR10**	**100**	**EL9 to EL10**	**100+ or defaulted[2]**

1 *We observe the disclosure convention that, in addition to those classified as EL9 to EL10, retail accounts classified EL1 to EL8 that are delinquent by 90 days or more are considered impaired, unless individually they have been assessed as not impaired (see page 143, Past due but not impaired gross financial instruments).*

2 *The expected loss (EL) percentage is derived through a combination of the probability of default (PD) and loss given default (LGD), and may exceed 100% in circumstances where the LGD is above 100% reflecting the cost of recoveries.*

Renegotiated loans and forbearance (page 143)

A range of forbearance strategies are employed in order to improve the management of customer relationships, maximise collection opportunities and, if possible, avoid default, foreclosure or repossession. They include extended payment terms, a reduction in interest or principal repayments, approved external debt management plans, debt consolidations, the deferral of foreclosures, and other forms of loan modifications and re-ageing.

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Interim Management Report (continued)

Our policies and practices are based on criteria which enable local management to judge whether repayment is likely to continue. These typically provide a customer with terms and conditions that are more favourable than those provided initially. Loan forbearance is only granted in situations where the customer has shown a willingness to repay the borrowing and is expected to be able to meet the revised obligations.

A summary of our current policies and procedures and practices regarding renegotiated loans and forbearance is provided on pages 192 to 194 in the *Annual Report and Accounts 2011*. There were no material changes to these policies procedures and practices in the half-year ended 30 June 2012.

Nature of HSBC s securitisation and other structured exposures (page 153)

Mortgage-backed securities (MBS s) are securities that represent interests in groups of mortgages and provide investors with the right to receive cash from future mortgage payments (interest and/or principal). An MBS which references mortgages with different risk profiles, is classified according to the highest risk class.

Collateralised debt obligations (CDO s) are securities backed by a pool of bonds, loans or other assets such as asset-backed securities (ABS s). CDOs may include exposure to sub-prime or Alt-A mortgage assets where these are part of the underlying assets or reference assets. As there is often uncertainty surrounding the precise nature of the underlying collateral supporting CDOs, all CDOs supported by residential mortgage-related assets are classified as sub-prime. Our holdings of ABSs and CDOs and direct lending positions, and the categories of mortgage collateral and lending activity, are described below.

Our exposure to non-residential mortgage-related ABSs and direct lending includes securities with collateral relating to commercial property mortgages, leveraged finance loans, student loans, and other assets, such as securities with other receivable-related collateral.

Categories of ABSs and CDOs	Definition	Classification
Sub-prime	Loans to customers who have limited credit histories, modest incomes or high debt-to-income ratios or have experienced credit problems caused by occasional delinquencies, prior charge-offs, bankruptcy or other credit-related actions.	For US mortgages, a FICO score of 620 or less has primarily been used to determine whether a loan is sub-prime; for non-US mortgages, management judgement is used.
US Home Equity Lines of Credit (HELoC s)	A form of revolving credit facility provided to customers, which is supported in the majority of circumstances by a second lien or lower ranking charge over residential property.	Holdings of HELoCs are classified as sub-prime.
US Alt-A	Lower risk loans than sub-prime, but they share higher risk characteristics than lending under fully conforming standard criteria.	

		US credit scores and the completeness of documentation held (such as proof of income), are considered when determining whether an Alt-A classification is appropriate. Non sub-prime mortgages in the US are classified as Alt-A if they are not eligible for sale to the major US Government mortgage agencies or sponsored entities.
US Government agency and sponsored enterprises mortgage-related assets	Securities that are guaranteed by US Government agencies such as the Government National Mortgage Association (Ginnie Mae), or by US Government sponsored entities including Fannie Mae and Freddie Mac.	Holdings of US Government agency and US Government sponsored enterprises mortgage-related assets are classified as prime exposures.
UK non-conforming mortgages	UK mortgages that do not meet normal lending criteria. Examples include mortgages where the expected level of documentation is not provided (such as income with self-certification), or where poor credit history increases risk and results in pricing at a higher than normal lending rate.	UK non-conforming mortgages are treated as sub-prime exposures.
Other mortgages	Residential mortgages, including prime mortgages, that do not meet any of the classifications described above.	Prime residential mortgage-related assets are included in this category.

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Impairment methodologies (page 155)

For available-for-sale ABSs, to identify objective evidence of impairment, an industry standard valuation model is normally applied which uses data with reference to the underlying asset pools and models their projected future cash flows. The estimated future cash flows of the securities are assessed at the specific financial asset level to determine whether any of them are unlikely to be recovered as a result of loss events occurring on or before the reporting date.

The principal assumptions and inputs to the models are typically the delinquency status of the underlying loans, the probability of delinquent loans progressing to default, the prepayment profiles of the underlying assets and the loss severity in the event of default. However, the models utilise other variables relevant to specific classes of collateral to forecast future defaults and recovery rates. Management uses externally available data and applies judgement when determining the appropriate assumptions in respect of these factors. We use a modelling approach which incorporates historically observed progression rates to default, to determine if the decline in aggregate projected cash flows from the underlying collateral will lead to a shortfall in contractual cash flows. In such cases the security is considered to be impaired.

In respect of CDOs, expected future cash flows for the underlying collateral are assessed to determine whether there is likely to be a shortfall in the contractual cash flows of the CDO.

When a security benefits from a contract provided by a monoline insurer that insures payments of principal and interest, the expected recovery on the contract is assessed in determining the total expected credit support available to the ABS.

Liquidity and funding (page 162)

The management of liquidity and funding is primarily undertaken locally (by country) in our operating entities in compliance with the Group s liquidity and funding risk framework (the framework), and with practices and limits set by the GMB through the Risk Management Meeting and approved by the Board. These limits vary according to the depth and the liquidity of the markets in which the entities operate. Our general policy is that each defined operating entity should be self-sufficient in funding its own activities. Where transactions exist between operating entities, they are reflected symmetrically in both entities.

As part of our Asset, Liability and Capital Management (ALCM) structure, we have established Asset and Liability Management Committees (ALCO s) at Group level, in the regions and in operating entities. The terms of reference of all ALCOs include the monitoring and control of liquidity and funding.

The primary responsibility for managing liquidity and funding within the Group s framework and risk appetite resides with the local operating entity ALCO. Our most significant operating entities are overseen by regional ALCOs, Group ALCO and the Risk Management Meeting. The remaining smaller operating entities are overseen by regional ALCOs, with appropriate escalation of significant issues to Group ALCO and the Risk Management Meeting.

Operating entities are predominately defined on a country basis to reflect our local management of liquidity and funding. Typically, an operating entity will be defined as a single legal entity. However, to take account of the situation where operations in a country are booked across multiple subsidiaries or branches:

- an operating entity may be defined as a wider sub-consolidated group of legal entities if it is incorporated in the same country, liquidity and funding are freely fungible between the entities and permitted by local regulation, and it reflects how liquidity and funding are managed locally; or

- an operating entity may be defined more narrowly as a principal office (branch) of a wider legal entity operating in multiple countries, reflecting the local country management of liquidity and funding.

The list of entities it directly oversees and the composition of these entities is reviewed and agreed annually by the Risk Management Meeting.

Primary sources of funding (page 162)

Customer deposits in the form of 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 depositor confidence in our capital strength and liquidity, and on competitive and transparent pricing.

We also access professional markets in order to obtain 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 professional markets. In aggregate, our banking entities are liquidity providers to the unsecured interbank market, placing more funds with other banks than they borrow. However, as a consequence of our credit risk appetite and liquidity policy, the extent of these types of placements is reducing.

The management of funding and liquidity risk (page 163)

Inherent liquidity risk categorisation

We place our operating entities into one of three categories (low, medium and high) to reflect our assessment of their inherent liquidity risk, considering political, economic and regulatory factors within the host country, and also factors specific to the operating entities themselves, such as the local market, market share, balance sheet strength and the control framework. The categorisation involves management judgement and is based on the perceived liquidity risk of an operating entity relative to other entities in the Group. The categorisation is intended to reflect the possible impact of a liquidity event, not the probability of an event. The categorisation is used to determine the prescribed stress scenario that we require our operating entities to be able to withstand, and to manage to.

Core deposits

A key assumption of our internal framework is the categorisation of customer deposits into core and non-core based on our expectation of the behaviour of these deposits during a liquidity stress. This characterisation takes into account the inherent liquidity risk categorisation of the operating entity originating the deposit, the nature of the customer and the size and pricing of the deposit. No deposit is considered to be core in its entirety unless it is contractually collateralising a loan. The core deposit base in each operating entity is considered to be a long-term source of funding and therefore is assumed not to be withdrawn in the liquidity stress scenario that we use to calculate our principal liquidity risk metrics.

The three filters considered in assessing whether a deposit in any operating entity is core are:

- price: any deposit priced significantly above market or benchmark rates is generally treated as entirely non-core;

- size: depositors with total funds above certain monetary thresholds are excluded. Thresholds are established by considering the business line and inherent liquidity risk categorisation; and

- line of business: the element of any deposit remaining after the application of the price and size filters is assessed on the basis of the line of business to which the deposit is associated. The proportion of any customer deposit that can be considered core under this filter is between 35% and 90%.

Repo transactions and bank deposits cannot be categorised as core deposits.

Advances to core funding ratio

Core customer deposits are an important source of funding to finance lending to customers, and discourage reliance on short-term professional funding. Limits are placed on operating entities to restrict their ability to increase loans and advances to customers without corresponding growth in core customer deposits or long-term debt funding with a residual maturity beyond one year; this measure is referred to as the advances to core funding ratio.

Advances to core funding ratio limits are set by the Risk Management Meeting for the most significant operating entities, and by regional ALCOs for smaller operating entities, and are monitored by ALCM teams. The ratio describes current 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. In general, customer loans are assumed to be renewed and are included in the numerator of the advances to core funding ratio, irrespective of the contractual maturity date. Reverse repurchase arrangements are excluded from the advances to core funding ratio.

Stressed coverage ratios (page 164)

The stressed coverage ratios are derived from stressed cash flow scenario analysis and express the stressed cash inflows as a percentage of stressed cash outflows over one-month and three-month time horizons.

The stressed cash inflows include:

- inflows (net of assumed haircuts) expected to be generated from the realisation of liquid assets; and

- contractual cash inflows from maturing assets that are not already reflected as a utilisation of liquid assets.

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In line with the approach adopted for the advances to core funding ratio, customer loans are, in general, assumed not to generate any cash inflows under stress scenarios and are therefore excluded from the numerator of the stressed coverage ratios, irrespective of the contractual maturity date.

A stressed coverage ratio of 100% or higher reflects a positive cumulative cash flow under the stress scenario being monitored. Group operating entities are required to maintain a ratio of 100% or greater out to three months under the combined market-wide and HSBC-specific stress scenario defined by the inherent liquidity risk categorisation of the operating entity concerned.

Compliance with operating entity limits is monitored by ALCM teams and reported monthly to the Risk Management Meeting for the main operating entities and regional ALCOs for the smaller operating entities.

Stressed scenario analysis

We use a number of standard Group stress scenarios designed to model:

- combined market-wide and HSBC-specific liquidity crisis scenarios; and
- market-wide liquidity crisis scenarios.

These scenarios are modelled by all operating entities. The appropriateness of the assumptions for each scenario is reviewed by ALCM monthly and formally approved by the Risk Management Meeting and the Board annually as part of the liquidity and funding risk appetite approval process.

Stressed cash outflows are determined by applying a standard set of prescribed stress assumptions to the Group s cash flow model. Our framework prescribes the use of two market-wide scenarios and three further combined market-wide and HSBC-specific stress scenarios of increasing severity. In addition to our standard stress scenarios, individual operating entities are required to design their own scenarios to reflect specific local market conditions, products and funding bases.

The three combined market-wide and HSBC-specific scenarios model a more severe scenario than the two market-wide scenarios. The relevant combined market-wide and HSBC-specific stress scenario that an operating entity manages to is based upon its inherent liquidity risk categorisation. The key assumptions factored into the three combined market-wide and HSBC-specific stress scenarios are summarised as follows:

- all non-core deposits are deemed to be withdrawn within three months (80% within one month), with the level of non-core deposits dependent on the operating entity s inherent liquidity risk categorisation;
- the ability to access interbank funding and unsecured term debt markets ceases for the duration of the scenario;

the ability to generate funds from illiquid asset portfolios (securitisation and secured borrowing) is restricted to 25-75% of the lower of issues in the last six months or the expected issues in the next six months. The restriction is based on current market conditions and dependent on the operating entity s inherent liquidity risk categorisation;

the ability to access repo funding ceases for any asset not classified as liquid under our liquid asset policy for the duration of the scenario;

drawdowns on committed lending facilities must be consistent with the severity of the market stress being modelled and dependent on the inherent liquidity risk categorisation of the operating entity;

outflows are triggered by a defined downgrade in long-term ratings. We maintain an on-going assessment of the appropriate number of notches to reflect;

customer loans are assumed to be renewed at contractual maturity;

interbank loans and reverse repos are assumed to run off contractually; and

assets defined as liquid assets are assumed to be realised in cash ahead of their contractual maturity, after applying a defined stressed haircut of up to 20%.

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Liquid assets of HSBC s principal operating entities (page 165)

Stressed scenario analysis and the numerator of the coverage ratio include the assumed cash inflows that would be generated from the realisation of liquid assets, after applying the appropriate stressed haircut. These assumptions are made based on management s expectation of when an asset is deemed to be realisable.

Liquid assets are unencumbered assets that meet the Group s definition of liquid assets and are either held outright or as a consequence of a reverse repo transaction with a residual contractual maturity beyond the time horizon of the stressed coverage ratio being monitored. Any unencumbered asset held as a result of reverse repo transactions with a contractual maturity within the time horizon of the stressed coverage ratio being monitored is excluded from the stock of liquid assets and instead reflected as a contractual cash inflow.

Our framework defines the asset classes that can be assessed locally as high quality and realisable within one month and between one month and three months. Each local ALCO has to be satisfied that any asset which may be treated as liquid in accordance with the Group s liquid asset policy will remain liquid under the stress scenario being managed to.

Inflows from the utilisation of liquid assets within one month can generally only be based on confirmed withdrawable central bank deposits, gold or the sale or repo of government and quasi-government exposures generally restricted to those denominated in the sovereign s domestic currency. High quality ABSs (predominantly US MBSs) and covered bonds are also included but inflows assumed for these assets are capped.

Inflows after one month are also reflected for high quality non-financial and non-structured corporate bonds and equities within the most liquid indices.

Internal categorisation	Cash inflow recognised	Asset classes
Level 1	Within one month	Central government
		Central bank (including confirmed withdrawable reserves)
		Supranationals
		Multilateral development banks
Level 2	Within one month but capped	Local and regional government
		Public sector entities
		Secured covered bonds and pass-through ABSs
		Gold

Level 3	From one to three months	Unsecured non-financial entity securities Equities listed on recognised exchanges and within liquid indices

Any entity owned and controlled by central or local/regional government but not explicitly guaranteed is treated as a public sector entity.

Other assets assessed as saleable ahead of the contractual maturity date

If an operating entity considers that it has other negotiable assets that could be sold ahead of their contractual maturity during the stress scenario applied by that entity, it can request a dispensation to recognise an inflow under Other in relation to these assets.

Wholesale debt monitoring

Where wholesale debt-term markets are accessed to raise funding, ALCO is required to establish cumulative rolling three-month and twelve-month debt maturity limits to ensure no unacceptable concentration of maturities within these timeframes.

Liquidity behaviouralisation

Liquidity behaviouralisation is applied to reflect our assessment of the expected period for which we are confident that we will have access to our liabilities, even under a severe liquidity stress scenario, and the expected period for which we must assume that we will need to fund our assets. Behaviouralisation is applied when the contractual terms do not reflect the expected behaviour. Liquidity behaviouralisation is reviewed and approved by local ALCO in compliance with policies set by the Risk Management Meeting. Our approach to liquidity risk management will often mean a different approach is applied to assets and liabilities. For example, management may assume a shorter life for liabilities and a longer term funding requirement for assets.

Interim Management Report (continued)

Contingent liquidity risk (page 166)

Operating entities provide customers with committed facilities and committed backstop lines to the conduit vehicles we sponsor. These facilities increase our funding requirements when customers drawdown. The liquidity risk associated with the potential drawdown on non-cancellable committed facilities is factored into our stressed scenarios and limits are set for these facilities.

Management of cross-currency liquidity and funding risk

Our liquidity and funding risk framework also considers the ability of each entity to continue to access foreign exchange markets under stress when a surplus in one currency is used to meet a deficit in another currency, for example, by the use of the foreign currency swap markets. Where appropriate, operating entities are required to monitor stressed coverage ratios and advances to core funding ratios for non-local currencies.

Market risk (page 168)

Monitoring and limiting market risk exposures

The management of market risk is principally undertaken in Global Markets using risk limits approved by the GMB. Limits are set for portfolios, products and risk types, with market liquidity being a primary factor in determining the level of limits set. Group Risk, an independent unit within Group Head Office, is responsible for our market risk management policies and measurement techniques. Each major operating entity has an independent market risk management and control function which is responsible for measuring market risk exposures in accordance with the policies defined by Group Risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis.

Each operating entity is required to assess the market risks arising on each product in its business and to transfer them to either its local Global Markets unit for management, or to separate books managed under the supervision of the local ALCO. Our aim is to ensure that all market risks are consolidated within operations that have the necessary skills, tools, management and governance to manage them professionally. In certain cases where the market risks cannot be fully transferred, we use simulation modelling to identify the impact of varying scenarios on valuations and net interest income.

We employ a range of tools to monitor and limit market risk exposures. These include sensitivity analysis, value at risk (VAR) and stress testing.

Sensitivity analysis (page 171)

We use sensitivity measures to monitor the market risk positions within each risk type, for example, the present value of a basis point movement in interest rates for interest rate risk. Sensitivity limits are set for portfolios, products and risk types, with the depth of the market being one of the principal factors in determining the level of limits set.

Value at risk (page 168)

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

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

Our historical simulation models assess potential market movements with reference to data from the past two years and calculate VAR to a 99% confidence level and for a one-day holding period.

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.

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Although a valuable guide to risk, VAR should always be viewed in the context of its limitations. For example:

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a one-day holding period assumes that all positions can be liquidated or the risks offset in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a one-day holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99% confidence level, by definition, does not take into account losses that might occur beyond this level of confidence;
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures; and
- VAR is unlikely to reflect loss potential on exposures that only arise under significant market moves.

Stress testing

In recognition of the limitations of VAR, we augment it with stress testing to evaluate the potential impact on portfolio values of more extreme, although plausible, events or movements in a set of financial variables.

The process is governed by the Stress Testing Review Group forum which, in conjunction with regional risk managers, determines the scenarios to be applied at portfolio and consolidated levels, as follows:

- sensitivity scenarios consider the impact of any single risk factor or set of factors that are unlikely to be captured within the VAR models, such as the break of a currency peg;
- technical scenarios consider the largest move in each risk factor without consideration of any underlying market correlation;
- hypothetical scenarios consider potential macroeconomic events, for example, a global flu pandemic; and
- historical scenarios incorporate historical observations of market movements during previous periods of stress which would not be captured within VAR.

Stress testing results provide senior management with an assessment of the financial effect such events would have on our profit.

Trading portfolios (page 170)

Our control of market risk in the trading portfolios is based on a policy of restricting individual operations to trading within a list of permissible instruments authorised for each site by Group Risk, of enforcing rigorous new product approval procedures, and of restricting trading in the more complex derivative products only to offices with appropriate levels of product expertise and robust control systems.

Credit spread risk

The risk associated with movements in credit spreads is primarily managed through sensitivity limits, stress testing and VAR.

Credit spread risk also arises on credit derivative transactions entered into by Global Banking in order to manage the risk concentrations within the corporate loan portfolio and so enhance capital efficiency. The mark-to-market of these transactions is reflected in the income statement.

Gap risk

Even for transactions that are structured to render the risk to HSBC negligible under a wide range of market conditions or events, there exists a remote possibility that a gap event could lead to loss. A gap event could arise from a significant change in market price with no accompanying trading opportunity, with the result that the threshold is breached beyond which the risk profile changes from no risk to full exposure to the underlying structure. Such movements may occur, for example, when, in reaction to an adverse event or unexpected news announcement, the market for a specific investment becomes illiquid, making hedging impossible.

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Given their characteristics, these transactions make little or no contribution to VAR or to traditional market risk sensitivity measures. We capture their risks within our stress testing scenarios and monitor gap risk on an ongoing basis. We regularly consider the probability of gap loss, and fair value adjustments are booked against this risk.

ABS/MBS positions

The ABS/MBS exposures within the trading portfolios are managed within sensitivity and VAR limits discussed above, and are included within the stress testing scenarios described above.

Non-trading portfolios (page 170)

The principal objective of market risk management of non-trading portfolios is to optimise net interest income.

Interest rate risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on embedded optionality within certain product areas such as the incidence of mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts.

Our control of market risk in the non-trading portfolios is based on transferring the risks to the books managed by Global Markets or the local ALCO. The net exposure is typically managed through the use of interest rate swaps within agreed limits. The VAR for these portfolios is included within the Group VAR.

Credit spread risk

The risk associated with movements in credit spreads is primarily managed through sensitivity limits, stress testing, and VAR for those portfolios where VAR is calculated. The VAR shows the effect on income from a one-day movement in credit spreads over a two-year period, calculated to a 99% confidence interval.

Structural foreign exchange exposures (page 171)

Structural foreign exchange exposures represent net investments in subsidiaries, branches and associates, the functional currencies of which are currencies other than the US dollar. An entity s functional currency is that of the primary economic environment in which the entity operates.

Exchange differences on structural exposures are recognised in other comprehensive income. We use the US dollar as our presentation currency in our consolidated financial statements because the US dollar and currencies linked to it form the major currency bloc in which we transact and fund our business. Our consolidated balance sheet is, therefore, affected by exchange differences between the US dollar and all the non-US dollar functional currencies of underlying subsidiaries.

We hedge structural foreign exchange exposures only in limited circumstances. Our structural foreign exchange exposures are managed with the primary objective of ensuring, where practical, that our consolidated capital ratios and the capital ratios of individual banking subsidiaries are largely protected from the effect of changes in exchange rates. This is usually achieved by ensuring that, for each subsidiary bank, the ratio of structural exposures in a given currency to risk-weighted assets denominated in that currency is broadly equal to the capital ratio of the subsidiary in question.

We may also transact hedges where a currency in which we have structural exposures is considered to be significantly overvalued and it is possible in practice to transact a hedge. Any hedging is undertaken using forward foreign exchange contracts which are accounted for under IFRSs as hedges of a net investment in a foreign operation, or by financing with borrowings in the same currencies as the functional currencies involved.

Sensitivity of net interest income (page 171)

A principal part of our management of market risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). We aim, through our management of market risk in non-trading portfolios, to mitigate the effect of prospective interest rate movements which could reduce future net interest income, while balancing the cost of such hedging activities on the current net revenue stream.

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For simulation modelling, entities apply a combination of scenarios and assumptions relevant to their local businesses and markets as well as standard scenarios which are required throughout HSBC. The latter are consolidated to illustrate the combined pro forma effect on our consolidated portfolio valuations and net interest income.

Projected net interest income sensitivity figures represent the effect of the pro forma movements in net interest income based on the projected yield curve scenarios and the Group s current interest rate risk profile. This effect, however, does not incorporate actions which would probably be taken by Balance Sheet Management or in the business units to mitigate the effect of interest rate risk. In practice, Balance Sheet Management seeks proactively to change the interest rate risk profile to minimise losses and optimise net revenues. The projections also assume that interest rates of all maturities move by the same amount (although rates are not assumed to become negative in the falling rates scenario) and, therefore, do not reflect the potential impact of non-parallel changes in the yield curve on net interest income. In addition, the projections take account of the effect on net interest income of anticipated differences in changes between interbank interest rates and interest rates linked to other bases (such as Central Bank rates or product rates over which the entity has discretion in terms of the timing and extent of rate changes). The projections make other simplifying assumptions, including that all positions run to maturity.

Projecting the movement in net interest income from prospective changes in interest rates is a complex interaction of structural and managed exposures. Our exposure to the effect of movements in interest rates on our net interest income arises from margin changes on savings and demand deposit accounts as well as Balance Sheet Management portfolios:

The net interest income of savings and demand deposit accounts increases as interest rates rise and decreases as interest rates fall. However, this risk is asymmetrical in a very low interest rate environment as there is limited room to lower deposit pricing in the event of interest rate reductions.

Residual interest rate risk is transferred from the commercial bank to Balance Sheet Management under our policy where interest rate risk is managed within defined limits.

The sensitivity analysis reflects the fact that our deposit-taking businesses generally benefit from rising rates which are partially offset by increased funding costs in Balance Sheet Management given our simplifying assumption of unchanged Balance Sheet Management positioning. The benefit to deposit-taking businesses of rising rates is also offset by the increased funding cost of trading assets, which is recorded in Net interest income and therefore captured in the sensitivity analysis, whereas the income from such assets is recorded in Net trading income .

Defined benefit pension schemes (page 172)

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. Pension scheme obligations fluctuate with changes in long-term interest rates, inflation, salary levels and the longevity of scheme members. Pension scheme assets include equities and debt securities, the cash flows of which change as equity prices and interest rates vary. There is a risk that market movements in equity prices and interest rates could result in asset values which, taken together with regular ongoing contributions, are insufficient over time to cover the level of projected obligations and these, in turn, could increase with a rise in inflation and members living longer. Management, together with the trustees who act on behalf of the pension scheme beneficiaries, assess these risks using reports prepared by independent external actuaries, take action and, where appropriate, adjust investment strategies and contribution levels accordingly.

Operational risk (page 174)

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

A formal governance structure provides oversight over the management of operational risk. A Global Operational Risk and Control Committee, which reports to the Risk Management Meeting, meets at least quarterly to discuss key risk issues and review the effective implementation of our operational risk management framework.

In each of our subsidiaries, business managers are responsible for maintaining an acceptable level of internal control, commensurate with the scale and nature of operations. They are responsible for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The operational risk management framework helps managers to fulfil these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational loss data.

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Interim Management Report (continued)

A centralised database is used to record the results of the operational risk management process. Operational risk self-assessments are input and maintained by business units. To ensure that operational risk losses are consistently reported and monitored at Group level, all Group companies are required to report individual losses when the net loss is expected to exceed US$10,000.

Further details of HSBC s approach to operational risk management may be found in the *Annual Report and Accounts 2011*, supplemented by the *Capital and Risk Management Pillar 3 Disclosures at 31 December 2011*.

Global security and fraud risk

Security and fraud risk issues are managed at Group level by Global Security and Fraud Risk. This unit, which has responsibility for physical risk, fraud, information and contingency risk, and geopolitical risk and business intelligence is fully integrated within the central Group Risk function. This enables management to identify and mitigate the permutations of these and other non-financial risks to its business lines across the jurisdictions in which we operate.

Legal risk

Each operating company is required to have processes and procedures in place to manage legal risk that conform to our standards.

Legal risk falls within the definition of operational risk and includes:

- contractual risk, which is the risk that the rights and/or obligations of an HSBC company within a contractual relationship are defective;
- dispute risk, which is made up of the risks that an HSBC company is subject to when it is involved in or managing a potential or actual dispute;
- legislative risk, which is the risk that an HSBC company fails to adhere to the laws of the jurisdictions in which it operates; and
- non-contractual rights risk, which is the risk that an HSBC company s assets are not properly owned or are infringed by others, or an HSBC company infringes another party s rights.

We have a global legal function to assist management in controlling legal risk. There are legal departments in 58 of the countries in which we operate. There are also regional legal functions in each of Europe, North America, Latin America, the Middle East and North Africa and Asia-Pacific headed by Regional General Counsels as well as General Counsels responsible for each of the global businesses.

Compliance risk (page 174)

Compliance risk falls within the definition of operational risk. All Group companies are required to observe the letter and spirit of all relevant laws, codes, rules, regulations and standards of good market practice. These rules, regulations, other standards and Group policies include those relating to anti-money laundering, anti-bribery and corruption, conduct of business, counter terrorist financing and sanctions compliance.

The Group Compliance Function is a control function, working as part of our Global Risk Function. It is responsible for resourcing decisions, performance reviews, objectives, strategy, budget and accountability within the Compliance Function and is empowered to set standards and has the authority to ensure those standards are met. The Group Compliance department oversees the global compliance function and is headed by the Head of Group Compliance who reports to the Group Chief Risk Officer. There are compliance teams in all of the countries where we operate and in all global businesses lines. These compliance teams are principally overseen by Regional Compliance Officers located in Europe, the US, Canada, Latin America, the Middle East and North Africa and Asia-Pacific and each business line is supported by a Global Business Compliance Officer. We have also established an Assurance team within Compliance that reviews the effectiveness of the Regional and Global Business Compliance Officers.

Group Compliance policies and procedures require the prompt identification and escalation to Group Compliance of all actual or suspected breaches of any law, rule, regulation, Group policy or other relevant requirement. These escalation procedures are supplemented by a requirement for the submission of compliance certificates at the half-year and year-end by all Group companies detailing any known breaches as above. The contents of these escalation and certification processes are used for reporting to the Risk Management Meeting, the Group Risk Committee and the Board and disclosure in the *Annual Report and Accounts* and *Interim Report*, if appropriate.

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Interim Management Report (continued)

Reputational risk (page 175)

Reputational risks can arise from a wide variety of causes and as a banking group, our good reputation depends not only upon the way in which we conduct our business, but it can also be affected by the way in which our clients conduct themselves.

A Group Reputational Risk Policy Committee (GRRPC) has been established to bring focus to activities that could attract reputational risk. The primary role of the GRRPC is to consider areas and activities presenting significant reputational risk and, where appropriate, to make recommendations to the Risk Management Meeting, the Group Standards Steering Committee and the GMB for policy or procedural changes to mitigate such risk. Reputational Risk Policy Committees have also been established in each of our geographical regions. These committees ensure that reputational risks are considered at a regional as well as Group level. Minutes from the regional committees are tabled at GRRPC. A wider description of HSBC s management of reputational risk is provided on page 209 in the *Annual Report and Accounts 2011*.

Insurance risk (page 176)

Overview of insurance products

The main contracts we manufacture are listed below:

Life insurance business

- life insurance contracts with discretionary participation features (DPF);
- credit life insurance business;
- annuities;
- term assurance and critical illness policies;
- linked life insurance;
- investment contracts with DPF;

- unit-linked investment contracts; and

- other investment contracts (including pension contracts written in Hong Kong).

Non-life insurance business

Non-life insurance contracts include motor, fire and other damage to property, accident and health, repayment protection and commercial insurance.

The management of insurance risk

Life and non-life business insurance risks are controlled by high-level policies and procedures set centrally, taking into account where appropriate local market conditions and regulatory requirements. Formal underwriting, reinsurance and claims-handling procedures designed to ensure compliance with regulations are applied, supplemented with stress testing.

As well as exercising underwriting controls, we use reinsurance as a means of mitigating exposure to insurance risk, in particular to aggregations of catastrophe risk. When we manage our exposure to insurance risk through the use of third-party reinsurers, the associated revenue and manufacturing profit is ceded to them. Although reinsurance provides a means of managing insurance risk, such contracts expose us to credit risk, the risk of default by the reinsurer.

HSBC s management of insurance risk, including the risks relating to different life and non-life products, is described on page 204 in the *Annual Report and Accounts 2011*.

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Capital

Our objective in the management of Group capital is to maintain efficient levels of well diversified and varied forms of capital to support our business strategy and meet our regulatory requirements.

Capital management

Our approach to capital management is driven by our strategic and organisational requirements, taking into account the regulatory, economic and commercial environment in which we operate. It is our objective to maintain a strong capital base to support the risks inherent in our business and invest in accordance with our five filters framework, exceeding regulatory capital requirements at all times.

Capital measurement and allocation

The FSA supervises HSBC on a consolidated basis and therefore receives information on the capital adequacy of, and sets capital requirements for, the Group as a whole. Individual banking subsidiaries are directly regulated by their local banking supervisors, who set and monitor their capital adequacy requirements. We calculate capital at a Group level using the Basel II framework, as amended for CRD III, commonly known as Basel 2.5.

A summary of our policies and practices regarding capital management, measurement and allocation is provided in the Appendix to Capital on page 202.

Capital overview

In the first half of 2012, there were no material changes to our capital management policies.

Capital ratios

	At 30 Jun 2012 %	At 30 Jun 2011 %	At 31 Dec 2011 %
Core tier 1 ratio	**11.3**	10.8	10.1
Tier 1 ratio	**12.7**	12.2	11.5
Total capital ratio	**15.1**	14.9	14.1
Core tier 1 target range	**9.5 10.5**		

Eligibility requirements for non-equity instruments under Basel III rules are still to be clearly defined in the UK. We therefore refrained from issuing any such capital securities during the first half of 2012.

Risk-weighted assets

RWAs by risk type

	At 30 Jun 2012 US$m	At 30 Jun 2011 US$m	At 31 Dec 2011 US$m
Credit risk	**931,724**	947,525	958,189
Standardised approach	**389,142**	357,537	372,039
IRB foundation approach	**8,822**	5,848	8,549
IRB advanced approach	**533,760**	584,140	577,601
Counterparty credit risk	**49,535**	52,985	53,792
Internal models method	**9,819**	9,036	10,229
Mark-to-market method	**39,716**	43,949	43,563
Market risk	**54,281**	44,456	73,177
Operational risk	**124,356**	123,563	124,356
Total	**1,159,896**	1,168,529	1,209,514
Of which:			
Run-off portfolios	**170,023**	171,106	181,657
Legacy credit in GB&M	**47,730**	29,107	50,023
US CML and Other	**122,293**	141,999	131,634
Card and Retail Services[1]		52,684	52,080

For footnote, see page 201.

Market risk RWAs

	At 30 Jun 2012 US$m	At 31 Dec 2011 US$m
VAR	**8,201**	11,345
Stressed VAR	**11,466**	19,117
Incremental risk charge	**4,613**	5,249
Comprehensive risk measure	**5,354**	6,013
VAR and stressed VAR from CRD equivalent jurisdictions	**11,167**	12,957
FSA standard rules	**13,480**	18,496
	54,281	73,177

Market risk RWA comparatives in the above table were not available for June 2011, as Basel 2.5 was introduced on 31 December 2011. These new rules implemented stressed VAR and the comprehensive risk measure, which resulted in changes to our existing incremental risk charge methodology, and the requirement to treat trading book securitisations under FSA standard rules. The resulting effect was partially offset by additional diversification benefits from consolidation of our approved US model on a line-by-line basis rather than by aggregation.

HSBC HOLDINGS PLC

Interim Management Report (continued)

RWAs by global businesses

	At 30 Jun 2012 US$bn	At 30 Jun 2011 US$bn	At 31 Dec 2011 US$bn
Total	**1,159.9**	1,168.5	1,209.5
Retail Banking and Wealth Management	**298.7**	365.0	351.2
Commercial Banking	**397.8**	363.3	382.9
Global Banking and Markets	**412.9**	385.4	423.0
Global Private Banking	**21.8**	23.9	22.5
Other	**28.7**	30.9	29.9

RWAs reduced by US$50bn to US$1,160bn in the first half of 2012, due to movements in credit risk and market risk. The US$26bn decrease in credit risk RWAs was primarily attributable to the sale of the US Card and Retail Services business in North America, which was completed in May 2012, reducing RWAs in RBWM by US$39bn. In addition, we have continued to manage down the residual balances in the US CML and other portfolios by a further US$9bn of RWAs. Growth in Rest of Asia-Pacific provided an offsetting increase in credit risk RWAs of US$24bn. This was primarily attributable to loan growth in our mainland China

RWAs by geographical regions[2]

	At 30 Jun 2012 US$bn	At 30 Jun 2011 US$bn	At 31 Dec 2011 US$bn
Total	**1,159.9**	1,168.5	1,209.5
Europe	**329.5**	315.7	340.2
Hong Kong	**108.0**	110.8	105.7
Rest of Asia-Pacific	**303.2**	241.1	279.3
MENA	**63.0**	58.1	58.9
North America	**279.2**	335.8	337.3
Latin America	**99.8**	110.5	102.3

For footnote, see page 201.

associates, evenly split between CMB and GB&M. Growth in corporate lending also increased GB&M RWAs in this region.

The decrease in market risk RWAs of US$19bn reflected a reduction in positions and the tightening of credit default swap spreads, reducing the stressed VAR and VAR components of market risk.

The decrease in counterparty credit risk RWAs of US$4bn was primarily driven by a reduction in mark-to-market of credit derivatives and an increased application of regulatory netting.

Movement in tier 1 capital in the first half of 2012

Source and application of tier 1 capital

	30 June 2012 US$m	Half-year to 30 June 2011 US$m	31 December 2011 US$m
Movement in tier 1 capital			
Opening core tier 1 capital	**122,496**	116,116	125,762
Contribution to core tier 1 capital from profit for the period	**10,011**	9,315	4,696
Consolidated profits attributable to shareholders of the parent company	**8,438**	9,215	7,582
Removal of own credit spread net of tax	**1,573**	100	(2,886)
Net dividends	**(3,447)**	(2,672)	(2,599)
Dividends	**(4,454)**	(4,006)	(3,495)
Add back: shares issued in lieu of dividends	**1,007**	1,334	896
(Increase)/decrease in goodwill and intangible assets deducted	**769**	(1,374)	1,956
Ordinary shares issued	**263**	13	83
Foreign currency translation differences	**(364)**	4,471	(7,176)
Other, including regulatory adjustments	**941**	(107)	(226)
Closing core tier 1 capital	**130,669**	125,762	122,496
Opening other tier 1 capital	**17,094**	17,063	17,351
Hybrid capital securities redeemed	**(776)**		
Other, including regulatory adjustments	**(53)**	288	(257)
Closing tier 1 capital	**146,934**	143,113	139,590

We complied with the FSA s capital adequacy requirements throughout 2011 and the first half of 2012. Internal capital generation contributed US$7bn to core tier 1 capital, being profits

attributable to shareholders of the parent company after regulatory adjustment for own credit spread and net of dividends.

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Interim Management Report (continued)

Capital structure

	At 30 June 2012 US$m	At 30 June 2011 US$m	At 31 December 2011 US$m
Composition of regulatory capital			
Tier 1 capital			
Shareholders equity	**160,606**	154,652	154,148
Shareholders equity per balance sheet[3]	**165,845**	160,250	158,725
Preference share premium	**(1,405)**	(1,405)	(1,405)
Other equity instruments	**(5,851)**	(5,851)	(5,851)
Deconsolidation of special purpose entities[4]	**2,017**	1,658	2,679
Non-controlling interests	**4,451**	3,871	3,963
Non-controlling interests per balance sheet	**7,921**	7,287	7,368
Preference share non-controlling interests	**(2,412)**	(2,445)	(2,412)
Non-controlling interests transferred to tier 2 capital	**(496)**	(507)	(496)
Non-controlling interests in deconsolidated subsidiaries	**(562)**	(464)	(497)
Regulatory adjustments to the accounting basis	**(3,308)**	888	(4,331)
Unrealised losses on available-for-sale debt securities[5]	**1,208**	3,290	2,228
Own credit spread	**(2,115)**	(773)	(3,608)
Defined benefit pension fund adjustment[6]	**(116)**	1,211	(368)
Reserves arising from revaluation of property and unrealised gains on available-for-sale equities	**(2,387)**	(3,085)	(2,678)
Cash flow hedging reserve	**102**	245	95
Deductions	**(31,080)**	(33,649)	(31,284)
Goodwill capitalised and intangible assets	**(26,650)**	(29,375)	(27,419)
50% of securitisation positions	**(1,364)**	(1,274)	(1,207)
50% of tax credit adjustment for expected losses	**145**	126	188
50% of excess of expected losses over impairment allowances	**(3,211)**	(3,126)	(2,846)
Core tier 1 capital	**130,669**	125,762	122,496
Other tier 1 capital before deductions	**17,110**	18,339	17,939
Preference share premium	**1,405**	1,405	1,405
Preference share non-controlling interests	**2,412**	2,445	2,412
Hybrid capital securities	**13,293**	14,489	14,122
Deductions	**(845)**	(988)	(845)
Unconsolidated investments[7]	**(990)**	(1,114)	(1,033)
50% of tax credit adjustment for expected losses	**145**	126	188
Tier 1 capital	**146,934**	143,113	139,590
Tier 2 capital			
Total qualifying tier 2 capital before deductions	**47,205**	50,544	48,676
Reserves arising from revaluation of property and unrealised gains on available-for-sale equities	**2,387**	3,085	2,678
Collective impairment allowances[8]	**2,551**	2,772	2,660
Perpetual subordinated debt	**2,778**	2,782	2,780
Term subordinated debt	**39,189**	41,605	40,258
Non-controlling interests in tier 2 capital	**300**	300	300
Total deductions other than from tier 1 capital	**(18,415)**	(19,873)	(17,932)

Unconsolidated investments[7]	**(13,834)**	(15,471)	(13,868)
50% of securitisation positions	**(1,364)**	(1,274)	(1,207)
50% of excess of expected losses over impairment allowances	**(3,211)**	(3,126)	(2,846)
Other deductions	**(6)**	(2)	(11)
Total regulatory capital	**175,724**	173,784	170,334

For footnotes, see page 201.

Interim Management Report (continued)

Future developments

Basel III

The regulation and supervision of financial institutions continues to undergo significant change in response to the global financial crisis. 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 . In June 2011, the Basel Committee issued a revision to the former document setting out the finalised capital treatment for counterparty credit risk in bilateral trades.

The Basel III rules set out the minimum common equity tier 1 (CET1) ratio requirement of 4.5% and an additional capital conservation buffer requirement of 2.5%, to be phased in sequentially from 1 January 2013, becoming fully effective on 1 January 2019. Any additional countercyclical capital buffer requirements will also be phased in, starting in 2016 to a proposed maximum level of 2.5% effective on 1 January 2019, although individual jurisdictions may choose to implement larger countercyclical capital buffers. The leverage ratio is subject to a supervisory monitoring period which commenced on 1 January 2011, and a parallel run period which will last from 1 January 2013 until 1 January 2017. Further calibration of the leverage ratio will be carried out in the first half of 2017 with a view to migrating to a pillar 1 requirement from 1 January 2018.

In addition to the criteria detailed in the Basel III proposals, the Basel Committee issued further minimum requirements in January 2011 to ensure that all classes of capital instruments fully absorb losses at the point of non-viability before taxpayers are exposed to loss. Instruments issued on or after 1 January 2013 may only be included in regulatory capital if the new requirements are met. The capital treatment of securities issued prior to this date will be phased out over a 10-year period commencing on 1 January 2013.

Effect of Basel III

In order to provide some insight into the possible effects of the Basel III rules on HSBC, we have estimated the Group s pro forma CET1 ratio on the basis of our interpretation of those rules applied to our position at 30 June 2012.

The Basel III changes, which will be progressively phased in, relate to increases in

RWAs, increased capital deductions and new regulatory adjustments. We estimate that applying the increased capital requirements which come into effect on 1 January 2013 to our 30 June 2012 core tier 1 ratio would lower it by 100bps to 10.3%.

The impact on our CET1 ratio from 1 January 2013 will result from changes to both our capital requirement and capital resource position. The decrease in the CET1 ratio attributable to the increase in capital requirements is primarily due to the new credit valuation adjustment (CVA) capital charge, and also due to risk-weighting securitisation positions which were previously deducted from capital at 1,250%, and increasing the financial correlation charge. The effect on the CET1 ratio is reduced by the change from securitisation capital deductions to RWAs.

In addition to the implications for CET1 capital, tier 1 capital and tier 2 capital will be affected by the derecognition of non-qualifying capital instruments. These changes will be phased in over 10 years from 1 January 2013, and will further reduce the tier 1 ratio and the total capital ratio by an estimated 10bps and 40bps, respectively, in 2013 excluding new issues of qualifying capital instruments.

The changes to capital deductions and regulatory adjustments, including those for deferred tax assets, material holdings, excess expected losses and unrealised losses on available-for-sale portfolios, will be phased in over a five-year period starting on 1 January 2014.

The above is partially mitigated by the run-off of positions including legacy credit in GB&M and the US CML portfolio. This will occur in the period up until 2019.

We are also considering hedging the CVA capital charge using credit default swaps as another potential mitigating action.

CRD IV

In July 2011, the European Commission published proposals for a new Regulation and Directive, known collectively as CRD IV, to give effect to the Basel III framework in the EU. The majority of the Basel III proposals are in the Regulation, removing national discretion, except for countercyclical and capital conservation buffers, which are in the Directive.

The CRD IV proposals, which are expected to apply from 1 January 2013, require all fair value positions to be included at their prudent value for the purpose of calculating regulatory capital. The regulatory basis of prudent value differs from the

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accounting basis for calculating fair values of financial instruments under IAS 39. It is proposed that when the accounting value is greater than the regulatory value, the difference should be deducted from CET1.

Our current methodology for calculating CVA for accounting purposes is described in Note 8 on the Financial Statements and is principally based on the use of probabilities of default from historical rating transition matrices, consistent with our approach to the management of derivative counterparty risk.

At present there is no formalised guidance, though it is expected that we will be required for the purposes of establishing a prudent regulatory value to calculate CVA based on a probability of default derived from relevant credit default swaps. A difference between the accounting and regulatory methodologies, therefore, would result in an overall adverse adjustment to CET1. Should the accounting treatment in future more closely align with the regulatory methodology, there would be an offsetting reduction in the regulatory adjustment applied to CET1.

We continue to monitor the interaction of the accounting and regulatory treatments as they evolve and assess our respective methodologies accordingly.

The Regulation additionally sets out provisions to harmonise prudential regulatory and financial reporting in the EU, commonly known as COREP and FINREP, respectively. In December 2011, the European Banking Authority (EBA) published a consultative document proposing measures to specify uniform formats, frequencies and dates of prudential reporting to the regulator.

During the first half of 2012, the EBA issued a number of consultations on the draft regulatory technical standards which will form part of the Regulation. Further consultative documents are expected during the year and we will continue to assess the effect on HSBC.

The CRD IV legislation is in draft and remains subject to agreement by the European Parliament, Council and Commission.

Trading activities

In May 2012, the Basel Committee issued a consultative document, Fundamental review of the trading book . The paper sets out proposals for a revised market risk framework, including enhanced risk measurement under both the internal models-based and standardised approaches, and specific measures for trading book capital requirements. This

aims to strengthen capital standards for market risk, and thereby contribute to a more resilient banking sector.

Systemically important banks

In parallel with the Basel III proposals, the Basel Committee issued a consultative document in July 2011, Global systemically important banks: assessment methodology and the additional loss absorbency requirement . In November 2011, they published their rules and the Financial Stability Board (FSB) issued the initial list of global systemically important banks (G-SIB s). This list, which includes HSBC and twenty-eight other major banks from around the world, will be re-assessed periodically through annual re-scoring of the individual banks and a triennial review of the methodology.

The rules set out an indicator-based approach to G-SIBs assessment employing five broad categories: size, interconnectedness, lack of substitutability, cross-jurisdictional activity and complexity. The designated G-SIBs will be required to hold minimum additional CET1 capital of between 1% and 2.5%, depending on their relative systemic importance as indicated by their assessed score. We expect to be required to hold capital towards the upper end of the range. A further 1% charge may be applied to any bank which fails to make progress or regresses in performance within the assessment categories set out above. The requirements, initially for those banks identified in November 2014 as G-SIBs, will be phased in from 1 January 2016, becoming fully effective on 1 January 2019. National regulators have discretion to introduce higher thresholds than these minima.

The proposals above form part of the FSB s broad mandate to reduce the potential moral hazard associated with G-SIBs. A further exercise of this mandate was the FSB s own direct consultation of October 2011. This proposed introducing, over the period 2012 to 2014, enhanced reporting by G-SIBs to the Basel Committee centrally. Further engagement with the financial industry at national and international level will be undertaken by the FSB during 2012.

In June 2012, complementing the G-SIBs proposal, the Basel Committee issued a consultative document, A framework for dealing with domestic systemically important banks . The Committee set out an assessment methodology for domestic systemically important banks (D-SIB s) which employs categories similar to those defined under the G-SIB framework. In addition, they require

Interim Management Report (continued)

higher loss absorbency requirements to be calibrated by national authorities and which are to be fully met by CET1. The proposals call for banks, identified as D-SIBs by their national authorities, to comply with the requirements in line with the phase-in arrangements for G-SIBs.

Potential effect on a G-SIB

The proposals described above indicate that the required minimum regulatory CET1 ratio for a G-SIB may ultimately lie in the range of 8% to 9.5%.

Potential CET1 requirements from 1 January 2019	
Minimum CET1	4.5%
Capital conservation buffer	2.5%
G-SIB buffer	1 2.5%

In addition to this, a G-SIB may be required to hold a countercyclical capital buffer. The countercyclical capital buffer is a macro-prudential tool at the disposal of national authorities that can be deployed when excess aggregate credit growth is judged to be increasing system-wide risk, and to protect the banking sector from future potential losses. Should a countercyclical buffer be required, it is expected to be held in the range of 0 2.5%.

Against the backdrop of eurozone instability, on a temporary basis, the EBA recommended banks aimed to reach a 9% core tier 1 ratio by the end of June 2012. We shall continue to review our target core tier 1 ratio of 9.5% to 10.5% as the applicable regulatory capital requirements evolve during the period until 1 January 2019.

UK banking reform

In September 2011, the Independent Commission on Banking (ICB) recommended measures on capital requirements for UK banking groups. In June 2012, the UK Government published its consultation, Banking reform: delivering stability and supporting a sustainable economy , which set out its detailed proposals for implementing the recommendations of the ICB. For further details, see page 106.

Recovery and resolution

In November 2010, the G20 endorsed the FSB s report on reducing the moral hazard posed by systemically important financial institutions and, in November 2011 they endorsed the core recommendations set out in Key attributes of effective resolution regimes for financial institutions which jurisdictions should implement to achieve these outcomes.

In June 2012, following international developments in this area, the European Commission published a legislative proposal for bank recovery and resolution. The aim of the proposed framework is to reduce implicit support for the banking sector and equip national regulators with common powers and tools for prevention, early intervention and resolution. The powers sought include the right to appoint a special manager and impose the sale of businesses, asset separation and the write-down of creditors (bail-in) to resolve banks in difficulties. The proposal from the European Commission is subject to negotiation with the European Parliament and European Council.

Footnotes to Capital

1 *Operational risk RWAs, under the standardised approach, are calculated using an average of the last three years revenues. For business disposals, the operational risk RWAs are not released immediately on disposal, but diminish over a 3-4 year period. On disposal of the Card and Retail Services business, the associated operational risk RWAs will be reported against the continuing business to the extent that the revenues are still included in the three-year average.*
2 *RWAs are non-additive across geographical regions due to market risk diversification effects within the Group.*
3 *Includes externally verified profits for the half-year to 30 June 2012.*
4 *Mainly comprises unrealised losses on available-for-sale debt securities within SPEs which are excluded from the regulatory consolidation.*
5 *Under FSA rules, unrealised gains/losses on debt securities net of tax must be excluded from capital resources.*
6 *Under FSA rules, any defined benefit asset is derecognised and a defined benefit liability may be substituted with the additional funding that will be paid into the relevant schemes over the following five-year period.*
7 *Mainly comprise investments in insurance entities.*
8 *Under FSA rules, collective impairment allowances on loan portfolios on the standardised approach are included in tier 2 capital.*

Interim Management Report (continued)

Appendix to Capital

Capital management and capital measurement and allocation

Capital management

Our policy on capital management is underpinned by a capital management framework (the framework) which enables us to manage our capital in a consistent manner. The framework, which is approved by the GMB annually, incorporates a number of different capital measures including market capitalisation, invested capital, economic capital and regulatory capital.

Capital measures

- market capitalisation is the stock market value of the company;
- invested capital is the equity capital invested in HSBC by our shareholders, adjusted for certain reserves and goodwill previously amortised or written off;
- economic capital is the internally calculated capital requirement which we deem necessary to support the risks to which we are exposed; and
- regulatory capital is the capital which we are required to hold in accordance with the rules established by the FSA for the consolidated Group and by our local regulators for individual Group companies.

The following material risks are managed through the framework: credit, market, operational, interest rate risk in the banking book, pension fund, insurance and residual risks.

We incorporate stress testing in the framework because it helps us understand how sensitive the core assumptions in our capital plans are to the adverse effect of extreme but plausible events. Stress testing allows us to formulate our response and mitigate risk in advance of conditions exhibiting the identified stress scenarios. The actual market stresses which occurred throughout the financial system in recent years have been used to inform our capital planning process and enhance the stress scenarios we employ. In addition to our internal stress tests, others are undertaken, both at the request of regulators and by the regulators themselves using their prescribed assumptions. We take into account the results of all such regulatory stress testing when assessing our internal capital management requirements.

The responsibility for global capital allocation principles and decisions rests with the GMB. Through our structured internal governance processes, we maintain discipline over our investment and capital allocation decisions and seek to ensure that returns on investment are adequate after taking into account capital costs. Our strategy is to allocate capital to businesses on the basis of their economic profit generation and their regulatory and economic capital requirements.

Our capital management process is articulated in the annual Group capital plan which is approved by the Board. The plan is drawn up with the objective of maintaining both an appropriate amount of capital and an optimal mix between its different components. HSBC Holdings and its major subsidiaries raise non-equity tier 1 capital and subordinated debt in accordance with Group guidelines on market and investor concentration, cost, market conditions, timing, capital composition and maturity profile. Each subsidiary manages its own capital to support its planned business growth and meet its local regulatory requirements within the context of the Group capital plan. Capital generated by subsidiaries in excess of planned requirements is returned to HSBC Holdings, normally by way of dividends, in accordance with the framework.

HSBC Holdings is the primary provider of equity capital to its subsidiaries and also provides them with non-equity capital where necessary. These investments are substantially funded by HSBC Holdings own capital issuance and profit retention. As part of its capital management process, HSBC Holdings seeks to maintain a prudent balance between the composition of its capital and its investment in subsidiaries.

Capital measurement and allocation

Our policy and practice in capital measurement and allocation at Group level is underpinned by the Basel II rules. However, local regulators are at different stages of implementation and some local reporting, notably in the US, is still on a Basel I basis. In most jurisdictions, non-banking financial subsidiaries are also subject to the supervision and capital requirements of local regulatory authorities.

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Interim Management Report (continued)

Regulatory and accounting consolidations

The basis of consolidation for financial accounting purposes is described on page 292 of the *Annual Report and Accounts 2011* and differs from that used for regulatory purposes. Investments in banking associates are equity accounted in the financial accounting consolidation, whereas their exposures are proportionally consolidated for regulatory purposes. Subsidiaries and associates engaged in insurance and non-financial activities are excluded from the regulatory consolidation and are deducted from regulatory capital. The regulatory consolidation does not include SPEs where significant risk has been transferred to third parties. Exposures to these SPEs are risk-weighted as securitisation positions for regulatory purposes.

Basel II is structured around three pillars : minimum capital requirements, supervisory review process and market discipline. The 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.

Regulatory capital

Our capital is divided into two tiers:

- tier 1 capital is divided into core tier 1 and other tier 1 capital. Core tier 1 capital comprises shareholders equity and related non-controlling interests. The book values of goodwill and intangible assets are deducted from core tier 1 capital and other regulatory adjustments are made for items reflected in shareholders equity which are treated differently for the purposes of capital adequacy. Qualifying capital instruments such as non-cumulative perpetual preference shares and hybrid capital securities are included in other tier 1 capital; and

- tier 2 capital comprises qualifying subordinated loan capital, related non-controlling interests, allowable collective impairment allowances and unrealised gains arising on the fair valuation of equity instruments held as available for sale. Tier 2 capital also includes reserves arising from the revaluation of properties.

To ensure the overall quality of the capital base, the FSA s rules set limits on the amount of hybrid capital instruments that can be included in tier 1 capital relative to core tier 1 capital, and limits overall tier 2 capital to no more than tier 1 capital.

Pillar 1 capital requirements

Pillar 1 covers the capital resources requirements for credit risk, market risk and operational risk. Credit risk includes counterparty credit risk and securitisation requirements. These requirements are expressed in terms of RWAs.

Credit risk capital requirements

Basel II applies three approaches of increasing sophistication to the calculation of pillar 1 credit risk capital requirements. The most basic level, the standardised approach, requires banks to use external credit ratings to determine the risk weightings applied to rated counterparties and group other counterparties into broad categories and apply standardised risk weightings to these categories. The next level, the internal ratings-based (IRB) foundation approach, allows banks to calculate their credit risk capital requirements on the basis of their internal assessment of the probability that a counterparty will default (PD), but subjects their quantified estimates of exposure at default (EAD) and loss given default (LGD) to standard supervisory parameters. Finally, the IRB advanced approach allows banks to use their own internal assessment in determining

PD and quantifying EAD and LGD.

The capital resources requirement, which is intended to cover unexpected losses, is derived from a formula specified in the regulatory rules which incorporates PD, LGD, EAD and other variables such as maturity and correlation. Expected losses under the IRB approaches are calculated by multiplying PD by EAD and LGD. Expected losses are deducted from capital to the extent that they exceed total accounting impairment allowances.

For credit risk we have adopted the IRB advanced approach for the majority of our businesses, with the remainder on either IRB foundation or standardised approaches.

Under our Basel II rollout plans, a number of our Group companies and portfolios are in transition to advanced IRB approaches. At the end of June 2012, portfolios in much of Europe, Hong Kong, Rest of Asia-Pacific and North America were on advanced IRB approaches. Others remain on the standardised or foundation approaches under Basel II, pending definition of local regulations or model approval, or under exemptions from IRB treatment.

Counterparty credit risk

Counterparty credit risk arises for OTC derivatives and securities financing transactions. It is calculated in both the trading and non-trading books and is the risk that the counterparty to a transaction may default before

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completing the satisfactory settlement of the transaction. Three approaches to calculating counterparty credit risk and determining exposure values are defined by Basel II: standardised, mark-to-market and internal model method. These exposure values are used to determine capital requirements under one of the credit risk approaches: standardised, IRB foundation and IRB advanced.

We use the mark-to-market and internal model method approaches for counterparty credit risk. Our longer-term aim is to migrate more positions from the mark-to-market to the internal model method approach.

Securitisation

Securitisation positions are held in both the trading and non-trading books. For non-trading book securitisation positions, Basel II specifies two methods for calculating credit risk requirements, these being the standardised and IRB approaches. Both approaches rely on the mapping of rating agency credit ratings to risk weights, which range from 7% to 1,250%. Positions that would otherwise be weighted at 1,250% are deducted from capital.

Within the IRB approach, we use the ratings-based method for the majority of our non-trading book securitisation positions, and the internal assessment approach for unrated liquidity facilities and programme-wide enhancements for asset-backed securitisations.

Following the implementation of Basel 2.5, the majority of securitisation positions in the trading book are treated for capital purposes as if they are held in the non-trading book under the standardised or IRB approaches. Other traded securitisation positions, known as correlation trading, are treated under an internal model approach approved by the FSA.

Market risk capital requirement

The market risk capital requirement is measured using internal market risk models where approved by the FSA, or the FSA s standard rules. Following the implementation of Basel 2.5, our internal market risk models comprise VAR, stressed VAR, incremental risk charge and correlation trading under the comprehensive risk measure.

Operational risk capital requirement

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

Pillar 2 capital requirements

We conduct an Internal Capital Adequacy Assessment Process (ICAAP) to determine a forward looking assessment of our capital requirements given our business strategy, risk profile, risk appetite and capital plan. This process incorporates the risk management processes and governance of the Group. A range of stress tests are applied to our base capital plan. These, coupled with our economic capital framework and other risk management practices, are used to assess our internal capital adequacy requirements.

The ICAAP is examined by the FSA as part of its Supervisory Review and Evaluation Process, which occurs periodically to enable the FSA to define the Individual Capital Guidance or minimum capital requirements for HSBC.

Pillar 3 disclosure requirements

Pillar 3 of Basel II is related to market discipline and aims to make firms more transparent by requiring them to publish specific, prescribed details of their risks, capital and risk management under the Basel II framework at least annually. Our Pillar 3 disclosures for the year ended 31 December 2011 were published as a separate document on the Group Investor Relations website.

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HSBC HOLDINGS PLC

Board of Directors and Senior Management

Directors

D J Flint, CBE, 57

Group Chairman

Skills and experience: extensive governance experience gained through membership of the Boards of HSBC and BP p.l.c.; considerable knowledge of finance and risk management in banking, multinational financial reporting, treasury and securities trading operations; honoured with a CBE in recognition of his services to the finance industry; member of the Institute of Chartered Accountants of Scotland and the Association of Corporate Treasurers. Fellow of The Chartered Institute of Management Accountants. Joined HSBC in 1995.

Appointed to the Board: 1995

Current appointments include: director of The Hong Kong Association; and Chairman of the Institute of International Finance since 6 June 2012 (formerly Vice Chairman and Chairman Designate).

Former appointments include: Group Finance Director and Chief Financial Officer, Executive Director, Risk and Regulation; Chairman and member of the Nomination Committee; Co-Chairman of the Counterparty Risk Management Policy Group III; Chairman of the Financial Reporting Council s review of the Turnbull Guidance on Internal Control; member of the Accounting Standards Board and the Standards Advisory Council of the International Accounting Standards Board; served on the Large Business Forum on Tax and Competitiveness and the Consultative Committee of the Large Business Advisory Board of HM Revenue and Customs; partner in KPMG; and non-executive director and Chairman of the Audit Committee of BP p.l.c.

S T Gulliver, 53

Group Chief Executive

Skills and experience: a career banker with over 30 years international experience with HSBC; has held a number of key roles in the Group s operations worldwide, including in London, Hong Kong, Tokyo, Kuala Lumpur and the United Arab Emirates; played a leading role in developing and expanding Global Banking and Markets, the wholesale banking division of the Group with operations in over 65 countries and territories. Joined HSBC in 1980.

Appointed to the Board: 2008

Current appointments include: Group Chief

Executive and Chairman of The Hongkong and Shanghai Banking Corporation Limited; Chairman of HSBC France; and Chairman of the Group Management Board.

Former appointments include: Chairman, Europe, Middle East and Global Businesses; Chairman of HSBC Bank plc and of HSBC Bank Middle East Limited; Head of Global Banking and Markets; Co-Head of Global Banking and Markets; Head of Global Markets; Head of Treasury and Capital Markets in Asia-Pacific; Deputy Chairman of HSBC Trinkaus & Burkhardt AG and member of its Supervisory Board; and Chairman of HSBC Private Banking Holdings (Suisse) SA.

S A Catz, 50

Skills and experience: a background in international business leadership, having helped transform Oracle into the largest producer of business management software and the world s leading supplier of software for information management.

Appointed to the Board: 2008

Current appointments include: President and Chief Financial Officer of Oracle Corporation. Joined Oracle in 1999 and appointed to the board of directors in 2001.

Former appointments include: Managing Director of Donaldson, Lufkin & Jenrette.

L M L Cha, GBS, 62

Member of the Corporate Sustainability Committee.

Skills and experience: extensive regulatory and policy making experience in the finance and securities sector in Hong Kong and mainland China; formerly Vice Chairman of the China Securities Regulatory Commission, being the first person outside mainland China to join the Central Government of the People s Republic of China at vice-ministerial rank; awarded Gold and Silver Bauhinia Stars by the Hong Kong Government for public service; formerly Deputy Chairman of the Securities and Futures Commission in Hong Kong; and has worked in the US and Asia.

Appointed to the Board: 2011

Current appointments include: non-executive Deputy Chairman of The Hongkong and Shanghai Banking Corporation Limited; non-official member of the Executive Council of Hong Kong SAR; Chairman of the ICAC Advisory Committee on Corruption; a Hong Kong Deputy to the 11th

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HSBC HOLDINGS PLC

Board of Directors and Senior Management (continued)

National People s Congress of China; non-executive director of China Telecom Corporation Limited; member of the Advisory Board of the Yale School of Management, Millstein Center of Corporate Governance, and Performance at Yale University; a Senior International Advisor for Foundation Asset Management Sweden AB; member of the State Bar of California; and Chairman of the Task Force on the Financial Services Development Council of Hong Kong SAR since 1 July 2012.

Former appointments include: non-executive director of Bank of Communications Co., Ltd., Baoshan Iron and Steel Co. Limited, Johnson Electric Holdings Limited; and Chairman of the University Grants Committee in Hong Kong. Ceased to be a director of Hong Kong Exchanges and Clearing Limited on 24 April 2012 and Tata Consultancy Services Limited on 29 June 2012.

M K T Cheung, GBS, OBE, 64

Member of the Group Audit Committee.

Skills and experience: a background in international business and financial accounting, particularly in greater China and the wider Asian economy; retired from KPMG Hong Kong in 2003 after more than 30 years; awarded the Gold Bauhinia Star by the Hong Kong Government. Fellow of the Institute of Chartered Accountants in England and Wales.

Appointed to the Board: 2009

Current appointments include: non-executive director of Hang Seng Bank Limited and HKR International Limited; non-executive Chairman of the Airport Authority Hong Kong and the Council of the Hong Kong University of Science and Technology; and director of The Association of Former Council Members of The Stock Exchange of Hong Kong Limited and The Hong Kong International Film Festival Society Ltd.

Former appointments include: non-executive director of Sun Hung Kai Properties Limited and Hong Kong Exchanges and Clearing Limited; Chairman and Chief Executive Officer of KPMG Hong Kong; and council member of the Open University of Hong Kong. Ceased to be a non-official member of the Executive Council of the Hong Kong SAR on 1 July 2012.

J D Coombe, 67

Chairman of the Group Audit Committee and member of the Group Risk Committee and Group Remuneration Committee.

Skills and experience: a background in international business, financial accounting and the pharmaceutical industry; formerly Chief Financial Officer of GlaxoSmithKline with responsibility for the group s financial operations globally. Fellow of the Institute of Chartered Accountants in England and Wales.

Appointed to the Board: 2005

Current appointments include: non-executive Chairman of Hogg Robinson Group plc; non-executive Chairman of Home Retail Group plc since 4 July 2012; and council member of The Royal Academy of Arts.

Former appointments include: executive director and Chief Financial Officer of GlaxoSmithKline plc; non-executive director of GUS plc; member of the Supervisory Board of Siemens AG; Chairman of The Hundred Group of Finance Directors; and member of the Accounting Standards Board.

J Faber, 62

Member of the Group Risk Committee since 1 March 2012.

Skills and experience: a background in banking and asset management with significant international experience, having worked in Germany, Tokyo, New York and London; former Chief Executive Officer of Allianz Global Investors AG and member of the management board of Allianz SE until December 2011; 14 years experience with Citigroup Inc. holding positions in Trading and Project Finance and as Head of Capital Markets for Europe, North America and Japan. Has a doctorate from the University of Administrative Sciences in Speyer.

Appointed to the Board: 1 March 2012

Current appointments include: Chairman of Joh A. Benckiser SARL and of the Investment Board of the Stifterverband für die Deutsche Wissenschaft; independent director of Deutsche Börse AG , Coty Inc.; member of the advisory board of the Siemens Group Pension Board, and the boards of management of Deutsche Krebshilfe and the European School for Management and Technology; and member of the Berlin Centre for Corporate Governance, the German Council for Sustainable Development and Allianz Climate Solutions.

Former appointments include: Chairman of Allianz Global Investors Kapitalanlagegesellschaft and Allianz Global Investors Deutschland GmbH; Chairman of the board of management of Allianz Global Investors Italia SGR SpA; member of the advisory board of Allianz SpA; and member of the supervisory board of Bayerische Boerse AG.

Board of Directors and Senior Management (continued)

R A Fairhead, CBE, 50

Chairman of the Group Risk Committee and member of the Group Audit Committee and Nomination Committee.

Skills and experience: a background in international industry, publishing, finance and general management; formerly Finance Director of Pearson plc with responsibility for overseeing the day-to-day running of the finance function and directly responsible for global financial reporting and control, tax and treasury. Has a Master s in Business Administration from the Harvard Business School.

Appointed to the Board: 2004

Current appointments include: Chairman, Chief Executive Officer and director of Financial Times Group Limited. Director of Pearson plc and non-executive director of The Economist Newspaper Limited; and non-executive member of the board of the UK Government s Cabinet Office.

Former appointments include: Executive Vice President, Strategy and Group Control of Imperial Chemical Industries plc; Finance Director of Pearson plc; and Chairman and director of Interactive Data Corporation.

A A Flockhart*, CBE, 60

Skills and experience: a career banker, being an emerging markets specialist with over 35 years experience with HSBC across Latin America, the Middle East, US and Asia; honoured with a CBE in recognition of his services to British business and charitable services and institutions in Mexico. Joined HSBC in 1974.

Appointed to the Board: 2008. Will retire from the Board on 31 July 2012.

Current appointments include: Chairman of HSBC Bank plc and director of HSBC Bank Middle East Limited. Will retire from these appointments on 31 July 2012.

Former appointments include: member of the Group Management Board and director of HSBC Bank Australia Limited; Chairman of HSBC Latin America Holdings (UK) Limited; Chairman, Personal and Commercial Banking; Chief Executive Officer of The Hongkong and Shanghai Banking Corporation Limited; director of HSBC Bank (China) Company Limited and Hang Seng Bank

Limited, vice-chairman and director of HSBC Bank (Vietnam) Limited; Chairman, HSBC Bank Malaysia Berhad; Chairman, President and Group Managing Director, Latin America and the Caribbean; Chief Executive Officer, Mexico; Senior Executive Vice-President, Commercial Banking, HSBC Bank USA, N.A.; Managing Director of The Saudi British Bank.

J W J Hughes-Hallett, CMG , SBS, 62

Member of the Group Risk Committee and Nomination Committee. Will cease to be a member of the Group Risk Committee on 31 July 2012.

Skills and experience: a background in financial accounting and experience of management of a broad range of international businesses, including aviation, insurance, property, shipping, manufacturing and trading in the Far East, UK, US and Australia; awarded the Silver Bauhinia Star by the Hong Kong Government. Fellow of the Institute of Chartered Accountants in England and Wales.

Appointed to the Board: 2005

Current appointments include: Chairman of John Swire & Sons Limited; non-executive director of Cathay Pacific Airways Limited and Swire Pacific Limited; a trustee of the Dulwich Picture Gallery and the Esmée Fairbairn Foundation; member of The Hong Kong Association and Chairman of the Governing Board of the Courtauld Institute of Art.

Former appointments include: non-executive director of The Hongkong and Shanghai Banking Corporation Limited.

W S H Laidlaw , 56

Member of the Group Remuneration Committee.

Skills and experience: significant international experience, particularly in the energy sector, having had responsibility for businesses in four continents. Qualified Solicitor and Master s in Business Administration from INSEAD.

Appointed to the Board: 2008

Current appointments include: Chief Executive Officer of Centrica plc; member of the UK Prime Minister s Business Advisory Group; and the Lead Non-executive Board Member of the UK Department for Transport.

Former appointments include: Executive Vice President of Chevron Corporation; non-executive director of Hanson PLC; Chief Executive Officer of Enterprise Oil plc; and President and Chief Operating Officer of Amerada Hess Corporation.

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HSBC HOLDINGS PLC

Board of Directors and Senior Management (continued)

J P Lipsky , 65

Member of the Group Risk Committee since 1 March 2012 and Nomination Committee since 24 May 2012.

Skills and experience: international experience having worked in Chile, New York, Washington and London and interacted with financial institutions, central banks and governments in many countries; served at the International Monetary Fund as First Deputy Managing Director, Acting Managing Director and as Special Advisor. Has a PhD from Stanford University.

Appointed to the Board: 1 March 2012

Current appointments include: Distinguished Visiting Scholar, International Economics Program at the Paul H. Nitze School of Advanced International Studies, Johns Hopkins University; Co-chairman of the Aspen Institute Program on the World Economy; director of the National Bureau of Economic Research; member of the advisory board of the Stanford Institute for Economic Policy Research and the Council on Foreign Relations.

Former appointments include: Vice Chairman J P Morgan Investment Bank; director of the American Council on Germany and the Japan Society; and a trustee of the Economic Club of New York.

J R Lomax , 67

Member of the Group Audit Committee and Group Risk Committee.

Skills and experience: experience in both the public and private sectors and a deep knowledge of the operation of the UK government and financial system.

Appointed to the Board: 2008

Current appointments include: non-executive director of The Scottish American Investment Company PLC, Reinsurance Group of America Inc., Arcus European Infrastructure Fund GP LLP and BAA Limited; member of the Council of Imperial College, London; and President of the

Institute of Fiscal Studies.

Former appointments include: Deputy Governor, Monetary Stability, at the Bank of England and member of the Monetary Policy Committee; Permanent Secretary at the UK Government Departments for Transport and Work and Pensions and the Welsh Office; and Vice President and Chief of Staff to the President of the World Bank.

I J Mackay, 50

Group Finance Director

Skills and experience: extensive financial and international experience, having worked in London, Paris, US and Asia. Member of the Institute of Chartered Accountants of Scotland. Joined HSBC in 2007.

Appointed to the Board: 2010

Current appointments include: member of the Group Management Board.

Former appointments include: director of Hang Seng Bank Limited; Chief Financial Officer, Asia Pacific; and Chief Financial Officer, HSBC North America Holdings Inc; Vice President and Chief Financial Officer of GE Consumer Finance and Vice President and Chief Financial Officer of GE Healthcare Global Diagnostic Imaging.

N R N Murthy, CBE, 65

Chairman of the Corporate Sustainability Committee.

Skills and experience: experience in information technology, corporate governance and education, particularly in India; founded Infosys Limited in India; was its Chief Executive Officer for 21 years; under his leadership Infosys established a global footprint and was listed on NASDAQ.

Appointed to the Board: 2008

Current appointments include: Chairman Emeritus of Infosys Limited; Chairman of the Public Health Foundation of India and of the National Payments Corporation of India; director of the United Nations Foundation and Catamaran Management Services Pvt. Ltd.

Former appointments include: former Chief Executive Officer of Infosys Limited; director of Unilever plc and Unilever n.v.; and non-executive director of DBS Group Holdings Limited, DBS Bank Limited and New Delhi Television Limited.

Sir Simon Robertson , 71

Deputy Chairman and senior independent non-executive Director

Chairman of the Nomination Committee.

Skills and experience: a background in international corporate advisory with a wealth of experience in mergers and acquisitions, merchant banking, investment banking and financial markets; honoured

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HSBC HOLDINGS PLC

Board of Directors and Senior Management (continued)

with a knighthood in recognition of his services to business; extensive international experience having worked in France, Germany, the UK and the US.

Appointed to the Board: 2006

Current appointments include: non-executive Chairman of Rolls-Royce Holdings plc, which became the holding company of the Rolls-Royce group of companies in May 2011 as part of a group restructuring. Formerly Chairman of Rolls-Royce Group plc, which was the holding company of the Rolls-Royce group of companies until May 2011. The founding member of Simon Robertson Associates LLP; non-executive director of Berry Bros. & Rudd Limited, The Economist Newspaper Limited, Royal Opera House, Covent Garden Limited and, since 8 May 2012, Troy Asset Management; partner of NewShore Partners LLP; and a trustee of the Eden Project Trust and of the Royal Opera House Endowment Fund.

Former appointments include: Managing Director of Goldman Sachs International and Chairman of Dresdner Kleinwort Benson.

J L Thornton , 58

Chairman of the Group Remuneration Committee.

Skills and experience: experience that bridges developed and developing economies and the public and private sectors; a deep knowledge of financial services and education systems, particularly in Asia. During his 23-year career with Goldman Sachs, he played a key role in the firm s global development and was Chairman of Goldman Sachs Asia.

Appointed to the Board: 2008

Current appointments include: non-executive Chairman and director of HSBC North America Holdings Inc.; Co-chairman and director of Barrick Gold Corporation since 15 February 2012 and 6 June 2012 respectively; professor and director of the Global Leadership Program at the Tsinghua University School of Economics and Management; Chairman of the Brookings Institution Board of Trustees; non-executive director of Ford Motor Company, News Corporation, Inc. and China Unicom (Hong Kong) Limited; director of National Committee on United States-China Relations; a Trustee of China Institute, The China Foreign Affairs University, member of the Council on Foreign Relations and the China Securities Regulatory Commission International Advisory Committee.

Former appointments include: non-executive director of Industrial and Commercial Bank of China

Limited and Intel Corporation, Inc.; Trustee of Asia Society; and President of the Goldman Sachs Group, Inc.

Independent non-executive Director.
* *Non-executive Director.*

Secretary

R G Barber, 61

Group Company Secretary

Joined HSBC in 1980. Group Company Secretary since 1986 and Company Secretary of HSBC Holdings plc since 1990. Appointed a Group General Manager in 2006. Chairman of the Disclosure Committee. A member of the Listing Authority Advisory Committee of the Financial Services Authority and of the Primary Markets Group of the London Stock Exchange. Fellow of the Institute of Chartered Secretaries and Administrators. Former HSBC appointments include: Corporation Secretary of The Hongkong and Shanghai Banking Corporation Limited and Company Secretary of HSBC Bank plc.

Adviser to the Board

D J Shaw, 66

Adviser to the Board since 1998. Director of HSBC Bank Bermuda Limited, HSBC Private Banking Holdings (Suisse) SA and HSBC Private Bank (Suisse) SA. Independent non-executive director of Kowloon Development Company Limited and Shui On Land Limited. Solicitor and formerly a partner in Norton Rose.

Group Managing Directors

A Almeida, 56

Group Head of Human Resources and Corporate Sustainability

Joined HSBC in 1992. A Group Managing Director since 2008. Former HSBC appointments include: Global Head of Human Resources for Global Banking and Markets, Global Private Banking, Global Transaction Banking and HSBC Amanah.

S Assaf, 52

Chief Executive, Global Banking and Markets

Joined HSBC in 1994. A Group Managing Director since 2011. Director of HSBC Bank Egypt S.A.E and of HSBC Trinkaus & Burkhardt AG. Former

Board of Directors and Senior Management (continued)

HSBC appointments include: director of HSBC Global Asset Management Limited; Head of Global Markets; and Head of Global Markets for Europe, Middle East and Africa.

R E T Bennett, 60

Group General Counsel

Joined HSBC in 1979. A Group Managing Director since 2011. Director of HSBC IM Pension Trust Limited. Former HSBC appointments include: Group General Manager, Legal & Compliance and Head of Legal & Compliance, Asia Pacific. Will retire from the Group on 31 December 2012.

A M Keir, 53

Global Head of Commercial Banking

Joined HSBC in 1981. A Group Managing Director since 2011. Former HSBC appointments include: Group General Manager, Commercial Banking, Europe and Global Co-Head, Global Commercial Banking.

S A Levey, 49

Chief Legal Officer

Joined HSBC on 13 January 2012. A Group Managing Director since 18 January 2012. Former appointments include: Under Secretary for Terrorism and Financial Intelligence in the US Department of Treasury; Senior Fellow for National Security and Financial Integrity at the

Council on Foreign Relations; Principal Associate Deputy Attorney General at the US Department of Justice; Partner at Miller, Cassidy, Larroca & Lewin LLP and Baker Botts LLP.

M M Moses, 54

Group Chief Risk Officer

Joined HSBC in 2005. A Group Managing Director since 2010. Director of HSBC Insurance (Bermuda) Limited. Former HSBC appointments include: Chief Financial and Risk Officer, Global Banking and Markets.

S P O Sullivan, 56

Group Chief Operating Officer

Joined HSBC in 1980. A Group Managing Director since 2011. Former HSBC appointments include: Group Chief Technology and Services Officer; director and Chief Operating Officer of HSBC Bank plc; and Chief Operating Officer of HSBC Bank Canada.

B Robertson, 58

Chief Executive, HSBC Bank plc

Joined HSBC in 1975. A Group Managing Director since 2008. Chairman of HSBC Life (UK) Limited. Director of HSBC Bank Bermuda Limited since 1 January 2012. Former HSBC appointments include: Group Chief Risk Officer; Group General Manager, Group Credit and Risk; and Head of Global Banking and Markets for North America.

P A Thurston, 58

Chief Executive, Retail Banking and Wealth Management

Joined HSBC in 1975. A Group Managing Director since 2008. Director of HSBC Private Banking Holdings (Suisse) SA and of The Hongkong and Shanghai Banking Corporation Limited. Former HSBC appointments include: Chief Executive and director of HSBC Bank plc and Chairman of HSBC Life (UK) Limited.

P T S Wong, 60

Chief Executive, The Hongkong and Shanghai Banking Corporation Limited

Joined HSBC in 2005. A Group Managing Director since 2010. Chairman of HSBC Bank (China) Company Limited and of HSBC Bank Malaysia Berhad. Non-executive director of Hang Seng Bank Limited, Bank of Communications Co., Ltd and Ping An Insurance (Group) Company of China, Ltd. Independent non-executive director of Cathay Pacific Airways Limited. Former HSBC appointments include: director of HSBC Bank Australia Limited. Ceased to be the Vice Chairman of HSBC Bank (Vietnam) Ltd on 16 January 2012.

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HSBC HOLDINGS PLC

Financial Statements (unaudited)

Consolidated income statement for the half-year to 30 June 2012

		Half-year to		
		30 June	30 June	31 December
		2012	2011	2011
	Notes	**US$m**	US$m	US$m
Interest income		**29,549**	31,046	31,959
Interest expense		**(10,173)**	(10,811)	(11,532)
Net interest income		**19,376**	20,235	20,427
Fee income		**10,281**	10,944	10,553
Fee expense		**(1,974)**	(2,137)	(2,200)
Net fee income		**8,307**	8,807	8,353
Trading income excluding net interest income		**3,134**	3,231	52
Net interest income on trading activities		**1,385**	1,581	1,642
Net trading income		**4,519**	4,812	1,694
Changes in fair value of long-term debt issued and related derivatives		**(1,810)**	(494)	4,655
Net income/(expense) from other financial instruments designated at fair value		**627**	394	(1,116)
Net income/(expense) from financial instruments designated at fair value		**(1,183)**	(100)	3,539
Gains less losses from financial investments		**1,023**	485	422
Dividend income		**103**	87	62
Net earned insurance premiums		**6,696**	6,700	6,172
Gains on disposal of US branch network and cards business	*14*	**3,809**		
Other operating income		**1,022**	1,285	481
Total operating income		**43,672**	42,311	41,150
Net insurance claims incurred and movement in liabilities to policyholders		**(6,775)**	(6,617)	(4,564)
Net operating income before loan impairment charges and other credit risk provisions		**36,897**	35,694	36,586
Loan impairment charges and other credit risk provisions		**(4,799)**	(5,266)	(6,861)
Net operating income		**32,098**	30,428	29,725
Employee compensation and benefits		**(10,905)**	(10,521)	(10,645)
General and administrative expenses		**(9,125)**	(8,419)	(9,040)
Depreciation and impairment of property, plant and equipment		**(706)**	(805)	(765)
Amortisation and impairment of intangible assets		**(468)**	(765)	(585)
Total operating expenses		**(21,204)**	(20,510)	(21,035)
Operating profit		**10,894**	9,918	8,690
Share of profit in associates and joint ventures		**1,843**	1,556	1,708
Profit before tax		**12,737**	11,474	10,398
Tax expense	*6*	**(3,629)**	(1,712)	(2,216)
Profit for the period		**9,108**	9,762	8,182

Profit attributable to shareholders of the parent company		**8,438**	9,215	7,582
Profit attributable to non-controlling interests		**670**	547	600
		US$	US$	US$
Basic earnings per ordinary share	*4*	**0.45**	0.51	0.41
Diluted earnings per ordinary share	*4*	**0.45**	0.50	0.41

The accompanying notes on pages 219 to 263 form an integral part of these financial statements[1].

For footnote, see page 218.

HSBC HOLDINGS PLC

Financial Statements (unaudited) (continued)

Consolidated statement of comprehensive income for the half-year to 30 June 2012

	Half-year to		
	30 June 2012	30 June 2011	31 December 2011
	US$m	US$m	US$m
Profit for the period	**9,108**	9,762	8,182
Other comprehensive income/(expense)			
Available-for-sale investments	**1,593**	1,136	(462)
fair value gains/(losses)	**2,362**	1,378	(99)
fair value gains transferred to income statement on disposal	**(1,017)**	(529)	(291)
amounts transferred to the income statement in respect of impairment losses	**450**	287	296
income taxes	**(202)**		(368)
Cash flow hedges	**(6)**	40	147
fair value gains/(losses)	**(307)**	231	(812)
fair value (gains)/losses transferred to income statement	**245**	(196)	984
income taxes	**56**	5	(25)
Actuarial gains/(losses) on defined benefit plans	**(469)**	(19)	1,028
before income taxes	**(619)**	(18)	1,285
income taxes	**150**	(1)	(257)
Share of other comprehensive income/(expense) of associates and joint ventures	**338**	(146)	(564)
Exchange differences	**(392)**	4,404	(7,269)
Income tax attributable to exchange differences		165	
Other comprehensive income/(expense) for the period, net of tax	**1,064**	5,580	(7,120)
Total comprehensive income for the period	**10,172**	15,342	1,062
Total comprehensive income for the period attributable to:			
shareholders of the parent company	**9,515**	14,728	638
non-controlling interests	**657**	614	424
	10,172	15,342	1,062

The accompanying notes on pages 219 to 263 form an integral part of these financial statements[1].

For footnote, see page 218.

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HSBC HOLDINGS PLC

Financial Statements (unaudited) (continued)

Consolidated balance sheet at 30 June 2012

	Notes	At 30 June 2012 US$m	At 30 June 2011 US$m	At 31 December 2011 US$m
Assets				
Cash and balances at central banks		**147,911**	68,218	129,902
Items in the course of collection from other banks		**11,075**	15,058	8,208
Hong Kong Government certificates of indebtedness		**21,283**	19,745	20,922
Trading assets	*7*	**391,371**	474,950	330,451
Financial assets designated at fair value	*11*	**32,310**	39,565	30,856
Derivatives	*12*	**355,934**	260,672	346,379
Loans and advances to banks		**182,191**	226,043	180,987
Loans and advances to customers		**974,985**	1,037,888	940,429
Financial investments	*13*	**393,736**	416,857	400,044
Assets held for sale	*14*	**12,383**	1,599	39,558
Other assets		**47,115**	45,904	48,699
Current tax assets		**1,312**	1,487	1,061
Prepayments and accrued income		**9,736**	12,556	10,059
Interests in associates and joint ventures		**23,790**	18,882	20,399
Goodwill and intangible assets		**28,916**	32,028	29,034
Property, plant and equipment		**10,642**	11,594	10,865
Deferred tax assets		**7,644**	7,941	7,726
Total assets		**2,652,334**	2,690,987	2,555,579
Liabilities and equity				
Liabilities				
Hong Kong currency notes in circulation		**21,283**	19,745	20,922
Deposits by banks		**123,553**	125,479	112,822
Customer accounts		**1,278,489**	1,318,987	1,253,925
Items in the course of transmission to other banks		**11,321**	16,317	8,745
Trading liabilities	*15*	**308,564**	385,824	265,192
Financial liabilities designated at fair value	*16*	**87,593**	98,280	85,724
Derivatives	*12*	**355,952**	257,025	345,380
Debt securities in issue		**125,543**	149,803	131,013
Liabilities of disposal groups held for sale		**12,599**	41	22,200
Other liabilities		**35,119**	31,542	27,967
Current tax liabilities		**3,462**	2,629	2,117
Liabilities under insurance contracts		**62,861**	64,451	61,259
Accruals and deferred income		**11,727**	13,432	13,106
Provisions	*17*	**5,259**	3,027	3,324
Deferred tax liabilities		**1,585**	1,157	1,518
Retirement benefit liabilities		**3,962**	2,958	3,666
Subordinated liabilities		**29,696**	32,753	30,606
Total liabilities		**2,478,568**	2,523,450	2,389,486

Equity			
Called up share capital	**9,081**	8,909	8,934
Share premium account	**9,841**	8,401	8,457
Other equity instruments	**5,851**	5,851	5,851
Other reserves	**24,806**	31,085	23,615
Retained earnings	**116,266**	106,004	111,868
Total shareholders equity	**165,845**	160,250	158,725
Non-controlling interests	**7,921**	7,287	7,368
Total equity	**173,766**	167,537	166,093
Total equity and liabilities	**2,652,334**	2,690,987	2,555,579

The accompanying notes on pages 219 to 263 form an integral part of these financial statements[1].

For footnote, see page 218.

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HSBC HOLDINGS PLC

Financial Statements (unaudited) (continued)

Consolidated statement of cash flows for the half-year to 30 June 2012

		Half-year to		
	Notes	**30 June 2012 US$m**	30 June 2011 US$m	31 December 2011 US$m
Cash flows from operating activities				
Profit before tax		**12,737**	11,474	10,398
Adjustments for:				
net gain from investing activities		**(1,481)**	(544)	(652)
share of profit in associates and joint ventures		**(1,843)**	(1,556)	(1,708)
gain on disposal of US branches and cards business		**(3,809)**		
other non-cash items included in profit before tax	*20*	**10,420**	8,825	11,053
change in operating assets	*20*	**(47,658)**	(92,560)	85,148
change in operating liabilities	*20*	**40,766**	130,301	(86,289)
elimination of exchange differences[2]		**3,504**	(16,046)	26,886
dividends received from associates		**278**	246	58
contributions paid to defined benefit plans		**(437)**	(588)	(589)
tax paid		**(2,304)**	(1,709)	(2,386)
Net cash generated from operating activities		**10,173**	37,843	41,919
Cash flows from investing activities				
Purchase of financial investments		**(177,427)**	(156,596)	(162,412)
Proceeds from the sale and maturity of financial investments		**188,242**	153,407	158,295
Purchase of property, plant and equipment		**(683)**	(665)	(840)
Proceeds from the sale of property, plant and equipment		**76**	194	106
Net purchase of intangible assets		**(507)**	(893)	(678)
Net cash inflow from disposal of US branch network and cards business		**23,484**		
Net cash inflow/(outflow) from disposal of other subsidiaries and businesses		**(1,537)**	5	211
Net cash outflow from acquisition of or increase in stake of associates		**(13)**	(39)	(51)
Proceeds from disposal of associates and joint ventures		**288**	11	14
Net cash used in investing activities		**31,923**	(4,576)	(5,355)
Cash flows from financing activities				
Issue of ordinary share capital		**263**	13	83
Net sales of own shares for market-making and investment purposes		**25**	27	(252)
(Purchases)/sales of own shares to meet share awards and share option awards			(27)	(109)
Subordinated loan capital issued				7
Subordinated loan capital repaid		**(1,453)**	(2,574)	(1,203)
Net cash outflow from change in stake in subsidiaries				104
Dividends paid to ordinary shareholders of the parent company		**(3,161)**	(2,192)	(2,822)
Dividends paid to non-controlling interests		**(325)**	(321)	(247)
Dividends paid to holders of other equity instruments		**(286)**	(286)	(287)
Net cash generated from/(used in) financing activities		**(4,937)**	(5,360)	(4,726)
Net increase/(decrease) in cash and cash equivalents		**37,159**	27,907	31,838
Cash and cash equivalents at the beginning of the period		**325,449**	274,076	312,351
Exchange differences in respect of cash and cash equivalents		**(3,601)**	10,368	(18,740)
Cash and cash equivalents at the end of the period	*20*	**359,007**	312,351	325,449

The accompanying notes on pages 219 to 263 form an integral part of these financial statements[1].

For footnotes, see page 218.

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HSBC HOLDINGS PLC

Financial Statements (unaudited) (continued)

Consolidated statement of changes in equity for the half-year to 30 June 2012

	Half-year to 30 June 2012				Other reserves						
	Called up share capital US$m	Share premium[3] US$m	Other equity instruments US$m	Retained earnings[4,5] US$m	Available-for-sale fair value reserve US$m	Cash flow hedging reserve[6] US$m	Foreign exchange reserve US$m	Merger reserve[4,7] US$m	Total shareholders equity US$m	Non-controlling interests US$m	Total equity US$m
At 1 January 2012	8,934	8,457	5,851	111,868	(3,361)	(95)	(237)	27,308	158,725	7,368	166,093
Profit for the period				8,438					8,438	670	9,108
Other comprehensive income (net of tax)				(114)	1,562	(7)	(364)		1,077	(13)	1,064
Available-for-sale investments					1,562				1,562	31	1,593
Cash flow hedges						(7)			(7)	1	(6)
Actuarial gains/(losses) on defined benefit plans				(452)					(452)	(17)	(469)
Share of other comprehensive income of associates and joint ventures				338					338		338
Exchange differences							(364)		(364)	(28)	(392)
Total comprehensive income for the period				8,324	1,562	(7)	(364)		9,515	657	10,172
Shares issued under employee share plans	84	1,447		(1,268)					263		263
Shares issued in lieu of dividends and amounts arising thereon[3]	63	(63)		1,007					1,007		1,007
Dividends to shareholders[8]				(4,454)					(4,454)	(398)	(4,852)
Tax credits on distributions				59					59		59
Own shares adjustment				32					32		32
Cost of share-based payment arrangements				541					541		541
Income taxes on share-based payments				(5)					(5)		(5)
Other movements				119					119	(11)	108
Acquisition and disposal of subsidiaries										376	376
Changes in ownership interests in subsidiaries that did not result in				43					43	(71)	(28)

loss of control											
At 30 June 2012	**9,081**	**9,841**	**5,851**	**116,266**	**(1,799)**	**(102)**	**(601)**	**27,308**	**165,845**	**7,921**	**173,766**

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Financial Statements (unaudited) (continued)

Consolidated statement of changes in equity for the half-year to 30 June 2012 *(continued)*

	Half-year to 30 June 2011										
					Other reserves						
	Called up share capital US$m	Share premium[3] US$m	Other equity instruments US$m	Retained earnings[4,5] US$m	Available-for-sale fair value reserve US$m	Cash flow hedging reserve[6] US$m	Foreign exchange reserve US$m	Merger reserve[4,7] US$m	Total shareholders equity US$m	Non-controlling interests US$m	Total equity US$m
At 1 January 2011	8,843	8,454	5,851	99,105	(4,077)	(285)	2,468	27,308	147,667	7,248	154,915
Profit for the period				9,215					9,215	547	9,762
Other comprehensive income (net of tax)				(144)	1,146	40	4,471		5,513	67	5,580
Available-for-sale investments					1,146				1,146	(10)	1,136
Cash flow hedges						40			40		40
Actuarial gains/(losses) on defined benefit plans				2					2	(21)	(19)
Share of other comprehensive income of associates and joint ventures				(146)					(146)		(146)
Exchange differences							4,471		4,471	98	4,569
Total comprehensive income for the period				9,071	1,146	40	4,471		14,728	614	15,342
Shares issued under employee share plans	1	12							13		13
Shares issued in lieu of dividends and amounts arising thereon[3]	65	(65)		1,334					1,334		1,334
Dividends to shareholders[8]				(4,006)					(4,006)	(413)	(4,419)
Tax credits on distributions				64					64		64
Own shares adjustment				(225)					(225)		(225)
Cost of share-based payment arrangements				588					588		588
Income taxes on share-based payments				36					36		36
Other movements				37	14				51	1	52
Acquisition and disposal of subsidiaries										(261)	(261)
Changes in ownership interests in subsidiaries that did not result in										98	98

loss of control											
At 30 June 2011	8,909	8,401	5,851	106,004	(2,917)	(245)	6,939	27,308	160,250	7,287	167,537

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HSBC HOLDINGS PLC

Financial Statements (continued)

	Half-year to 31 December 2011										
					Other reserves						
	Called up share capital US$m	Share premium[3] US$m	Other equity instruments US$m	Retained earnings[4,5] US$m	Available-for-sale fair value reserve US$m	Cash flow hedging reserve[6] US$m	Foreign exchange reserve US$m	Merger reserve[4,7] US$m	Total shareholders equity US$m	Non-controlling interests US$m	Total equity US$m
At 1 July 2011	8,909	8,401	5,851	106,004	(2,917)	(245)	6,939	27,308	160,250	7,287	167,537
Profit for the period				7,582					7,582	600	8,182
Other comprehensive income (net of tax)				512	(430)	150	(7,176)		(6,944)	(176)	(7,120)
Available-for-sale investments					(430)				(430)	(32)	(462)
Cash flow hedges						150			150	(3)	147
Actuarial losses on defined benefit plans				1,076					1,076	(48)	1,028
Share of other comprehensive income of associates and joint ventures				(564)					(564)		(564)
Exchange differences							(7,176)		(7,176)	(93)	(7,269)
Total comprehensive income for period				8,094	(430)	150	(7,176)		638	424	1,062
Shares issued under employee share plans	5	78							83		83
Shares issued in lieu of dividends and amounts arising thereon[3]	20	(22)		898					896		896
Dividends to shareholders[8]				(3,495)					(3,495)	(402)	(3,897)
Tax credits on distributions				64					64		64
Own shares adjustment				(136)					(136)		(136)
Cost of share-based payment arrangements				566					566		566
Income taxes on share based payments				(15)					(15)		(15)
Other movements				(112)	(14)				(126)	27	(99)
Acquisition and disposal of subsidiaries										9	9
Changes in ownership interests in subsidiaries that did not result in loss of control										23	23
At 31 December 2011	8,934	8,457	5,851	111,868	(3,361)	(95)	(237)	27,308	158,725	7,368	166,093

The accompanying notes on pages 219 to 263 form an integral part of these financial statements[1].

For footnotes, see page 218.

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Financial Statements (unaudited) (continued)

Footnotes to Financial Statements

1 *The tables: Maximum exposure to credit risk (page 114), Gross loans and advances by industry sector (page 115), Gross loans and advances to customers by industry sector and by geographical region (page 116), Movement in impairment allowances on loans and advances to customers and banks (page 149), the Composition of regulatory capital within Capital structure (page 198), Impaired loans (page 146), and the table Impaired loans and advances to customers (page 147) also form an integral part of these financial statements.*

2 *Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense.*

3 *Share premium includes the deduction of nil in respect of issuance costs incurred during the period (30 June 2011: nil; 31 December 2011: US$2m).*

4 *Cumulative goodwill amounting to US$5,138m has been charged against reserves in respect of acquisitions of subsidiaries prior to 1 January 1998, including US$3,469m charged against the merger reserve arising on the acquisition of HSBC Bank plc. The balance of US$1,669m was charged against retained earnings.*

5 *Retained earnings include 83,578,031 (US$5,719m) of own shares held within HSBC s insurance business, retirement funds for the benefit of policyholders or beneficiaries within employee trusts for the settlement of shares expected to be delivered under employee share schemes or bonus plans, and the market-making activities in Global Markets (30 June 2011: 77,926,453 (US$968m); 31 December 2011: 98,498,019 (US$1,320m)).*

6 *Amounts transferred to the income statement in respect of cash flow hedges for the half-year to 30 June 2012 include US$12m loss (30 June 2011: US$345m gain; 31 December 2011: US$241m loss) taken to Net interest income and US$232m loss (30 June 2011: US$149m loss; 31 December 2011: US$744m loss) taken to Net trading income .*

7 *Statutory share premium relief under Section 131 of the Companies Act 1985 (the Act) was taken in respect of the acquisition of HSBC Bank in 1992, HSBC France in 2000 and HSBC Finance in 2003 and the shares issued were recorded at their nominal value only. In HSBC s consolidated financial statements the fair value differences of US$8,290m in respect of HSBC France and US$12,768m in respect of HSBC Finance were recognised in the merger reserve. The merger reserve created on the acquisition of HSBC Finance subsequently became attached to HSBC Overseas Holdings (UK) Limited (HOHU), following a number of intra-Group reorganisations. During 2009, pursuant to Section 131 of the Companies Act 1985, statutory share premium relief was taken in respect of the rights issue and US$15,796m was recognised in the merger reserve. The merger reserve includes the deduction of US$614m in respect of costs relating to the rights issue, of which US$149m was subsequently transferred to the income statement. Of this US$149m, US$121m was a loss arising from accounting for the agreement with the underwriters as a contingent forward contract. The merger reserve excludes the loss of US$344m on a forward foreign exchange contract associated with hedging the proceeds of the rights issue.*

8 *Including distributions paid on preference shares and capital securities classified as equity.*

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HSBC HOLDINGS PLC

Notes on the Financial Statements (unaudited)

1 Basis of preparation

(a) Compliance with International Financial Reporting Standards

The interim consolidated financial statements of HSBC have been prepared in accordance with the Disclosure Rules and Transparency Rules of the Financial Services Authority and IAS 34 Interim Financial Reporting (IAS 34) as issued by the International Accounting Standards Board (IASB) and as endorsed by the EU.

The consolidated financial statements of HSBC at 31 December 2011 were prepared in accordance with International Financial Reporting Standards (IFRSs) as issued by the IASB and as endorsed by the 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 the consolidated financial statements at that date, 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 were prepared in accordance with IFRSs as issued by the IASB.

On 20 December 2010, the IASB issued Deferred tax: Recovery of Underlying Assets (amendments to IAS 12) which is effective for periods beginning on or after 1 January 2012 but has not yet been endorsed by the EU. The effect of the application of the amendment is not significant to HSBC.

At 30 June 2012, there were no other unendorsed standards effective for the period ended 30 June 2012 affecting these interim consolidated financial statements, and there was no significant difference between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to HSBC.

IFRSs comprise accounting standards issued by the IASB and its predecessor body as well as interpretations issued by the IFRS Interpretations Committee (IFRIC) and its predecessor body.

During the half-year ended 30 June 2012, HSBC also adopted amendments to standards which had an insignificant effect on these interim consolidated financial statements.

(b) Presentation of information

In accordance with HSBC s policy to provide meaningful disclosures that help investors and other stakeholders understand the Group s performance, financial position and changes thereto, the information provided in the Notes on the Financial Statements and the Interim Management Report goes beyond the minimum levels required by accounting standards, statutory and regulatory requirements and listing rules. In particular, HSBC has adopted the British Bankers Association Code for Financial Reporting Disclosure (the BBA Code). The BBA Code aims to increase the quality and comparability of banks disclosures and sets out five disclosure principles together with supporting guidance. In line with the principles of the BBA Code, HSBC assesses the applicability and relevance of good practice recommendations issued from time to time by relevant regulators and standard setters, enhancing disclosures where appropriate.

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HSBC HOLDINGS PLC

Notes on the Financial Statements (unaudited) (continued)

HSBC s consolidated financial statements are presented in US dollars. HSBC Holdings functional currency is also the US dollar because the US dollar and currencies linked to it are the most significant currencies relevant to the underlying transactions, events and conditions of its subsidiaries, as well as representing a significant proportion of its funds generated from financing activities. HSBC uses the US dollar as its presentation currency in its consolidated financial statements because the US dollar and currencies linked to it form the major currency bloc in which HSBC transacts and funds its business.

(c) Use of estimates and assumptions

The preparation of financial information requires the use of estimates and assumptions about future conditions. The use of available information and the application of judgement are inherent in the formation of estimates; actual results in the future may differ from those reported. Management believes that HSBC s critical accounting policies where judgement is necessarily applied are those which relate to impairment of loans and advances, goodwill impairment, the valuation of financial instruments, the impairment of available-for-sale financial assets, deferred tax assets and provisions for liabilities. These critical accounting policies are described on pages 38 to 42 of the *Annual Report and Accounts 2011*.

(d) Consolidation

The interim consolidated financial statements of HSBC comprise the financial statements of HSBC Holdings and its subsidiaries. The method adopted by HSBC to consolidate its subsidiaries is described on pages 292 to 293 of the *Annual Report and Accounts 2011.*

(e) Future accounting developments

At 30 June 2012, a number of standards and amendments to standards had been issued by the IASB, which are not effective for these consolidated financial statements. Most of these new requirements have not yet been endorsed for use in the EU. In addition to the projects to complete financial instrument accounting, the IASB is continuing to work on projects on insurance, revenue recognition and lease accounting which, together with the standards described below, will represent significant changes to accounting requirements from 2013.

Amendments issued by the IASB and endorsed by the EU

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

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

Based on our estimate of the impact of this particular amendment on the 2011 consolidated financial statements, the change would decrease pre-tax profit, with no effect on the pension liability. The effect on total operating expenses and pre-tax profit is not expected to be material. The effect at the date of adoption will depend on market interest rates, rates of return and the actual mix of scheme assets at that time.

Standards and amendments issued by the IASB but not endorsed by the EU

Standards applicable in 2013

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

Under IFRS 10, there will be one approach for determining consolidation for all entities, based on the concept of power, variability of returns and their linkage. This will replace the current approach which emphasises legal

HSBC HOLDINGS PLC

Notes on the Financial Statements (unaudited) (continued)

control or exposure to risks and rewards, depending on the nature of the entity. IFRS 11 places more focus on the investors rights and obligations than on the structure of the arrangement, and introduces the concept of a joint operation. IFRS 12 includes the disclosure requirements for subsidiaries, joint arrangements and associates and introduces new requirements for unconsolidated structured entities for which comparative information need not be provided for periods prior to initial application.

Based on our assessment to date, while the consolidation status of some entities may change because HSBC has control but not the majority of risks and rewards, or vice versa, we do not expect the overall impact of IFRS 10 and IFRS 11 on the financial statements to be material.

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

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

HSBC is currently assessing IFRS 13 and it is not practicable to quantify the effect as at the date of the publication of these financial statements, which will depend on final interpretations of the standard, market conditions and HSBC s holdings of financial instruments at 1 January 2013. However, based on the analysis performed to date, the main effect of applying IFRS 13 is considered to be an adjustment to derivative liabilities for HSBC s own credit risk which is often referred to as debit valuation adjustment . This adjustment would be made on a symmetrical basis to credit valuation adjustments applied in valuing derivative assets. The magnitude of this impact will depend on the credit valuation adjustment methodology at the point of initial application of IFRS 13. See Note 8 for further information on credit valuation adjustment methodologies.

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

Standards applicable in 2014

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

HSBC is currently assessing the impact of these clarifications but it is not practicable to quantify the effect as at the date of the publication of these financial statements.

Standards applicable in 2015

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

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

The second and third phases in the IASB s project to replace IAS 39 will address the impairment of financial assets measured at amortised cost and hedge accounting.

Notes on the Financial Statements (unaudited) (continued)

The IASB re-opened the requirements for classification and measurement in IFRS 9 in 2012 to address practice and other issues, with an exposure draft of revised proposals expected in the second half of 2012. Therefore, HSBC remains unable to provide a date by which it will apply IFRS 9 and it remains impracticable to quantify the effect of IFRS 9 as at the date of the publication of these financial statements.

(f) Changes in composition of the Group

Except as discussed in Note 14 there were no material changes in the composition of the Group.

2 Accounting policies

The accounting policies adopted by HSBC for these interim consolidated financial statements are consistent with those described on pages 294 to 312 of the *Annual Report and Accounts 2011*. The methods of computation applied by HSBC for these interim consolidated financial statements are consistent with those applied for the *Annual Report and Accounts 2011.*

3 Dividends

The Directors declared after the end of the period a second interim dividend in respect of the financial year ending 31 December 2012 of US$0.09 per ordinary share, a distribution of approximately US$1,643m which will be payable on 4 October 2012. No liability is recorded in the financial statements in respect of this dividend.

Dividends to shareholders of the parent company

	30 June 2012			Half-year to 30 June 2011			31 December 2011		
	Per share US$	**Total US$m**	**Settled in scrip US$m**	Per share US$	Total US$m	Settled in scrip US$m	Per share US$	Total US$m	Settled in scrip US$m
Dividends declared on ordinary shares									
In respect of previous year:									
fourth interim dividend	**0.14**	**2,535**	**259**	0.12	2,119	1,130			
In respect of current year:									
first interim dividend	**0.09**	**1,633**	**748**	0.09	1,601	204			
second interim dividend							0.09	1,603	178
third interim dividend							0.09	1,605	720
	0.23	**4,168**	**1,007**	0.21	3,720	1,334	0.18	3,208	898

Quarterly dividends on preference shares classified as equity						
March dividend	**15.50**	**22**	15.50	22		
June dividend	**15.50**	**23**	15.50	23		
September dividend					15.50	22
December dividend					15.50	23
	31.00	**45**	31.00	45	31.00	45
Quarterly coupons on capital securities classified as equity[1]						
January coupon	**0.508**	**44**	0.508	44		
March coupon	**0.500**	**76**	0.500	76		
April coupon	**0.508**	**45**	0.508	45		
June coupon	**0.500**	**76**	0.500	76		
July coupon					0.508	45
September coupon					0.500	76
October coupon					0.508	45
December coupon					0.500	76
	2.016	**241**	2.016	241	2.016	242

1 *HSBC Holdings issued Perpetual Subordinated Capital Securities of US$3,800m in June 2010 and US$2,200m in April 2008, which are classified as equity under IFRSs.*

On 16 July 2012, HSBC paid a further coupon on the capital securities of US$0.508 per security, a distribution of US$45m. No liability is recorded in the financial statements in respect of this coupon payment.

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Notes on the Financial Statements (unaudited) (continued)

4 Earnings per share

Basic earnings per ordinary share were calculated by dividing the profit attributable to ordinary shareholders of the parent company by the weighted average number of ordinary shares outstanding, excluding own shares held. Diluted earnings per ordinary share were calculated by dividing the basic earnings, which require no adjustment for the effects of dilutive potential ordinary shares, by the weighted average number of ordinary shares outstanding, excluding own shares held, plus the weighted average number of ordinary shares that would be issued on conversion of dilutive potential ordinary shares.

Profit attributable to ordinary shareholders of the parent company

		Half-year to	
	30 June 2012 US$m	30 June 2011 US$m	31 December 2011 US$m
Profit attributable to shareholders of the parent company	**8,438**	9,215	7,582
Dividend payable on preference shares classified as equity	**(45)**	(45)	(45)
Coupon payable on capital securities classified as equity	**(241)**	(241)	(242)
Profit attributable to ordinary shareholders of the parent company	**8,152**	8,929	7,295

Basic and diluted earnings per share

	Half-year to 30 June 2012			Half-year to 30 June 2011			Half-year to 31 December 2011		
	Profit US$m	**Number of shares (millions)**	**Amount per share US$**	Profit US$m	Number of shares (millions)	Amount per share US$	Profit US$m	Number of shares (millions)	Amount per share US$
Basic[1]	**8,152**	**17,983**	**0.45**	8,929	17,631	0.51	7,295	17,768	0.41
Effect of dilutive potential ordinary shares		**158**			266			179	
Diluted[2]	**8,152**	**18,141**	**0.45**	8,929	17,897	0.50	7,295	17,947	0.41

1 *Weighted average number of ordinary shares outstanding.*
2 *Weighted average number of ordinary shares outstanding assuming dilution.*

5 Post-employment benefits

Included within Employee compensation and benefits are components of net periodic benefit cost related to HSBC s defined benefit pension plans and other post-employment benefits, as follows:

		Half-year to	
	30 June 2012 US$m	30 June 2011 US$m	31 December 2011 US$m
Defined benefit pension plans			
Current service cost	**276**	279	271
Interest cost	**792**	859	830
Expected return on plan assets	**(858)**	(911)	(895)
Past service cost	**3**	(579)	37
Gains on curtailments			(59)
Gains on settlements			(4)
	213	(352)	180
Defined benefit healthcare plans	**20**	31	1
Total (income)/expense	**233**	(321)	181

HSBC revalues its defined benefit post-employment plans each year at 31 December, in consultation with the plans local actuaries. The assumptions underlying the calculations are used to determine the expected income statement charge for the year going forward. At 30 June each year, HSBC revalues all plan assets to current market prices. HSBC also reviews the assumptions used to calculate the defined benefit obligations (the liabilities of the plans) and updates the carrying amount of the obligations if there have been significant changes as a consequence of changes in assumptions.

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Retirement benefit liabilities for the Group have increased from US$3.7bn at 31 December 2011 to US$4.0bn at 30 June 2012. Retirement benefit assets for the Group were US$2.5bn at 30 June 2012, unchanged from the amount at 31 December 2011. Retirement benefit assets are reported as part of other assets in the consolidated balance sheet and are primarily in respect of a surplus in the HSBC Bank (UK) Pension Scheme funded defined benefit plan (the principal plan). At 30 June 2012 the principal plan was in surplus by US$2.2bn as a result of the special contribution made in 2010 and the changes in fair value of the derivative swaps entered into with HSBC Bank plc noted below.

In the first half of 2012, there was a reduction in the average yields of high quality (AA rated or equivalent) debt instruments in the UK, together with a decrease in inflation expectations. The change in these and other actuarial assumptions resulted in a US$489m decrease in the defined benefit obligation for the principal plan. This decrease was recognised directly in equity as an actuarial gain.

This gain has been offset by actuarial losses in the US and Hong Kong schemes due to decreasing discount rates noted in the table below. The fall in the Hong Kong discount rate is mainly due to a fall in yields on longer-dated government bonds, which are referenced due to the lack of a deep corporate bond market in Hong Kong.

In the US, the fall in the discount rate used is a result of the fall in the yields of long-term, high grade corporate bonds.

The discount rates used to calculate the Group s obligations to the largest defined benefit pension plans were as follows:

Discount rates

	At 30 June 2012 %	At 30 June 2011 %	At 31 December 2011 %
UK	**4.70**	5.60	4.80
Hong Kong	**0.96**	2.28	1.47
US	**4.05**	5.35	4.60

The inflation rate used to calculate the principal plan obligation at 30 June 2012 was 3.0% (30 June 2011: 3.8%; 31 December 2011: 3.2%). Other than described above, there were no material changes to other assumptions.

The actual return on plan assets of the principal plan was approximately US$572m below the expected return. This difference was recognised directly in equity as an actuarial loss.

Actuarial gains and losses

	Half-year to		
	30 June 2012 US$m	30 June 2011 US$m	31 December 2011 US$m
Defined benefit pension plans			

Experience gains/(losses) on plan liabilities	**37**	(36)	(425)
Experience gains/(losses) on plan assets	**(495)**	166	3,460
Losses from changes in actuarial assumptions	**(136)**	(139)	(1,723)
Other movements[1]	**(3)**	(16)	41
	(597)	(25)	1,353
Defined benefit healthcare plans	**(22)**	7	(68)
Total net actuarial gains/(losses)	**(619)**	(18)	1,285

1 *Other movements include changes in the effect of the limit on plan surpluses.*

Actuarial gains and losses comprise experience adjustments on plan assets and liabilities as well as adjustments arising from changes in actuarial assumptions. The experience gains and losses on plan assets arise as a result of the difference between the expected returns on the plan assets and the actual movement in the value of the plan assets during the period. The changes in actuarial assumptions arise as a result of changes in the plan assumptions, primarily discount rates and inflation rates, as previously described.

Notes on the Financial Statements (unaudited) (continued)

Total cumulative net actuarial losses, including the cumulative effect of the limit on plan surpluses recognised in equity at 30 June 2012, were US$4,002m (30 June 2011: US$4,738m cumulative losses; 31 December 2011: US$3,453m cumulative losses). Of this the cumulative effect of the limit on plan surpluses was US$20m (30 June 2011: US$65m; 31 December 2011: US$18m).

On 17 June 2010, HSBC Bank plc agreed with the Trustee to accelerate the reduction of the deficit of the principal plan with a special contribution of £1,760m (US$2,638m) in June 2010 followed by a revised payment schedule in the following years, as shown below.

In December 2011, HSBC Bank plc made a £184m (US$286m) special contribution to the principal plan. The additional contribution did not result in an amendment to the future funding payments to the principal plan.

Additional future funding payments to the principal plan

	US$m[1]	£m
2016	776	495
2017	988	630
2018	988	630

1 *The payment schedule was agreed with the Trustee in pounds sterling and the equivalent US dollar amounts are shown at the exchange rate effective as at 30 June 2012.*

The triennial valuation applicable to the HSBC Bank (UK) Pension Scheme as at 31 December 2011 is currently being performed and is due to be completed no later than 31 March 2013.

As disclosed in Related party transactions on page 411 in the *Annual Report and Accounts 2011*, the principal plan entered into collateralised swap transactions with HSBC to manage the inflation and interest rate sensitivity of the Scheme s pension obligations. At 30 June 2012, the swaps had a positive fair value of US$4,896m to the Scheme (30 June 2011: US$2,457m positive to the Scheme; 31 December 2011: US$5,560m positive to the Scheme). All swaps were executed at prevailing market rates and within standard market bid-offer spreads.

6 Tax

	Half-year to		
	30 June 2012	30 June 2011	31 December 2011
	US$m	US$m	US$m
Current tax			
UK corporation tax charge	**100**	230	590

Overseas tax[1]	**3,549**	1,694	2,561
	3,649	1,924	3,151
Deferred tax			
Origination and reversal of temporary differences	**(20)**	(212)	(935)
Tax expense	**3,629**	1,712	2,216
Effective tax rate	**28.5%**	14.9%	21.3%

1 *Overseas tax included Hong Kong profits tax of US$476m (first half of 2011: US$453m; second half of 2011: US$544m). Subsidiaries in Hong Kong provided for Hong Kong profits tax at the rate of 16.5% (2011: 16.5%) on the profits for the period assessable in Hong Kong. Other overseas subsidiaries and overseas branches provided for taxation at the appropriate rates in the countries in which they operate.*

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Notes on the Financial Statements (unaudited) (continued)

Tax reconciliation

The tax charged to the income statement differs to the tax charge that would apply if all profits had been taxed at the UK corporation tax rate as follows:

	Half-year to					
	30 June 2012		30 June 2011		31 December 2011	
	US$m	**%**	US$m	%	US$m	%
Profit before tax	**12,737**		11,474		10,398	
Taxation at 24.5% (2011: 26.5%)	**3,122**	**24.5**	3,041	26.5	2,755	26.5
Effect of differently taxed overseas profits	**265**	**2.1**	(275)	(2.4)	(217)	(2.1)
Adjustments in respect of prior period liabilities	**479**	**3.7**	522	4.6	(27)	(0.3)
Deferred tax temporary differences not recognised/ (previously not recognised)	**2**		(1,008)	(8.8)	85	0.8
Effect of profit in associates and joint ventures	**(459)**	**(3.6)**	(412)	(3.6)	(453)	(4.4)
Non taxable income and gains	**(280)**	**(2.2)**	(184)	(1.6)	(359)	(3.4)
Permanent disallowables	**405**	**3.2**	95	0.8	372	3.6
Change in tax rates	**(18)**	**(0.1)**	2		(5)	
Local taxes and overseas withholding tax	**205**	**1.6**	117	1.0	150	1.4
Other items (including low income housing tax credits)	**(92)**	**(0.7)**	(186)	(1.6)	(85)	(0.8)
Total tax charged to the income statement	**3,629**	**28.5**	1,712	14.9	2,216	21.3

The effective tax rate for the first half of 2012 was 28.5% compared with 14.9% for the first half of 2011. The higher effective tax rate in the first half of 2012 reflects the impact of higher taxed profits arising on the disposal of the US branch network and cards business combined with the non deductible provision in respect of certain US regulatory matters. The lower effective tax rate in the first half of 2011 included the benefit of deferred tax of US$0.9bn eligible to be recognised in respect of foreign tax credits in the US.

The UK Government announced that the main rate of corporation tax for the year beginning 1 April 2012 will reduce from 26% to 24% to be followed by further 1% reductions per annum to 22% for the year beginning 1 April 2014. The reduction in the corporate tax rate to 24% was substantively enacted in the first half of 2012 and this results in a weighted average of 24.5% for 2012 (2011: 26.5%). The reduction to 23% was enacted through the 2012 Finance Act in July and the reduction to 22% is expected to be enacted through the 2013 Finance Act. It is not expected that the future rate reductions will have a significant effect on the net UK deferred tax liability at 30 June 2012 of US$327m.

For the period ended 30 June 2012, HSBC s share of associates tax on profit was US$476m (30 June 2011: US$418m; 31 December 2011: US$472m), which is included within share of profit in associates and joint ventures in the income statement.

The Group s legal entities are subject to routine review and audit by tax authorities in the territories in which the Group operates. The Group provides 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 open issues. A substantial proportion of the material open issues relate to the UK of which the principal matter concerns the application of the UK Controlled Foreign Company (CFC) rules. Following further discussion with Her Majesty s Revenue and Customs, the CFC and certain other open UK issues have now been resolved.

Deferred taxation

United States

Of the total net deferred tax assets of US$6.1bn at 30 June 2012 (30 June 2011: US$6.8bn; 31 December 2011: US$6.2bn) the net deferred tax asset relating to HSBC s operations in the US is US$5.0bn (30 June 2011: US$5.1bn; 31 December 2011: US$5.2bn). The deferred tax assets included in this total reflect the carry forward of tax losses and tax credits (US$0.2bn; 30 June 2011: US$1.0bn; 31 December 2011: US$1.2bn), deductible temporary differences in respect of loan impairment allowances (US$2.5bn; 30 June 2011: US$2.8bn; 31 December 2011: US$2.7bn) and other temporary differences (US$2.3bn; 30 June 2011: US$1.3bn; 31 December 2011: US$1.3bn).

Deductions for loan impairments for US tax purposes generally occur when the impaired loan is charged off, often in the period subsequent to that in which the impairment is recognised for accounting purposes. As a result, the amount of the associated deferred tax asset should generally move in line with the impairment allowance balance.

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The taxable gains on the disposal of the US branch network and cards business has resulted in a reduction in the amount of deferred tax assets related to carried forward tax losses and tax credits. This was offset in part by the reversal of deferred tax liabilities as a result of these disposals.

On the evidence available, including historical levels of profitability, management projections of future income and HSBC Holdings commitment to continue to invest sufficient capital in North America to recover the deferred tax asset, it is expected there will be sufficient taxable income generated by the business to realise these assets. Management projections of profits from the US operations are prepared for a 10 year period and include assumptions about future house prices and US economic conditions, including unemployment levels.

Management projections of profits from the US operations currently indicate that the existing carry forward tax losses and tax credits will be fully recovered by 2015. The current level of the deferred tax asset in respect of loan impairment allowances is projected to reduce over the 10-year period in line with the reduction of the consumer lending portfolio.

As there has been a recent history of losses in HSBC s US operations, management s analysis of the recognition of these deferred tax assets significantly discounts any future expected profits from the US operations and relies to a greater extent on capital support from HSBC Holdings, including tax planning strategies implemented in relation to such support. The principal strategy involves generating future taxable profits through the retention of capital in the US in excess of normal regulatory requirements in order to reduce deductible funding expenses or otherwise deploy such capital to increase levels of taxable income.

Brazil

The net deferred tax asset relating to HSBC s operations in Brazil is US$0.7bn at 30 June 2012 (30 June 2011: US$0.8bn; 31 December 2011: US$0.7bn). The deferred tax assets included in this total arise primarily in relation to deductible temporary differences in respect of loan impairment allowances. Deductions for loan impairments for Brazilian tax purposes generally occur in periods subsequent to those in which they are recognised for accounting purposes and, as a result, the amount of the associated deferred tax assets will move in line with the impairment allowance balance.

Loan impairment deductions are recognised for tax purposes typically within 24 months of accounting recognition. On the evidence available, including historical levels of profitability, management projections of income and the state of the Brazilian economy, it is anticipated there will be sufficient taxable income generated by the business to realise these assets when deductible for tax purposes. There are no material carried forward tax losses or tax credits recognised within the Group s deferred tax assets in Brazil.

Mexico

The net deferred tax asset relating to HSBC s operations in Mexico is US$0.5bn at 30 June 2012 (30 June 2011: US$0.6bn; 31 December 2011: US$0.5bn). The deferred tax assets included in this total relate primarily to deductible temporary differences in respect of accounting provisions for impaired loans, including losses realised on sales of impaired loans. The annual deduction for loan impairments is capped under Mexican legislation at 2.5% of the average qualifying loan portfolio. The balance is carried forward to future years without expiry but with annual deduction subject to the 2.5% cap.

On the evidence available, including historic and