

HSBC HOLDINGS PLC
Form 6-K
November 10, 2009

FORM 6-K

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Report of Foreign Private Issuer

**Pursuant to Rule 13a - 16 or 15d - 16 of
the Securities Exchange Act of 1934**

For the month of November

HSBC Holdings plc

42nd Floor, 8 Canada Square, London E14 5HQ, England

(Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F).

Form 20-F Form 40-F

(Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934).

Yes..... No

(If "Yes" is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82-.....).

UNITED STATES SECURITIES AND

EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2009

OR

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

For the transition period from _____ to _____

Commission file number 1-7436

HSBC USA Inc.

(Exact name of registrant as specified in its charter)

Maryland
(State of Incorporation)

13-2764867
(I.R.S. Employer Identification No.)

452 Fifth Avenue, New York, New York

10018

(Address of principal executive offices)

(Zip Code)

(212) 525-5000

Registrant's telephone number, including area code

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

As of October 31, 2009, there were 712 shares of the registrant's common stock outstanding, all of which are owned by HSBC North America Inc.

HSBC USA Inc.

Form 10-Q

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HSBC USA Inc.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CONSOLIDATED STATEMENT OF INCOME (LOSS) (UNAUDITED)

| | Three Months Ended | | Nine Months Ended | |
|--|-----------------------|--------------|----------------------|--------------|
| | September 30, | | September 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| | (in millions) | | | |
| Interest income: | | | | |
| | \$ | \$ | \$ | \$ |
| Loans | 1,370 | 1,423 | 4,378 | 4,270 |
| Securities | 233 | 313 | 731 | 943 |
| Trading assets | 52 | 139 | 162 | 435 |
| Short-term investments | 21 | 100 | 68 | 323 |
| Other | 12 | 54 | 35 | 198 |
| Total interest income | 1,688 | 2,029 | 5,374 | 6,169 |
| Interest expense: | | | | |
| Deposits | 224 | 575 | 804 | 1,956 |
| Short-term borrowings | 16 | 60 | 51 | 227 |
| Long-term debt | 188 | 225 | 634 | 766 |
| Total interest expense | 428 | 860 | 1,489 | 2,949 |
| Net interest income | 1,260 | 1,169 | 3,885 | 3,220 |
| Provision for credit losses | 1,006 | 658 | 3,247 | 1,762 |
| Net interest income after provision for credit losses | 254 | 511 | 638 | 1,458 |
| Other revenues: | | | | |
| Credit card fees | 333 | 215 | 1,032 | 653 |
| Other fees and commissions | 201 | 192 | 652 | 539 |
| Trust income | 30 | 44 | 92 | 114 |
| Trading revenue (loss) | 353 | (122) | 351 | (947) |
| Net other-than-temporary impairment losses(1) | (26) | (180) | (84) | (204) |
| Other securities gains (losses), net | 5 | 2 | 299 | 76 |
| Servicing and other fees from HSBC affiliates | 24 | 30 | 95 | 109 |
| Residential mortgage banking revenue | 15 | 13 | 139 | 64 |
| Gain (loss) on instruments designated at fair value and related derivatives | 44 | 111 | (201) | 121 |
| Other income (loss) | (84) | (35) | (154) | (191) |
| Total other revenues | 895 | 270 | 2,221 | 334 |
| Operating expenses: | | | | |
| Salaries and employee benefits | 280 | 329 | 873 | 971 |
| Support services from HSBC affiliates | 387 | 300 | 1,228 | 891 |
| Occupancy expense, net | 59 | 72 | 211 | 201 |
| Other expenses | 193 | 268 | 668 | 651 |

| | | | | |
|---|---------------|------------|--------------|--------------|
| Total operating expenses | 919 | 969 | 2,980 | 2,714 |
| Income (loss) before income tax expense (benefit) | 230 | (188) | (121) | (922) |
| Income tax expense (benefit) | 69 | (52) | 56 | (334) |
| | | \$ | \$ | \$ |
| Net Income (loss) | \$ 161 | (136) | (177) | (588) |

- (1) During the three and nine months ended September 30, 2009, \$28 million and \$188 million, respectively, of gross other-than-temporary impairment (“OTTI”) losses on securities available-for-sale were recognized, of which \$2 million and \$104 million, respectively, were recognized in accumulated other comprehensive income (loss) (“AOCI”).

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

CONSOLIDATED BALANCE SHEET (UNAUDITED)

| | September 30, December 31, | |
|---|-----------------------------------|--------------------|
| | <u>2009</u> | <u>2008</u> |
| | (in millions) | |
| Assets | | |
| Cash and due from banks | \$ 2,571 | \$ 2,972 |
| Interest bearing deposits with banks | 18,504 | 15,940 |
| Federal funds sold and securities purchased under agreements to resell | 4,463 | 10,813 |
| Trading assets | 24,848 | 31,292 |
| Securities available-for-sale | 29,563 | 24,908 |
| Securities held to maturity (fair value of \$2.9 billion at September 30, 2009 and at December 31, 2008) | 2,792 | 2,875 |
| Loans | 82,566 | 81,113 |
| Less – allowance for credit losses | (3,867) | (2,397) |
| Loans, net | <u>78,699</u> | <u>78,716</u> |
| Loans held for sale (includes \$1.1 billion and \$1.0 billion designated under fair value option at September 30, 2009 and December 31, 2008, respectively) | 2,803 | 4,431 |
| Properties and equipment, net | 531 | 559 |
| Intangible assets, net | 429 | 374 |
| Goodwill | 2,647 | 2,647 |
| Other assets | <u>7,659</u> | <u>10,042</u> |
| | \$ | \$ |
| Total assets | 175,509 | 185,569 |
| Liabilities | | |
| Debt: | | |
| Deposits in domestic offices: | | |
| Noninterest bearing | \$ 17,487 | \$ 17,663 |
| Interest bearing (includes \$3.9 billion and \$2.3 billion designated under fair value option at September 30, 2009 and December 31, 2008, respectively) | 69,152 | 67,903 |

| | | |
|--|-----------------------|----------------|
| Deposits in foreign offices: | | |
| Noninterest bearing | 1,243 | 922 |
| Interest bearing | <u>27,667</u> | <u>32,550</u> |
| Total deposits | <u>115,549</u> | <u>119,038</u> |
| Short-term borrowings | 8,259 | 10,495 |
| Long-term debt (includes \$4.6 billion and \$2.6 billion designated under fair value option at September 30, 2009 and December 31, 2008, respectively) | <u>21,432</u> | <u>22,089</u> |
| Total debt | <u>145,240</u> | <u>151,622</u> |
| Trading liabilities | 10,510 | 16,323 |
| Interest, taxes and other liabilities | <u>4,563</u> | <u>4,907</u> |
| Total liabilities | <u>160,313</u> | <u>172,852</u> |
| Shareholders' equity | | |
| Preferred stock | 1,565 | 1,565 |
| Common shareholder's equity: | | |
| Common stock (\$5 par; 150,000,000 shares authorized; 712 and 709 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively) | - | - |
| Additional paid-in capital | 13,807 | 11,694 |
| Retained earnings | 28 | 245 |
| Accumulated other comprehensive loss | (204) | (787) |
| Total common shareholder's equity | <u>13,631</u> | <u>11,152</u> |
| Total shareholders' equity | <u>15,196</u> | <u>12,717</u> |
| | \$ | \$ |
| Total liabilities and shareholders' equity | 175,509 | 185,569 |

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

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (UNAUDITED)

| <u>Nine Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> |
|---|------------------------|------------------------|
| | (in millions) | |
| Preferred stock | | |
| Balance at beginning and end of period | <u>\$ 1,565</u> | <u>\$ 1,565</u> |
| Common stock | | |
| Balance at beginning and end of period | = | = |
| Additional paid-in capital | | |
| Balance at beginning of period | 11,694 | 8,123 |
| Capital contributions from parent | 2,167 | 1,460 |
| Return of capital on preferred shares issued to CT Financial Services, Inc. | (55) | - |
| Employee benefit plans and other | 1 | <u>11</u> |
| Balance at end of period | <u>13,807</u> | <u>9,594</u> |
| Retained earnings | | |
| Balance at beginning of period | 245 | 1,901 |
| Adjustment to initially apply fair value measurement and fair value option accounting, net of tax | - | 113 |

| | | |
|---|---------------|-----------------|
| Adjustment to initially apply new guidance for other-than-temporary impairment on debt securities, net of tax | <u>15</u> | = |
| Balance at beginning of period, as adjusted | 260 | 2,014 |
| Net loss | (177) | (588) |
| Cash dividends declared on preferred stock | <u>(55)</u> | <u>(60)</u> |
| Balance at end of period | <u>28</u> | <u>1,366</u> |
| <i>Accumulated other comprehensive income (loss)</i> | | |
| Balance at beginning of period | (787) | (352) |
| Adjustment to initially apply new guidance for other-than-temporary impairment on debt securities, net of tax | <u>(15)</u> | = |
| Balance at beginning of period, as adjusted | (802) | (352) |
| Net change in unrealized gains (losses), net of tax on: | | |
| Securities available-for-sale not other-than-temporarily impaired | 502 | (355) |
| Other-than-temporarily impaired debt securities available-for-sale (includes \$188 million of gross OTTI losses less \$84 million of gross losses recognized in other revenues) | (60) | - |
| Derivatives classified as cash flow hedges | 148 | (14) |
| Unrecognized actuarial gains, transition obligation and prior service costs relating to pension and post-retirement benefits, net of tax | 8 | 6 |
| Foreign currency translation adjustments, net of tax | = | <u>(2)</u> |
| Other comprehensive income (loss), net of tax | <u>598</u> | <u>(365)</u> |
| Balance at end of period | <u>(204)</u> | <u>(717)</u> |
| | \$ | \$ |
| <i>Total shareholders' equity</i> | 15,196 | 11,808 |
| <i>Comprehensive income (loss)</i> | | |
| Net loss | \$ (177) | \$ (588) |
| Other comprehensive income (loss), net of tax | <u>598</u> | <u>(365)</u> |
| <i>Comprehensive income (loss)</i> | \$ 421 | \$ (953) |

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

CONSOLIDATED STATEMENT OF CASH FLOWS (UNAUDITED)

| <u>Nine Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> |
|---|---------------|-------------|
| | (in millions) | |
| <i>Cash flows from operating activities</i> | | |
| Net income (loss) | \$ (177) | \$ (588) |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 253 | 244 |
| Provision for credit losses | 3,247 | 1,762 |
| Other-than-temporarily impaired available-for-sale securities | 84 | 204 |
| Net change in other assets and liabilities | 1,101 | (1,249) |

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| | | |
|--|------------------------|----------------|
| Net change in loans held for sale | 1,879 | 1,702 |
| Loans attributable to tax refund anticipation loans program: | | |
| Originations of loans | (9,020) | (12,628) |
| Sales of loans to HSBC Finance, including premium | 9,031 | 12,641 |
| Net change in trading assets and liabilities | 1,142 | 2,991 |
| Mark-to-market on financial instruments designated at fair value and related derivatives | 193 | (243) |
| Net change in fair value of derivatives and hedged items | 33 | (259) |
| Net cash provided by operating activities | <u>7,766</u> | <u>4,577</u> |
| <i>Cash flows from investing activities</i> | | |
| Net change in interest bearing deposits with banks | (2,564) | 848 |
| Net change in federal funds sold and securities purchased under agreements to resell | 6,350 | (1,928) |
| Securities available-for-sale: | | |
| Purchases of securities available-for-sale | (32,299) | (8,273) |
| Proceeds from sales of securities available-for-sale | 16,911 | 3,026 |
| Proceeds from maturities of securities available-for-sale | 11,215 | 4,415 |
| Securities held to maturity: | | |
| Purchases of securities held to maturity | (152) | (383) |
| Proceeds from maturities of securities held to maturity | 235 | 433 |
| Change in loans: | | |
| Originations, net of collections | 35,023 | 13,864 |
| Recurring loan purchases from HSBC Finance | (27,624) | (17,804) |
| Cash paid on bulk purchase of loans from HSBC Finance | (8,821) | - |
| Loans sold to third parties | 3,997 | 4,959 |
| Net cash used for acquisitions of properties and equipment | (24) | (53) |
| Other, net | <u>234</u> | <u>(21)</u> |
| Net cash provided by (used in) investing activities | <u>2,481</u> | <u>(917)</u> |
| <i>Cash flows from financing activities</i> | | |
| Net change in deposits | (3,677) | 5,677 |
| Net change in short-term borrowings | (2,236) | (3,048) |
| Change in long-term debt: | | |
| Issuance of long-term debt | 3,022 | 3,463 |
| Repayment of long-term debt | (9,396) | (9,493) |
| Debt issued by consolidated VIE | (419) | - |
| Capital contribution from parent | 2,167 | 1,460 |
| Return of capital on preferred shares issued to CT Financial Services, Inc. | (55) | - |
| Other increases in capital surplus | 1 | 11 |
| Preferred dividends paid | (55) | (60) |
| Net cash used in financing activities | <u>(10,648)</u> | <u>(1,990)</u> |
| Net change in cash and due from banks | (401) | 1,670 |
| Cash and due from banks at beginning of period | <u>2,972</u> | <u>3,567</u> |
| <i>Cash and due from banks at end of period</i> | \$ 2,571 | \$ 5,237 |
| <i>Supplemental disclosure of non-cash flow investing activities</i> | | |
| Trading securities pending settlement | \$ 511 | \$ 699 |
| Assumption of indebtedness from HSBC Finance related to the bulk loan purchase | \$ 6,077 | \$ - |
| Transfer of receivables to real estate owned | \$ 3 | \$ 17 |

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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1. Organization and Basis of Presentation

HSBC USA Inc. is an indirect wholly owned subsidiary of HSBC North America Holdings Inc. (“HSBC North America”), which is an indirect wholly owned subsidiary of HSBC Holdings plc (“HSBC”). The accompanying unaudited interim consolidated financial statements of HSBC USA Inc. and its subsidiaries (collectively “HUSI”), including its principal subsidiary HSBC Bank USA, National Association (“HSBC Bank USA”), have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X, as well as in accordance with predominant practices within the banking industry. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all normal and recurring adjustments considered necessary for a fair presentation of financial position, results of operations and cash flows for the interim periods have been made. HSBC USA Inc. may also be referred to in this Form 10-Q as “we,” “us” or “our.” These unaudited interim consolidated financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2008 (the “2008 Form 10-K”). Certain reclassifications have been made to prior period amounts to conform to the current period presentation. Subsequent events have been evaluated through November 10, 2009, the date this Form 10-Q was issued and filed with the U.S. Securities and Exchange Commission.

The preparation of financial statements in conformity with U.S. GAAP requires the use of estimates and assumptions that affect reported amounts and disclosures. Actual results could differ from those estimates. Interim results should not be considered indicative of results in future periods.

During the first quarter of 2009, we adopted new disclosure requirements related to derivative instruments, hedging activities and fair value of financial instruments. Additionally, effective January 1, 2009, we early adopted new accounting guidance related to the recognition and presentation of other-than-temporarily impaired debt securities as well as new accounting guidance related to determining fair value when there has been a decrease in the volume and level of market activities and new accounting guidance related to identifying transactions in the marketplace that are not considered to be orderly. See Note 20, "New Accounting Pronouncements" for further details and related impacts.

2. Restructuring Activities

We continue to review our expense base in an effort to create a more streamlined organization, reduce expense growth and provide for future business initiatives. This review includes improving workforce management, consolidating certain functions where appropriate and increasing the use of global resourcing initiatives. The following summarizes the changes in the severance accrual relating to these activities during the three and nine months ended September 30, 2009 and 2008:

| | <u>2009</u> | <u>2008</u> |
|---|---------------|-------------|
| | (in millions) | |
| Three months ended September 30: | | |
| Balance at beginning of period | \$ 11 | \$ 6 |
| Costs recorded during the period | - | 10 |
| Costs paid during the period | <u>(2)</u> | <u>(3)</u> |
| Balance at end of period | \$ 9 | \$ 13 |
| Nine months ended September 30: | | |
| Balance at beginning of period, | \$ 19 | \$ 12 |
| Costs recorded during the period | 3 | 16 |
| Costs paid during the period | <u>(13)</u> | <u>(15)</u> |
| Balance at end of period | \$ 9 | \$ 13 |

Also in November 2008, we announced that we would exit the wholesale/correspondent channel of our Residential Mortgage business and focus our attention on our retail sales channel. In connection with this decision, we recorded expense of \$3 million relating to one-time termination benefits of which approximately \$2 million has been paid through September 30, 2009. The remaining \$1 million was reversed in the third quarter of 2009. No additional charges relating to this decision are anticipated in future periods.

3. Trading Assets and Liabilities

Trading assets and liabilities are summarized in the following table.

| | <u>2009</u> | <u>2008</u> |
|--|---------------|--------------|
| | (in millions) | |
| | September 30, | December 31, |
| Trading assets: | | |
| U.S. Treasury | \$ 266 | \$ 27 |
| U.S. Government agency | 22 | 271 |
| U.S. Government sponsored enterprises(1) | 18 | 521 |
| Asset backed securities | 1,684 | 1,698 |
| Corporate and foreign bonds | 1,878 | 1,614 |
| Other securities | 759 | 982 |

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| | | |
|------------------------------------|----------------------|---------------|
| Precious metals | 8,587 | 4,905 |
| Fair value of derivatives | <u>11,634</u> | <u>21,274</u> |
| | \$ | \$ |
| | 24,848 | 31,292 |
| Trading liabilities: | | |
| Securities sold, not yet purchased | \$ 524 | \$ 406 |
| Payables for precious metals | 2,205 | 1,599 |
| Fair value of derivatives | <u>7,781</u> | <u>14,318</u> |
| | \$ | \$ |
| | 10,510 | 16,323 |

(1) Includes mortgage backed securities of \$14 million and \$328 million issued or guaranteed by the Federal National Mortgage Association (FNMA) and mortgage backed securities of \$4 million and \$193 million issued or guaranteed by the Federal Home Loan Mortgage Corporation (FHLMC) at September 30, 2009 and December 31, 2008, respectively.

At September 30, 2009 and December 31, 2008, the fair value of derivatives included in trading assets have been reduced by \$3.2 billion and \$6.1 billion, respectively, relating to amounts recognized for the obligation to return cash collateral received under master netting agreements with derivative counterparties.

At September 30, 2009 and December 31, 2008, the fair value of derivatives included in trading liabilities have been reduced by \$7.4 billion and \$11.8 billion, respectively, relating to amounts recognized for the right to reclaim cash collateral paid under master netting agreements with derivative counterparties.

4. Securities

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

| <u>September 30, 2009</u> | Amortized Non-Credit | Unrealized | Unrealized | Fair | |
|--|----------------------|------------|-----------------|------------------|-----------------|
| | <u>Cost</u> | Loss | <u>Gains(5)</u> | <u>Losses(5)</u> | <u>Value</u> |
| | Component of OTTI | | | | |
| | <u>Securities(5)</u> | | | | |
| | (in millions) | | | | |
| Securities available-for-sale: | | | | | |
| U.S. Treasury | \$ 9,058 | \$ - | \$ 94 | \$ (12) | \$ 9,140 |
| U.S. Government sponsored enterprises:(1) | | | | | |
| Mortgage-backed securities | 62 | - | - | (3) | 59 |
| Direct agency obligations | 303 | - | 4 | (1) | 306 |
| U.S. Government agency issued or guaranteed: | | | | | |
| Mortgage-backed securities | 4,197 | - | 140 | (3) | 4,334 |

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| | | | | | |
|---|------------|-------|----------|---------|------------|
| Collateralized mortgage obligations | 6,746 | - | 111 | (9) | 6,848 |
| Direct agency obligations | 1,502 | - | 18 | (8) | 1,512 |
| Obligations of U.S. states and political subdivisions | 726 | - | 27 | (1) | 752 |
| Asset backed securities collateralized by: | | | | | |
| Residential mortgages | 1,139 | (79) | 1 | (151) | 910 |
| Commercial mortgages | 986 | - | 3 | (31) | 958 |
| Home equity | 665 | (25) | - | (245) | 395 |
| Auto | 70 | - | - | (1) | 69 |
| Student loans | 36 | - | - | (5) | 31 |
| Other | 23 | - | 1 | - | 24 |
| Other domestic debt securities(2) | 868 | - | 10 | (14) | 864 |
| Foreign debt securities(2) | 2,455 | - | 45 | - | 2,500 |
| Equity securities(3) | <u>852</u> | = | <u>9</u> | = | <u>861</u> |
| | \$ | \$ | | \$ | \$ |
| Total available-for-sale securities | 29,688 | (104) | \$ 463 | (484) | 29,563 |
| Securities held to maturity: | | | | | |
| U.S. Government sponsored enterprises:(4) | | | | | |
| Mortgage-backed securities | \$ 1,858 | \$ - | \$ 129 | \$ - | \$ 1,987 |
| U.S. Government agency issued or guaranteed: | | | | | |
| Mortgage-backed securities | 118 | - | 14 | - | 132 |
| Collateralized mortgage obligations | 348 | - | 30 | - | 378 |
| Obligations of U.S. states and political subdivisions | 177 | - | 9 | - | 186 |
| Asset backed securities collateralized by: | | | | | |
| Residential mortgages | 191 | - | - | (26) | 165 |
| Foreign debt securities | <u>100</u> | = | = | = | <u>100</u> |
| Total held-to-maturity securities | \$ 2,792 | \$ - | \$ 182 | \$ (26) | \$ 2,948 |

December 31, 2008

| | Amortized | Gross | Gross | Fair |
|---|-------------|---------------|---------------|--------------|
| | <u>Cost</u> | Unrealized | Unrealized | <u>Value</u> |
| | | <u>Gains</u> | <u>Losses</u> | |
| | | (in millions) | | |
| Securities available-for-sale: | | | | |
| U.S. Treasury | \$ 3,544 | \$ 154 | \$ (12) | \$ 3,686 |
| U.S. Government sponsored enterprises(1) | 11,271 | 187 | (96) | 11,362 |
| U.S. Government agency issued or guaranteed | 5,746 | 135 | (6) | 5,875 |
| Obligations of U.S. states and political subdivisions | 699 | 2 | (31) | 670 |
| Asset-backed securities | 3,462 | - | (987) | 2,475 |
| Other domestic debt securities | 144 | 7 | (7) | 144 |
| Foreign debt securities | 641 | 13 | (9) | 645 |
| Equity securities(3) | <u>52</u> | = | <u>(1)</u> | <u>51</u> |
| | \$ | | \$ | |
| Total | 25,559 | \$ 498 | (1,149) | \$ 24,908 |
| Securities held to maturity: | | | | |

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| | | | | |
|---|-----------|--------|---------|-----------|
| U.S. Government sponsored enterprises(4) | \$ 1,892 | \$ 73 | \$ (7) | \$ 1,958 |
| U.S. Government agency issued or guaranteed | 495 | 23 | (2) | 516 |
| Obligations of U.S. states and political subdivisions | 217 | 8 | (5) | 220 |
| Asset-backed securities | 185 | 1 | (31) | 155 |
| Foreign debt securities | <u>86</u> | = | = | <u>86</u> |
| Total | \$ 2,875 | \$ 105 | \$ (45) | \$ 2,935 |

- (1) Includes securities at amortized cost of \$40 million and \$5.1 billion issued or guaranteed by the Federal National Mortgage Association (“FNMA”) at September 30, 2009 and December 31, 2008, respectively, and \$22 million and \$5.9 billion issued or guaranteed by Federal Home Loan Mortgage Corporation (“FHLMC”) at September 30, 2009 and December 31, 2008, respectively.
- (2) At September 30, 2009, other domestic debt securities included \$452 million of securities at amortized cost fully backed by the Federal Deposit Insurance Corporation (“FDIC”) and foreign debt securities consisted of \$2.4 billion of securities fully backed by foreign governments.
- (3) Includes preferred equity securities at amortized cost issued by FNMA of \$2 million at September 30, 2009 and December 31, 2008. Balances at September 30, 2009 and December 31, 2008 reflect other-than-temporary impairment charges of \$203 million.
- (4) Includes securities at amortized cost of \$682 million and \$700 million issued or guaranteed by FNMA at September 30, 2009 and December 31, 2008, respectively, and \$1.2 billion issued and guaranteed by FHLMC at both September 30, 2009 and December 31, 2008.
- (5) For available for sale debt securities which are other-than-temporarily impaired, the non-credit loss component of OTTI is recorded in accumulated other comprehensive income (loss) beginning in 2009.

A summary of gross unrealized losses and related fair values as of September 30, 2009 and December 31, 2008, classified as to the length of time the losses have existed follows:

| <u>September 30, 2009</u> | <u>One Year or Less</u> | | | <u>Greater Than One Year</u> | | |
|---|-------------------------|-------------------|----------------------------------|------------------------------|-------------------|-------------------|
| | <u>Number</u> | <u>Gross</u> | <u>Aggregate</u> | <u>Number</u> | <u>Gross</u> | <u>Aggregate</u> |
| | <u>of</u> | <u>Unrealized</u> | <u>Fair</u> | <u>of</u> | <u>Unrealized</u> | <u>Fair</u> |
| | <u>Securities</u> | <u>Losses</u> | <u>Value</u> | <u>Securities</u> | <u>Losses</u> | <u>Value</u> |
| | | | <u>of</u> | | | <u>of</u> |
| | | | <u>Investment</u> | | | <u>Investment</u> |
| | | | <u>(dollars are in millions)</u> | | | |
| Securities available-for-sale: | | | | | | |
| U.S. Treasury | 3 | \$ (12) | \$ 216 | - | \$ - | \$ - |
| U.S. Government sponsored enterprises | 12 | (1) | 123 | 37 | (3) | 39 |
| U.S. Government agency issued or guaranteed | 59 | (19) | 3,107 | 38 | (1) | 45 |
| Obligations of U.S. states and political subdivisions | 1 | - | 2 | 11 | (1) | 81 |

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| | | | | | | |
|---|----|---------|-------|-----|---------|--------|
| Asset backed securities | 3 | - | - | 124 | (433) | 1,737 |
| Other domestic debt securities | 1 | (8) | 50 | 2 | (6) | 44 |
| Foreign debt securities | 2 | - | 199 | 2 | - | 30 |
| Equity securities | 1 | = | = | = | = | = |
| | | | \$ | | \$ | \$ |
| Securities available-for-sale | 82 | \$ (40) | 3,697 | 214 | (444) | 1,976 |
| Securities held to maturity: | | | | | | |
| U.S. Government sponsored enterprises | 8 | - | 21 | - | - | - |
| U.S. Government agency issued or guaranteed | 15 | - | - | 2 | - | - |
| Obligations of U.S. states and political subdivisions | 26 | - | 11 | 8 | - | 17 |
| Asset backed securities | 1 | (1) | 6 | 12 | (25) | 159 |
| Securities held to maturity | 50 | \$ (1) | \$ 38 | 22 | \$ (25) | \$ 176 |

| <u>December 31, 2008</u> | <u>One Year or Less</u> | | | <u>Greater Than One Year</u> | | | |
|---|-------------------------|-------------------|----------------------------------|------------------------------|-------------------|-------------------|--|
| | <u>Number</u> | <u>Gross</u> | <u>Aggregate</u> | <u>Number</u> | <u>Gross</u> | <u>Aggregate</u> | |
| | <u>of</u> | <u>Unrealized</u> | <u>Fair</u> | <u>of</u> | <u>Unrealized</u> | <u>Fair</u> | |
| | <u>Securities</u> | <u>Losses</u> | <u>Value</u> | <u>Securities</u> | <u>Losses</u> | <u>Value</u> | |
| | | | <u>of</u> | | | <u>of</u> | |
| | | | <u>Investment</u> | | | <u>Investment</u> | |
| | | | <u>(dollars are in millions)</u> | | | | |
| Securities available-for-sale: | | | \$ | | | | |
| U.S. Treasury | 5 | \$ (12) | 1,251 | - | \$ - | \$ - | |
| U.S. Government sponsored enterprises | 136 | (42) | 1,361 | 101 | (54) | 2,295 | |
| U.S. Government agency issued or guaranteed | 97 | (1) | 576 | 41 | (5) | 237 | |
| Obligations of U.S. states and political subdivisions | 36 | (7) | 226 | 53 | (24) | 333 | |
| Asset backed securities | 51 | (419) | 1,099 | 110 | (568) | 1,330 | |
| Other domestic debt securities | 3 | (6) | 71 | 1 | (1) | 4 | |
| Foreign debt securities | 1 | - | 5 | 5 | (9) | 97 | |
| Equity securities | 2 | (1) | = | = | = | = | |
| | | | \$ | | \$ | \$ | |
| Securities available-for-sale | 331 | \$ (488) | 4,589 | 311 | (661) | 4,296 | |
| Securities held to maturity: | | | | | | | |
| U.S. Government sponsored enterprises | 18 | \$ (2) | \$ 113 | 7 | \$ (5) | \$ 132 | |
| U.S. Government agency issued or guaranteed | 176 | (2) | 105 | - | - | - | |
| Obligations of U.S. states and political subdivisions | 54 | (5) | 48 | 5 | - | 3 | |
| Asset backed securities | 2 | (10) | 52 | 10 | (21) | 96 | |
| Securities held to maturity | 250 | \$ (19) | \$ 318 | 22 | \$ (26) | \$ 231 | |

Gross unrealized losses within the available-for-sale and held-to-maturity portfolios decreased overall primarily due to a reduction in credit spreads for asset backed securities during the first nine months of 2009 due to improved market conditions. We have reviewed the securities for which there is an unrealized loss in accordance with our accounting policies for other-than-temporary impairment described below. During the nine months ended September 30, 2009, 18 debt securities, six of which were identified in the quarter ended September 30, 2009, were determined to be other-than-temporarily impaired in 2009 in accordance with new accounting guidance related to the recognition of other-than-temporarily impairment associated with debt securities which we early adopted effective January 1, 2009 and is described more fully below. As a result, we recorded other-than-temporary impairment charges of \$28 million and \$188 million during the three and nine months ended September 30, 2009 on these investments. Consistent with the new accounting guidance described below, the credit loss component of the applicable debt securities totaling \$26 million and \$84 million respectively, during the three and nine months ended September 30, 2009 was recorded as a component of net other-than-temporary impairment losses in the accompanying consolidated statement of income (loss), while the remaining non-credit portion of the impairment loss was recognized in other comprehensive income (loss).

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

On-going Assessment for Other-Than-Temporary Impairment

On a quarterly basis, we perform an assessment to determine whether there have been any events or economic circumstances indicating that a security with an unrealized loss has suffered other-than-temporary impairment. Subsequent to the adoption of new accounting principles related to the determination of other-than-temporary impairments on January 1, 2009, a debt security is considered impaired if the fair value is less than its amortized cost basis at the reporting date. If impaired, we then assess whether the unrealized loss is other-than-temporary. Prior to January 1, 2009, unrealized losses that were determined to be temporary were recorded, net of tax, in other comprehensive income for available-for-sale securities, whereas unrealized losses related to held to maturity securities determined to be temporary were not recognized. Regardless of whether the security was classified as available-for-sale or held to maturity, unrealized losses that were determined to be other-than-temporary were recorded to earnings in their entirety. An unrealized loss was considered other-than-temporary if (i) it was not probable that the holder would collect all amounts due according to the contractual terms of the debt security, or (ii) the fair value was below the amortized cost of the debt security for a prolonged period of time and we did not have the positive intent and ability to hold the security until recovery or maturity.

Under the new accounting principles early adopted effective January 1, 2009, an unrealized loss is generally deemed to be other-than-temporary and a credit loss is deemed to exist if the present value of the expected future cash flows is less than the amortized cost basis of the debt security and, as a result, the credit loss component of an other-than-temporary impairment write-down is recorded in earnings as a component of net other-than-temporary impairment losses in the accompanying consolidated statement of loss, while the remaining portion of the impairment loss is recognized in other comprehensive income (loss), provided we do not intend to sell the underlying debt security and it is "more likely than not" that we will not have to sell the debt security prior to recovery.

For all securities held in the available-for-sale or held to maturity portfolio for which unrealized losses have existed for a period of time, we do not have the intention to sell and believe we will not be required to sell the securities for contractual, regulatory or liquidity reasons as of the reporting date. Debt securities issued by U.S. Treasury, U.S. Government agencies and government sponsored entities accounted for 78 percent of total available-for-sale and held to maturity securities as of September 30, 2009. Our assessment for credit loss was concentrated on private label

asset backed securities for which we evaluate for credit losses on a quarterly basis. We considered the following factors in determining whether a credit loss exists and the period over which the debt security is expected to recover:

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

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

The excess of amortized cost over the present value of expected future cash flows on our other-than-temporarily impaired debt securities, which represents the credit loss associated with these securities, was \$84 million for the nine months ended September 30, 2009. The excess of the present value of expected future cash flows over fair value, which represents the non-credit component of the unrealized loss associated with these securities, was \$104 million as of September 30, 2009. Since we do not have the intention to sell the securities and have sufficient capital and liquidity to hold these securities until a full recovery of the fair value occurs, only the credit loss component is reflected in the consolidated statement of income (loss). The non-credit component of the unrealized loss is recorded, net of taxes, in other comprehensive income (loss).

The following table summarizes the roll-forward of credit losses on debt securities held by us for which a portion of an other-than-temporary impairment is recognized in other comprehensive income:

| | Three Months Ended | Nine Months Ended |
|--|---|---|
| | <u>September 30,</u> <u>2009</u> | <u>September 30,</u> <u>2009</u> |
| | (in millions) | |
| Credit losses at the beginning of the period | \$ 63 | \$ 5 |
| | 3 | 77 |

| | | |
|---|--------------|--------------|
| Credit losses related to securities for which an other-than-temporary impairment was not previously recognized | | |
| Increase in credit losses for which an other-than-temporary impairment was previously recognized | <u>23</u> | <u>7</u> |
| Ending balance of credit losses on debt securities held for which a portion of an other-than-temporary impairment was recognized in other comprehensive income (loss) | <u>\$ 89</u> | <u>\$ 89</u> |

At September 30, 2009, we held 170 individual asset-backed securities in the available-for-sale portfolio, of which 33 were also wrapped by a monoline insurance company. The asset backed securities backed by a monoline wrap comprised \$471 million of the total aggregate fair value of asset-backed securities of \$2.4 billion at September 30, 2009. The gross unrealized losses on these securities was \$245 million at September 30, 2009. During the first nine months of 2009, two monoline insurers were downgraded to below investment grade and as a result, we did not take into consideration the financial guarantee from those monoline insurers associated with certain securities. As of September 30, 2009, four of the securities wrapped by the downgraded monoline insurance companies with an aggregate fair value of \$43 million were deemed to be other-than-temporarily impaired. In evaluating the extent of our reliance on investment grade monoline insurance companies, consideration is given to our assessment of the creditworthiness of the monoline and other market factors.

At December 31, 2008, we held 161 individual asset-backed securities in the available-for-sale portfolio of which 37 were wrapped by a monoline insurance company. These asset backed securities backed by a monoline wrap comprised \$629 million of the total aggregate fair value of asset-backed securities of \$2.5 billion at December 31, 2008. The gross unrealized losses on these securities were \$404 million at December 31, 2008. As of December 31, 2008, we deemed these securities to be temporarily impaired as our analysis of the structure and our credit analysis of the monoline insurer resulted in the conclusion that it was probable we would receive all contractual cash flows from our investment, including amounts to be paid by the investment grade monoline insurers.

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

| | Gross | Gross | Net |
|---|---------------------|------------------------|------------------------|
| | Realized | Realized | Realized |
| | <u>Gains</u> | <u>(Losses)</u> | <u>(Losses)</u> |
| | | | <u>Gains</u> |
| | (in millions) | | |
| Three months ended September 30, 2009: | | | |
| Securities available-for-sale | \$ 9 | \$ (30) | \$ (21) |
| Securities held to maturity(1) | = | = | = |
| | \$ 9 | \$ (30) | \$ (21) |
| Three months ended September 30, 2008: | | | |
| Securities available-for-sale | \$ 15 | \$ (193) | \$ (178) |
| Securities held to maturity(1) | = | = | = |
| | \$ 15 | \$ (193) | \$ (178) |
| Nine months ended September 30, 2009: | | | |
| Securities available-for-sale | | | \$ 215 |

| | | | |
|--|------------|--------------|--------|
| | \$ | \$ | |
| | 345 | (130) | |
| Securities held to maturity(1) | = | = | = |
| | \$ | \$ | \$ 215 |
| | 345 | (130) | |
| Nine months ended September 30, 2008: | | | |
| | \$ | \$ | \$ |
| Securities available-for-sale | 103 | (231) | (128) |
| Securities held to maturity(1) | = | = | = |
| | \$ | \$ | \$ |
| | 103 | (231) | (128) |

(1) Maturities, calls and mandatory redemptions.

The amortized cost and fair values of securities available-for-sale and securities held to maturity at September 30, 2009, are summarized in the table below by contractual maturity. Expected maturities differ from contractual maturities because borrowers have the right to prepay obligations without prepayment penalties in certain cases. Securities available-for-sale amounts exclude equity securities as they do not have stated maturities. The table below also reflects the distribution of maturities of debt securities held at September 30, 2009, together with the approximate taxable equivalent yield of the portfolio. The yields shown are calculated by dividing annual interest income, including the accretion of discounts and the amortization of premiums, by the amortized cost of securities outstanding at September 30, 2009. Yields on tax-exempt obligations have been computed on a taxable equivalent basis using applicable statutory tax rates.

| | <u>Within</u> | <u>After One</u> | <u>After Five</u> | <u>After Ten</u> | | | | |
|---|------------------|-------------------|-------------------|------------------|-----------------|--------------|------------------|--------------|
| | <u>One Year</u> | <u>But Within</u> | <u>But Within</u> | <u>Years</u> | | | | |
| | | | <u>Five Years</u> | <u>Ten Years</u> | | | | |
| <u>Taxable Equivalent Basis</u> | <u>Amount</u> | <u>Yield</u> | <u>Amount</u> | <u>Yield</u> | <u>Amount</u> | <u>Yield</u> | <u>Amount</u> | <u>Yield</u> |
| | (\$ in millions) | | | | | | | |
| Available-for-sale: | | | | | | | | |
| U.S. Treasury | \$ 7,465 | .37% | \$ 1,494 | 1.12% | \$ - | -% | \$ 99 | -% |
| U.S. Government sponsored enterprises | - | - | 109 | 2.87 | 200 | 3.02 | 57 | 1.77 |
| U.S. Government agency issued or guaranteed | - | - | 7 | 4.51 | 878 | 1.70 | 11,559 | 3.47 |
| Obligations of U.S. states and political subdivisions | - | - | - | - | 279 | 5.03 | 446 | 5.01 |
| Asset backed securities | 43 | 2.11 | 126 | 5.34 | 169 | 3.79 | 2,476 | 3.81 |
| Other domestic debt securities | 4 | .72 | 762 | 2.37 | - | - | 103 | 6.80 |
| Foreign debt securities | <u>15</u> | 1.37 | <u>2,431</u> | 2.51 | <u>10</u> | 5.13 | = | - |
| Total amortized cost | <u>\$ 7,527</u> | .38% | <u>\$ 4,929</u> | 2.15% | <u>\$ 1,536</u> | 2.72% | <u>\$ 14,740</u> | 3.56% |
| Total fair value | <u>\$ 7,598</u> | | <u>\$ 4,995</u> | | <u>\$ 1,567</u> | | <u>\$ 14,542</u> | |
| Held to maturity: | | | | | | | | |
| U.S. Government sponsored enterprises | \$ - | 7.50% | \$ 33 | 5.97% | 8 | 6.74% | \$ 1,817 | 5.86% |
| U.S. Government agency issued or guaranteed | - | 7.32 | 1 | 7.50 | 6 | 8.89 | 459 | 6.31 |
| Obligations of U.S. states and political subdivisions | 12 | 5.79 | 33 | 4.94 | 25 | 4.53 | 107 | 5.15 |

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| | | | | | | | |
|-------------------------|---------------|-------|--------------|-------|--------------|-------|-----------------------|
| Asset backed securities | - | - | - | - | - | 191 | 5.80 |
| Foreign debt securities | <u>100</u> | 2.64 | = | - | = | = | - |
| Total amortized cost | <u>\$ 112</u> | 3.01% | <u>\$ 67</u> | 5.48% | <u>\$ 39</u> | 5.65% | <u>\$ 2,574</u> 5.91% |
| Total fair value | <u>\$ 112</u> | | <u>\$ 72</u> | | <u>\$ 44</u> | | <u>\$ 2,720</u> |

Investments in FHLB stock, FRB stock, and MasterCard Class B shares of \$152 million, \$456 million and \$0 million, respectively, were included in other assets at September 30, 2009. Investments in FHLB stock, FRB stock and MasterCard Class B shares of \$209 million, \$349 million and \$29 million, respectively, were included in other assets at December 31, 2008.

5. Loans

Loans consisted of the following:

| | September 30, | December 31, |
|------------------------------------|----------------------|---------------------|
| | <u>2009</u> | <u>2008</u> |
| | (in millions) | |
| Commercial loans: | | |
| Construction and other real estate | \$ 8,743 | \$ 8,885 |
| Other commercial | <u>23,630</u> | <u>28,544</u> |
| Total commercial | <u>32,373</u> | <u>37,429</u> |
| Consumer loans: | | |
| HELOC and home equity mortgages | 4,362 | 4,549 |
| Other residential mortgages | 14,423 | 17,948 |
| Private label cards | 14,614 | 17,074 |
| Credit cards | 13,326 | 2,137 |
| Auto finance | 1,925 | 154 |
| Other consumer | <u>1,543</u> | <u>1,822</u> |
| Total consumer | <u>50,193</u> | <u>43,684</u> |
| | \$ | \$ |
| Total loans | 82,566 | 81,113 |

Secured financings of \$550 million and \$2.5 billion at September 30, 2009 are secured by \$326 million and \$2.9 billion of private label cards and credit cards, respectively, as well as restricted available for sale investments of \$292 million and \$438 million, respectively. Secured financings of \$1.2 billion at December 31, 2008 were secured by \$1.6 billion of private label cards.

Purchased Loan Portfolios:

In January 2009, we purchased the General Motors MasterCard receivable portfolio (“GM Portfolio”) and the AFL-CIO Union Plus MasterCard/Visa receivable portfolio (“UP Portfolio”) with an aggregate outstanding principal balance of \$6.3 billion and \$6.1 billion, respectively from HSBC Finance. The aggregate purchase price for the GM and UP Portfolios was \$12.2 billion, which included the transfer of approximately \$6.1 billion of indebtedness, resulting in a cash consideration of \$6.1 billion. The purchase price was determined based on independent valuation opinions.

HSBC Finance retained the customer relationships and by agreement we purchase additional loan originations generated under existing and future accounts from HSBC Finance on a daily basis at fair market value. HSBC Finance continues to service the GM and UP Portfolios for us for a fee.

Purchased loans for which at the time of acquisition there was evidence of deterioration in credit quality since origination and for which it was probable that all contractually required payments would not be collected and that the associated line of credit has been closed were recorded upon acquisition at an amount based upon the cash flows expected to be collected. The difference between these expected cash flows and the purchase price represents accretable yield which is amortized to interest income over the life of the loan. The following table provides details on the loans obtained in connection with the acquisition of these portfolios subject to these accounting requirements (the "Purchased Impaired Loans"):

| | GM | UP |
|---|-----------------------------|-----------|
| | <u>Portfolio</u> | |
| | <u>(in millions)</u> | |
| | \$ | \$ |
| Outstanding contractual receivable balance at acquisition | 355 | 399 |
| Cash flows expected to be collected at acquisition | 164 | 167 |
| Basis in acquired receivables at acquisition | 122 | 114 |

The carrying amount of the Purchased Impaired Loans, net of credit loss reserves at September 30, 2009 totaled \$71 million and \$70 million for the GM and UP Portfolios, respectively, and is included in credit card loans. The outstanding contractual balances at September 30, 2009 for these receivables were \$89 million and \$105 million for the GM and UP Portfolios, respectively. During the three month period ended September 30, 2009, credit loss reserves were reduced by \$8 million for the acquired GM and UP receivables primarily due to quarterly charge-off activity, resulting in a total credit loss reserve of \$12 million at September 30, 2009. There were no reclassifications to accretable yield from non-accretable difference during the three or nine months ended September 30, 2009. The following summarizes the change in accretable yield associated with the Purchased Impaired Loans:

| | Three Months | Nine Months |
|---|-----------------------------|-----------------------------|
| | Ended | Ended |
| | <u>September 30,</u> | <u>September 30,</u> |
| | <u>2009</u> | <u>2009</u> |
| | (in millions) | |
| Accretable yield at beginning of period | \$ (50) | \$ (95) |
| Accretable yield amortized to interest income during the period | 10 | 39 |
| Reclassification to non-accretable difference | = | <u>16</u> |
| Accretable yield at end of period | \$ (40) | \$ (40) |

In January 2009, we also purchased auto finance loans from HSBC Finance with an aggregate outstanding principal balance of \$3.0 billion for a purchase price of \$2.8 billion. HSBC Finance continues to service these loans for us for a fee. None of the auto finance loans purchased were delinquent at the time of purchase and as such were not subject to the accounting requirements for purchased impaired loans discussed above.

Troubled Debt Restructurings (“TDR”):

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

| | September 30, | December 31, |
|------------------------------------|----------------------|---------------------|
| | <u>2009</u> | <u>2008</u> |
| | (in millions) | |
| TDR Loans(1): | | |
| Commercial loans: | | |
| Construction and other real estate | \$ 36 | \$ 26 |
| Other commercial | <u>68</u> | <u>18</u> |
| Total commercial | <u>104</u> | <u>44</u> |
| Consumer loans: | | |
| Residential mortgages | 101 | 38 |
| Private label cards | 204 | 156 |
| Credit cards | 133 | 13 |
| Auto finance | 39 | - |
| Other consumer | = | = |
| Total consumer | <u>477</u> | <u>207</u> |
| Total TDR Loans | \$ 581 | \$ 251 |

| | September 30, | December 31, |
|---|----------------------|---------------------|
| | <u>2009</u> | <u>2008</u> |
| | (in millions) | |
| Allowance for credit losses for TDR Loans(2): | | |
| Commercial loans: | | |
| Construction and other real estate | \$ 3 | \$ 2 |
| Other commercial | <u>2</u> | <u>2</u> |
| Total commercial | <u>5</u> | <u>4</u> |
| Consumer loans: | | |
| Residential mortgages | 15 | 6 |
| Private label cards | 45 | 29 |
| Credit cards | 21 | 3 |
| Auto finance | 9 | - |
| Other consumer | = | = |
| Total consumer | <u>90</u> | <u>38</u> |
| Total Allowance for credit losses for TDR Loans | \$ 95 | \$ 42 |

(1) The TDR loan balances above include \$8 million of auto finance and \$2 million of residential mortgage loans held for sale at September 30, 2009 for which there are no credit loss reserves as these loans are carried at the lower of cost or fair value. There were no held for sale TDR loans at December 31, 2008.

(2) Included in the allowance for credit losses.

The following tables presents information about average TDR Loan balances and interest income recognized on TDR loans during the three and nine months ended September 30, 2009 and 2008:

| <u>Three Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> |
|--|----------------------|--------------------|
| | (in millions) | |
| Average balance of TDR Loans | \$ 524 | \$ 231 |
| Interest income recognized on TDR Loans | 8 | 3 |

| <u>Nine Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> |
|---|----------------------|--------------------|
| | (in millions) | |
| Average balance of TDR Loans | \$ 455 | \$ 217 |
| Interest income recognized on TDR Loans | 22 | 10 |

Concentrations of Credit Risk:

Our loan portfolio includes the following types of loans:

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

The following table summarizes the balances of high LTV, interest-only and ARM loans in our loan portfolios, including loans held for sale, at September 30, 2009 and December 31, 2008.

| | <u>September 30,</u> | <u>December 31,</u> |
|---|-----------------------------|----------------------------|
| | <u>2009</u> | <u>2008</u> |
| | (in billions) | |
| Residential mortgage loans with high LTV and no mortgage insurance(1) | \$ 1.4 | \$ 1.6 |
| Interest-only residential mortgage loans | 2.8 | 4.2 |
| ARM loans(2) | 7.6 | 10.5 |

- (1) Residential mortgage loans with high LTV and no mortgage insurance includes both fixed rate and adjustable rate mortgages. Excludes \$242 million and \$274 million of sub-prime residential mortgage loans held for sale at September 30, 2009 and December 31, 2008, respectively.
- (2) ARM loan balances above exclude \$232 million and \$342 million of sub-prime residential mortgage loans held for sale September 30, 2009 and December 31, 2008, respectively. For the remainder of 2009 and in 2010, approximately \$1.0 billion and \$1.0 billion, respectively of ARM loans will experience their first interest rate reset.

Concentrations of first and second liens within the residential mortgage loan portfolio are summarized in the following table. Amounts in the table exclude closed end first lien loans held for sale of \$1.3 billion.

| | September 30, 2009 | | December 31, 2008 | |
|-------------|---------------------------|----|--------------------------|----|
| | <u>2009</u> | | <u>2008</u> | |
| | (in millions) | | | |
| Closed end: | | | | |
| | | \$ | | \$ |
| First lien | 14,423 | | 17,948 | |
| Second lien | 610 | | 756 | |
| Revolving: | | | | |
| Second lien | <u>3,752</u> | | <u>3,793</u> | |
| | | \$ | | \$ |
| Total | 18,785 | | 22,497 | |

6. Allowance for Credit Losses

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

| | Three Months Ended | | Nine Months Ended | |
|---|---------------------------|-------------|--------------------------|-------------|
| | <u>September 30,</u> | | <u>September 30,</u> | |
| | <u>2009</u> | <u>2008</u> | <u>2009</u> | <u>2008</u> |
| | (in millions) | | | |
| Balance at beginning of period | \$ 3,740 | \$ 1,796 | \$ 2,397 | \$ 1,414 |
| Provision for credit losses | 1,006 | 658 | 3,247 | 1,762 |
| Charge-offs | (954) | (479) | (2,433) | (1,324) |
| Recoveries | 78 | 63 | 230 | 207 |
| Allowance on loans transferred (to) from held for sale | (4) | 21 | (12) | - |
| Allowance related to bulk loan purchase from HSBC Finance | - | - | 437 | - |
| Other | <u>1</u> | = | <u>1</u> | = |
| Balance at end of period | \$ 3,867 | \$ 2,059 | \$ 3,867 | \$ 2,059 |

Increased provision for credit losses for 2009 includes the impact of the GM, UP and auto finance portfolios which were purchased in January 2009 from HSBC Finance.

7. *Loans Held for Sale*

Loans held for sale consisted of the following:

| | September 30 | December 31, |
|---------------------------|------------------------|------------------------|
| | <u>2009</u> | <u>2008</u> |
| | (in millions) | |
| Commercial loans | \$ <u>1,138</u> | \$ <u>874</u> |
| Consumer loans: | | |
| Residential mortgages | 1,280 | 3,512 |
| Auto finance | 353 | - |
| Other consumer | <u>32</u> | <u>45</u> |
| Total consumer | <u>1,665</u> | <u>3,557</u> |
| Total loans held for sale | \$ <u>2,803</u> | \$ <u>4,431</u> |

We originate commercial loans in connection with our participation in a number of leveraged acquisition finance syndicates. A substantial majority of these loans were originated with the intent of selling them to unaffiliated third parties and are classified as commercial loans held for sale at September 30, 2009. The fair value of commercial loans held for sale under this program were \$1.1 billion and \$874 million at September 30, 2009 and December 31, 2008, respectively, all of which are recorded at fair value as we have elected to designate these loans under fair value option. During the first nine months of 2009, the market value of these loans increased due to narrowing credit spreads. See Note 11, "Fair Value Option," of the consolidated financial statements for additional information.

In addition to normal loan sales during the nine months ended September 30, 2009, we sold approximately \$4.0 billion of prime adjustable and fixed rate residential mortgage loans. As a result we recorded gains of \$67 million during the nine months ended September 30, 2009. Gains and losses from the sale of residential mortgage loans are reflected as a component of residential mortgage banking revenue in the accompanying consolidated statement of income (loss). We retained the servicing rights in relation to the mortgages upon sale.

Residential mortgage loans held for sale include sub-prime residential mortgage loans with a fair value of \$855 million and \$1.2 billion at September 30, 2009 and December 31, 2008, respectively, which were acquired from unaffiliated third parties and from HSBC Finance with the intent of securitizing or selling the loans to third parties. Also included in residential mortgage loans held for sale are first mortgage loans originated and held for sale primarily to various governmental agencies.

During the nine months ended September 30, 2009, we transferred \$353 million of auto finance loans to held for sale. Other consumer loans held for sale consist of student loans.

Excluding the commercial loans designated under fair value option discussed above, loans held for sale are recorded at the lower of cost or fair value. The book value of loans held for sale continued to exceed fair value at September 30, 2009. We continue to experience increases to the valuation allowance primarily due to adverse conditions in the U.S. residential mortgage markets in 2009, although the dollar magnitude of the increases has been slowing. The

valuation allowance related to loans held for sale is presented in the following table.

| | Three Months Ended | | Nine Months Ended | |
|--|----------------------|-------------|----------------------|-------------|
| | <u>2009</u> | <u>2008</u> | <u>2009</u> | <u>2008</u> |
| | <u>September 30,</u> | | <u>September 30,</u> | |
| | (in millions) | | | |
| | | | | \$ |
| Balance at beginning of period | \$ (925) | \$ (610) | \$ (869) | (475) |
| Increase in allowance for net reductions in market value | (9) | (94) | (154) | (350) |
| Releases of valuation allowance for loans sold | <u>45</u> | <u>16</u> | <u>134</u> | <u>137</u> |
| | | | | \$ |
| Balance at end of period | \$ (889) | \$ (688) | \$ (889) | (688) |

Loans held for sale are subject to market risk, liquidity risk and interest rate risk, in that their value will fluctuate as a result of changes in market conditions, as well as the interest rate and credit environment. Interest rate risk for residential mortgage loans held for sale is partially mitigated through an economic hedging program to offset changes in the fair value of the mortgage loans held for sale. Trading related revenue associated with this economic hedging program, which are included in net interest income and trading revenue (loss) in the consolidated statement of income (loss), were gains of \$3 million and \$58 million for the three and nine months ended September 30, 2009, respectively, compared with gains of \$4 million and \$34 million for the three and nine months ended September 30, 2008, respectively.

8. Intangible Assets

Intangible assets consisted of the following:

| | September 30, December 31, | |
|---------------------------|----------------------------|-------------|
| | <u>2009</u> | <u>2008</u> |
| | (in millions) | |
| Mortgage servicing rights | \$ 400 | \$ 341 |
| Other | <u>29</u> | <u>33</u> |
| Intangible assets | \$ 429 | \$ 374 |

Mortgage Servicing Rights ("MSRs")

A servicing asset is a contract under which estimated future revenues from contractually specified cash flows, such as servicing fees and other ancillary revenues, are expected to exceed the obligation to service the financial assets. We recognize the right to service mortgage loans as a separate and distinct asset at the time they are acquired or when originated loans are sold.

MSRs are subject to credit, prepayment and interest rate risk, in that their value will fluctuate as a result of changes in these economic variables. Interest rate risk is mitigated through an economic hedging program that uses securities and

derivatives to offset changes in the fair value of MSR's. Since the hedging program involves trading activity, risk is quantified and managed using a number of risk assessment techniques, which are addressed in more detail in the 2008 Form 10-K.

Residential Mortgage Servicing Rights

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

Fair value of residential MSR's is calculated using the following critical assumptions:

| | September 30, December 31, | |
|---|-----------------------------------|--------------------|
| | <u>2009</u> | <u>2008</u> |
| Annualized constant prepayment rate ("CPR") | 22.3% | 39.4% |
| Constant discount rate | 14.1% | 10.3% |
| Weighted average life | 3 years.4 | 3 years.1 |

Residential MSR's activity is summarized in the following table:

| | Three Months Ended | | Nine Months Ended | |
|--|-------------------------------|--------------------|------------------------------|--------------------|
| | <u>September 30,</u> | | <u>September 30,</u> | |
| | <u>2009</u> | <u>2008</u> | <u>2009</u> | <u>2008</u> |
| | (in millions) | | | |
| Fair value of MSR's: | | | | |
| Beginning balance | \$ 434 | \$ 546 | \$ 333 | \$ 489 |
| Additions related to loan sales | 22 | 31 | 87 | 113 |
| Changes in fair value due to: | | | | |
| Change in valuation inputs or assumptions used in the valuation models | (54) | (39) | 6 | (14) |
| Realization of cash flows | (8) | (16) | (32) | (66) |
| Ending balance | \$ 394 | \$ 522 | \$ 394 | \$ 522 |

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

| | September 30, December 31, | |
|--|-----------------------------------|--------------------|
| | <u>2009</u> | <u>2008</u> |

| | (in millions) | |
|--|----------------------|-----------|
| Outstanding principal balances at period end | \$ 50,533 | \$ 46,215 |
| Custodial balances maintained and included in noninterest bearing deposits at period end | \$ 827 | \$ 695 |

Servicing fees collected are included in residential mortgage banking revenue and totaled \$33 million and \$99 million during the three and nine months ended September 30, 2009, respectively. Servicing fees collected totaled \$34 million and \$96 million during the three and nine months ended September 30, 2008, respectively.

Commercial Mortgage Servicing Rights

Commercial MSR, which are accounted for using the lower of cost or fair value method, totaled \$6 million and \$8 million at September 30, 2009 and December 31, 2008, respectively.

Other Intangible Assets

Other intangible assets, which result from purchase business combinations, are comprised of favorable lease arrangements of \$21 million and \$24 million at September 30, 2009 and December 31, 2008, respectively, and customer lists of \$8 million and \$9 million at September 30, 2009 and December 31, 2008, respectively.

9. Goodwill

Goodwill was \$2.6 billion at September 30, 2009 and December 31, 2008. Goodwill is evaluated for impairment annually at the reporting unit level, but impairment may be reviewed earlier if circumstances indicate the carrying amount may not be recoverable. During the third quarter of 2009, we completed our annual impairment test of goodwill. At the testing date, we determined the fair value of all of our reporting units exceeded their carrying values, including goodwill. As a result of the continued deterioration in economic and credit conditions in the U.S., we performed interim impairment tests of the goodwill of our Global Banking and Markets reporting unit during the first, second and third quarters of 2009. Additionally, during the third quarter of 2009, we also performed an interim impairment test of the goodwill of our Private Banking reporting unit. As a result of these tests, the fair value of our Global Banking and Markets and Private Banking reporting units continue to exceed their carrying value including goodwill. Our goodwill impairment testing is, however, highly sensitive to certain assumptions and estimates used. In the event that further significant deterioration in the economic and credit conditions beyond the levels already reflected in our cash flow forecasts occur, or changes in the strategy or performance of our business or product offerings occur, additional interim impairment tests will again be required during the fourth quarter of 2009.

10. Derivative Financial Instruments

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

Derivatives Held for Risk Management Purposes

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

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

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

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

For reporting purposes, changes in fair value of a derivative designated in a qualifying fair value hedge, along with the changes in the fair value of the hedged asset or liability that is attributable to the hedged risk, are recorded in current period earnings. We recognized net losses of \$9 million and \$6 million for the three and nine months ended September 30, 2009, respectively, reported as other income (loss) in the consolidated statement of income (loss), which represented the ineffective portion of all fair value hedges. We recognized net gains of approximately \$5 million in other income (loss) for the three and nine months ended September 30, 2008. The interest accrual related to the derivative contract is recognized in interest income.

The changes in fair value of the hedged item designated in a qualifying hedge are captured as an adjustment to the carrying value of the hedged item (basis adjustment). If the hedging relationship is terminated and the hedged item continues to exist, the basis adjustment is amortized over the remaining term of the original hedge. We recorded basis adjustments for active fair value hedges which decreased the carrying value of our debt by \$189 million and \$53 million for the nine months ended September 30, 2009 and 2008, respectively. We amortized less than \$1 million and \$2 million of basis adjustments related to terminated and/or re-designated fair value hedge relationships for the three and nine months ended September 30, 2009, respectively. We amortized \$1 million and \$4 million of basis adjustments related to terminated and/or re-designated fair value hedge relationships for the three and nine months ended September 30, 2008, respectively. The total accumulated unamortized basis adjustment amounted to an increase in the carrying value of our debt of \$118 million and \$367 million as of September 30, 2009 and December 31, 2008, respectively.

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

| Balance Sheet | <u>Derivative Assets(1)</u> | | <u>Derivative Liabilities(1)</u> | | |
|-------------------------|-----------------------------|--------------|---|-------------------------|--------------|
| | <u>Fair Value as of</u> | | Balance Sheet | <u>Fair Value as of</u> | |
| | September 30, | December 31, | | September 30, | December 31, |
| <u>Location</u> | <u>2009</u> | <u>2008</u> | <u>Location</u> | <u>2009</u> | <u>2008</u> |
| Interest rate contracts | \$ 185 | \$ 372 | (in millions) Interest, taxes and other liabilities | \$ 37 | \$ 207 |

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

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

| | Location of Gain or (Loss) Recognized in Income on Derivatives | Amount of Gain or (Loss) Recognized in Income on Derivatives | | | |
|-------------------------|--|--|-------------|-------------------|-------------|
| | | Three Months Ended | | Nine Months Ended | |
| | | September 30, | | September 30, | |
| | | <u>2009</u> | <u>2008</u> | <u>2009</u> | <u>2008</u> |
| Interest rate contracts | Other income (loss) | \$ 15 | \$ - | \$ (71) | \$ (68) |
| Interest rate contracts | Interest income | (37) | 8 | (106) | 18 |
| Total | | \$ (22) | \$ 8 | \$ (177) | \$ (50) |

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

| <u>Gain/(Loss) on Derivative</u> | <u>Gain (Loss) on Hedged</u> | <u>Gain (Loss) on Derivative</u> | <u>Gain (Loss) on Hedged</u> |
|----------------------------------|------------------------------|----------------------------------|------------------------------|
|----------------------------------|------------------------------|----------------------------------|------------------------------|

| | <u>Items</u> | | <u>Items</u> | | | | | |
|---|------------------|---------------|------------------|---------------|------------------|---------------|------------------|---------------|
| | Interest | Other | Interest | Other | Interest | Other | Interest | Other |
| | Income | Income | Income | Income | Income | Income | Income | Income |
| | <u>(Expense)</u> | <u>(Loss)</u> | <u>(Expense)</u> | <u>(Loss)</u> | <u>(Expense)</u> | <u>(Loss)</u> | <u>(Expense)</u> | <u>(Loss)</u> |
| | <u>2009</u> | | | | <u>2008</u> | | | |
| | (in millions) | | | | | | | |
| Three Months Ended September 30, | | | | | | | | |
| Interest rate contracts/AFS Securities | \$ (2) | \$ (54) | \$ 27 | \$ 59 | \$ (1) | \$ 3 | \$ 3 | \$ (3) |
| Interest rate contracts/commercial loans | - | - | - | - | - | (3) | - | 2 |
| Interest rate contracts/subordinated debt | (35) | 69 | (71) | (83) | 9 | = | (10) | 7 |
| Total | \$ (37) | \$ 15 | \$ (44) | \$ (24) | \$ 8 | \$ - | \$ (7) | \$ 6 |
| Nine Months Ended September 30, | | | | | | | | |
| Interest rate contracts/AFS Securities | \$ (17) | \$ 132 | \$ 65 | (124) | \$ (1) | \$ (19) | \$ 16 | \$ 19 |
| Interest rate contracts/commercial loans | - | (1) | 1 | - | 3 | (2) | 1 | 1 |
| Interest rate contracts/subordinated debt | (89) | (202) | (212) | 189 | 16 | (47) | (65) | 53 |
| Total | \$ (106) | \$ (71) | \$ (146) | \$ 65 | \$ 18 | (68) | (48) | \$ 73 |

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

Changes in fair value associated with the effective portion of a derivative instrument designated as a qualifying cash flow hedge are recognized initially in accumulated other comprehensive income (loss). When the cash flows for which the derivative is hedging materialize and are recorded in income or expense, the associated gain or loss from the hedging derivative previously recorded in accumulated other comprehensive income (loss) is released into the corresponding income or expense account. If a cash flow hedge of a forecasted transaction is de-designated because it is no longer highly effective, or if the hedge relationship is terminated, the cumulative gain or loss on the hedging derivative will continue to be reported in accumulated other comprehensive income (loss) unless the hedged forecasted transaction is no longer expected to occur, at which time the cumulative gain or loss is released into earnings. For the three and nine months ended September 30, 2009, \$10 million and \$40 million, respectively, of losses related to terminated and/or re-designated cash flow hedge relationships were amortized to earnings from accumulated other comprehensive income (loss). During the next twelve months, we expect to amortize \$10 million of remaining losses to earnings resulting from these terminated and/or re-designated cash flow hedges. For the three and nine months ended September 30, 2008, \$17 million and \$54 million, respectively, of losses related to terminated and/or re-designated cash flow hedge relationships were amortized to earnings from accumulated other comprehensive income (loss). The interest accrual related to the derivative contract is recognized in interest income.

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

| | | <u>Derivative Assets(1)</u> | | <u>Derivative Liabilities(1)</u> | | |
|-------------------------|--------------|-----------------------------|---------------------|---|----------------------|---------------------|
| | | <u>Fair Value as of</u> | | <u>Fair Value as of</u> | | |
| <u>Balance Sheet</u> | | <u>September 30,</u> | <u>December 31,</u> | <u>Balance Sheet</u> | <u>September 30,</u> | <u>December 31,</u> |
| <u>Location</u> | | <u>2009</u> | <u>2008</u> | <u>Location</u> | <u>2009</u> | <u>2008</u> |
| Interest rate contracts | Other assets | \$ - | \$ 5 | (in millions) Interest, taxes and other liabilities | \$ 64 | \$ 212 |

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

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

| | <u>Gain (Loss) Recognized in AOCI on Derivative (Effective Portion)</u> | | <u>Location of Gain (Loss) Reclassified from AOCI into Income</u> | | <u>Location of Gain (Loss) Recognized in Income on the Derivative (Ineffective Portion and Amount Excluded from Effectiveness Testing)</u> | | <u>Gain (Loss) Reclassified from AOCI into Income (Ineffective Portion)</u> | |
|---|---|-------------|---|----------------------------|--|---------------------|---|-------------|
| | <u>2009</u> | <u>2008</u> | <u>(Effective Portion)</u> | <u>(Effective Portion)</u> | <u>2009</u> | <u>2008</u> | <u>2009</u> | <u>2008</u> |
| Three Months Ended September 30, | | | | | | | | |
| Interest rate contracts | \$ 50 | \$ (3) | Other income (loss) | \$ (10) | \$ (17) | Other income (loss) | \$ (1) | \$ (5) |
| Foreign exchange contracts | = | 5 | Other income (loss) | = | = | Other income (loss) | = | = |
| Total | \$ 50 | \$ 2 | | \$ (10) | \$ (17) | | \$ (1) | \$ (5) |
| Nine Months Ended September 30, | | | | | | | | |
| Interest rate contracts | \$ 141 | \$ (24) | Other income (loss) | \$ (40) | \$ (54) | Other income (loss) | \$ 6 | \$ (6) |
| Foreign exchange contracts | = | = | Other income (loss) | = | = | Other income (loss) | = | = |
| Total | \$ 141 | \$ (24) | | \$ (40) | \$ (54) | | \$ 6 | \$ (6) |

Trading and Other Derivatives

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

Derivative instruments designated as economic hedges that do not qualify for hedge accounting are recorded in a similar manner as derivative instruments held for trading. Realized and unrealized gains and losses are recognized in other income (loss) while the derivative asset or liability positions are reflected as other assets or other liabilities. As of September 30, 2009, we have entered into credit default swaps which are designated as economic hedges against the credit risks within our loan portfolio and certain own debt issuances. In the event of an impairment loss occurring in a loan that is economically hedged, the impairment loss is recognized as provision for credit losses while the gain on the credit default swap is recorded as other income (loss). In addition, we also from time to time have designated certain forward purchase or sale of to-be-announced (TBA) securities to economically hedge mortgage servicing rights. Changes in the fair value of TBA positions, which are considered derivatives, are recorded in residential mortgage banking revenue.

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

| | Balance Sheet | <u>Derivative Assets(1)</u> | | Balance Sheet | <u>Derivative Liabilities(1)</u> | |
|----------------------------|------------------------|------------------------------------|----------------------------|------------------------|---|----------------------------|
| | | <u>Fair Value as of</u> | | | <u>Fair Value as of</u> | |
| | | <u>September 30,</u> | <u>December 31,</u> | | <u>September 30,</u> | <u>December 31,</u> |
| | | <u>2009</u> | <u>2008</u> | <u>Location</u> | <u>2009</u> | <u>2008</u> |
| | <u>Location</u> | | | | | |
| | | | | (in millions) | | |
| Interest rate contracts | Trading assets | \$ 34,208 | \$ 59,861 | Trading Liabilities | \$ 34,227 | \$ 60,104 |
| Foreign exchange contracts | Trading assets | 15,543 | 24,437 | Trading Liabilities | 16,058 | 23,890 |
| Equity contracts | Trading assets | 2,581 | 2,981 | Trading Liabilities | 2,569 | 2,848 |
| Precious Metals contracts | Trading assets | 1,125 | 2,667 | Trading Liabilities | 1,268 | 2,255 |
| Credit contracts | | 22,650 | 64,341 | | 22,302 | 64,032 |

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| | | | | | | |
|-------|-------------------|-----------|------------|------------------------|-----------|------------|
| | Trading assets | | | Trading Liabilities | | |
| Other | Trading assets | <u>29</u> | <u>55</u> | Trading Liabilities | <u>2</u> | <u>7</u> |
| Total | | \$ 76,136 | \$ 154,342 | | \$ 76,426 | \$ 153,136 |

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

Derivative assets and liabilities balances from December 31, 2008, were impacted by market volatilities as valuations of foreign exchange, interest rate and credit derivatives all reduced from significant spread tightening in all sectors. Specifically, credit derivatives had a large decrease as a number of transaction unwinds and commutations reduced the outstanding market value as we sought to actively reduce exposure.

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

| | | <u>Derivative Assets(1)</u> | | | <u>Derivative Liabilities(1)</u> | |
|----------------------------|----------------------|-----------------------------|----------------------|---------------------------------------|----------------------------------|-----------|
| | | <u>Fair Value as of</u> | | | <u>Fair Value as of</u> | |
| <u>Balance Sheet</u> | <u>September 30,</u> | <u>December 31,</u> | <u>Balance Sheet</u> | <u>September 30,</u> | <u>December 31,</u> | |
| <u>Location</u> | <u>2009</u> | <u>2008</u> | <u>Location</u> | <u>2009</u> | <u>2008</u> | |
| (in millions) | | | | | | |
| Interest rate contracts | Other assets | \$ 446 | \$ 794 | Interest, taxes and other liabilities | \$ 16 | \$ 6 |
| Foreign exchange contracts | Other assets | 28 | 1 | Interest, taxes and other liabilities | 19 | 42 |
| Equity contracts | Other assets | 138 | 2 | Interest, taxes and other liabilities | 15 | 244 |
| Credit contracts | Other assets | <u>30</u> | <u>210</u> | Interest, taxes and other liabilities | <u>22</u> | <u>70</u> |
| | | | \$ | | | |
| Total | | \$ 642 | 1,007 | | \$ 72 | \$ 362 |

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

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

| | | Amount of Gain (Loss) Recognized in Income on Derivatives | | | | | |
|----------------------------|---------------------------|--|-----------------|---|---------------|--|--|
| | | Location of Gain (Loss) Recognized in Income on Derivatives | | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | | 2009 | 2008 | 2009 | 2008 | | |
| (in millions) | | | | | | | |
| Interest rate contracts | Trading revenue (loss) | \$ (182) | \$ - | \$ (321) | \$ (142) | | |
| Foreign exchange contracts | Trading revenue (loss) | 204 | (331) | 775 | 269 | | |
| Equity contracts | Trading revenue (loss) | 24 | 191 | 145 | 534 | | |
| Precious Metals contracts | Trading revenue (loss) | 21 | 112 | 49 | 218 | | |
| Credit contracts | Trading revenue (loss) | (124) | 1,053 | (272) | 1 | | |
| Other | Trading revenue (loss) | 79 | = | 37 | = | | |
| Total | | \$ 22 | \$ 1,025 | \$ 413 | \$ 880 | | |

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

| | | Amount of Gain (Loss) Recognized in Income on Derivatives | | | | | |
|----------------------------|------------------------|--|-------------|---|-------------|--|--|
| | | Location of Gain (Loss) Recognized in Income on Derivatives | | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | | 2009 | 2008 | 2009 | 2008 | | |
| (in millions) | | | | | | | |
| Interest rate contracts | Other income (loss) | \$ 140 | \$ 85 | \$ (281) | \$ 121 | | |
| Foreign exchange contracts | Other income (loss) | (14) | (13) | 21 | 71 | | |
| Equity contracts | Other income (loss) | 201 | (179) | 367 | (380) | | |
| Credit contracts | | (54) | 109 | (148) | 87 | | |

| | | | | | |
|-------|------------------------|--------|------|---------|----------|
| | Other income (loss) | | | | |
| Other | Other income (loss) | = | = | = | = |
| Total | | \$ 273 | \$ 2 | \$ (41) | \$ (101) |

Credit-Risk-Related Contingent Features We enter into total return swap, interest rate swap, cross-currency swap and credit default swap contracts, amongst others which contain provisions that require us to maintain a specific credit rating from each of the major credit rating agencies. Sometimes the derivative instrument transactions are a part of broader structured products transaction. As of September 30, 2009, HSBC Bank USA was given credit ratings of AA and Aa3 by S&P and Moody's respectively and was given a short-term debt rating of A-1+ and P-1 by S&P and Moody's respectively. If our credit ratings were to fall below our current ratings, the counterparties to our derivative instruments could demand additional collateral to be posted with them. The amount of additional collateral required to be posted will depend on whether we are downgraded by one or more notches as well as whether the downgrade is in relation to our long-term or short-term ratings. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that are in a liability position as of September 30, 2009, is \$10.4 billion for which we have posted collateral of \$9.3 billion.

In the event of a credit downgrade, we do not expect our long-term ratings to go below A2 and A+ and our short-term ratings to go below P-2 and A-1 by Moody's and S&P, respectively. The following tables summarize our obligation to post additional collateral (from the current collateral level) in certain hypothetical "commercially reasonable" downgrade scenarios. It is not appropriate to accumulate or extrapolate information presented in the table below to determine our total obligation because the information presented to determine our obligation in hypothetical rating scenarios is not mutually exclusive.

Moody's

| <u>Short-Term Ratings</u> | <u>Long-Term Ratings</u> | | |
|---------------------------|--------------------------|-----------|-----------|
| | <u>Aa3</u> | <u>A1</u> | <u>A2</u> |
| | (in millions) | | |
| P-1 | \$ - | \$ 133 | \$ 223 |
| P-2 | 217 | 324 | 406 |

S&P

| <u>Short-Term Ratings</u> | <u>Long-Term Ratings</u> | | |
|---------------------------|--------------------------|------------|-----------|
| | <u>AA</u> | <u>AA-</u> | <u>A+</u> |
| | (in millions) | | |
| A-1+ | \$ - | \$ 3 | \$ 98 |
| A-1 | 274 | 276 | 372 |

We would be required to post \$488 million of additional collateral on total return swaps if we are not rated by any two of the rating agencies at least A-1 (Moody's), A+ (Fitch), A+ (S&P), or not rated A (high) by DBRS.

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

| | <u>September 30,</u> <u>2009</u> | <u>December 31,</u> <u>2008</u> |
|--|-------------------------------------|------------------------------------|
| | (in billions) | |
| Interest rate: | | |
| Futures and forwards | \$ 228 | \$ 282 |
| Swaps | 1,225 | 1,593 |
| Options written | 65 | 100 |
| Options purchased | <u>77</u> | <u>90</u> |
| | 1,595 | 2,065 |
| Foreign Exchange: | | |
| Swaps, futures and forwards | 478 | 560 |
| Options written | 35 | 31 |
| Options purchased | 35 | 32 |
| Spot | <u>62</u> | <u>36</u> |
| | 610 | 659 |
| Commodities, equities and precious metals: | | |
| Swaps, futures and forwards | 30 | 35 |
| Options written | 10 | 14 |
| Options purchased | <u>15</u> | <u>14</u> |
| | 55 | 63 |
| Credit derivatives | <u>906</u> | <u>968</u> |
| Total | \$ 3,166 | \$ 3,755 |

11. Fair Value Option

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

Loans We elected to apply FVO to all commercial leveraged acquisition finance loans and unfunded commitments. The election allows us to account for these loans and commitments at fair value which is consistent with the manner in which the instruments are managed. As of September 30, 2009, commercial leveraged acquisition finance loans and unfunded commitments of \$1.1 billion carried at fair value had an aggregate unpaid principal balance of \$1.3 billion. As of December 31, 2008, commercial leveraged acquisition finance loans and unfunded commitments of \$874 million carried at fair value had an aggregate unpaid principal balance of \$1.3 billion. These loans are included in loans held for sale in the consolidated balance sheet. Interest from these loans is recorded as interest income in the consolidated statement of income (loss). Because substantially all of the loans elected for the fair value option are floating rate assets, changes in their fair value are primarily attributable to changes in loan-specific credit risk. The components of gain (loss) related to loans designated at fair value are summarized in the table below.

As of September 30, 2009 and December 31, 2008, no loans for which the fair value option has been elected are 90 days or more past due or are on non-accrual status.

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

Fixed rate debt accounted for under FVO at September 30, 2009 totaled \$1.8 billion and had an aggregate unpaid principal balance of \$1.8 billion. Fixed rate debt accounted for under FVO at December 31, 2008 totaled \$1.7 billion and had an aggregate unpaid principal balance of \$1.8 billion. Interest paid on the fixed rate debt elected for FVO is recorded as interest expense in the consolidated statement of income (loss). The components of gain (loss) related to long-term debt designated at fair value are summarized in the table below.

Hybrid Instruments Upon the adoption of accounting guidance related to certain hybrid financial instruments effective January 1, 2006, we elected to measure all hybrid instruments issued after January 1, 2006 that contain embedded derivatives which should be bifurcated from the debt host at fair value. Such election reduced the differences between IFRSs and U.S. GAAP. Fair value option accounting principles effective January 1, 2008 have incorporated accounting requirements similar to those for hybrid financial instruments and because fair value option accounting principles have a broader application than the accounting guidance for certain hybrid financial instruments, we elected to apply fair value option accounting principles to all of our hybrid instruments, inclusive of structured notes and structured deposits, issued after January 1, 2006.

As of September 30, 2009, interest bearing deposits in domestic offices included \$3.9 billion of structured deposits accounted for under FVO which had an unpaid principal balance of \$3.9 billion. As of December 31, 2008, interest bearing deposits in domestic offices included \$2.3 billion of structured deposits accounted for under FVO which had an unpaid principal balance of \$2.4 billion. Long-term debt at September 30, 2009 included structured notes of \$2.8 billion accounted for under FVO which had an unpaid principal balance of \$2.7 billion. Long-term debt at December 31, 2008 included structured notes of \$959 million accounted for under FVO which had an unpaid principal balance of \$1.2 billion. Interest incurred was recorded as interest expense in the consolidated statement of income (loss). The components of gain (loss) related to hybrid instruments designated at fair value which reflect the instruments described above are summarized in the table below.

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

| | <u>Three Months Ended September 30,</u> | | | | | |
|-------------------------|---|---------------|--------------|-------------------------|---------------|----------------------|
| | <u>2009</u> | | | <u>2008</u> | | |
| | <u>Loans Long-</u> | <u>Hybrid</u> | <u>Total</u> | <u>Loans Long-</u> | <u>Hybrid</u> | <u>Total</u> |
| | <u>Term Instruments</u> | | | <u>Term Instruments</u> | | |
| | <u>Debt</u> | | | <u>Debt</u> | | |
| | (in millions) | | | | | |
| Interest rate component | \$ - | \$ (57) | (265) | \$ (322) | \$ - (58) | \$ 125 \$ 67 |
| Credit risk component | <u>128</u> | <u>(77)</u> | <u>(27)</u> | <u>24</u> (94) | <u>176</u> | <u>(1)</u> <u>81</u> |
| Total | <u>128</u> | <u>(134)</u> | <u>(292)</u> | <u>(298)</u> | (94) 118 | 124 148 |
| mark-to-market | | | | | | |

| | | | | | | | | |
|---|--------|---------|---------|-------|------|--------|-------|--------|
| on financial instruments designated at fair value | | | | | | | | |
| Mark-to-market on the related derivatives | - | 71 | 251 | 322 | - | 65 | 1 | 66 |
| Net realized gain (loss) on the related derivatives | = | 20 | = | 20 | = | 16 | (119) | (103) |
| Total gain (loss) on related derivatives | = | 91 | 251 | 342 | = | 81 | (118) | (37) |
| Gain (loss) on instruments designated at fair value and related derivatives | \$ 128 | \$ (43) | \$ (41) | \$ 44 | (94) | \$ 199 | \$ 6 | \$ 111 |

Nine Months Ended September 30,**2009****2008****Loans Long- Hybrid Total Loans Long Hybrid Total****Term Instruments****Term Instruments****Debt****Debt****(in millions)**

| | | | | | | | | |
|--|------------|--------------|--------------|--------------|--------------|------------|--------------|--------------|
| Interest rate component | \$ - | \$ 198 | (509) | (311) | \$ - | (75) | \$ 155 | \$ 80 |
| Credit risk component | <u>258</u> | <u>(291)</u> | <u>37</u> | <u>4</u> | <u>(196)</u> | <u>256</u> | <u>181</u> | <u>241</u> |
| Total mark-to-market on financial instruments designated at fair value | 258 | (93) | (472) | (307) | (196) | 181 | 336 | 321 |
| Mark-to-market on the related derivatives | - | (395) | 509 | 114 | (1) | 77 | (154) | (78) |
| Net realized gain (loss) on the related derivatives | = | <u>51</u> | <u>(59)</u> | <u>(8)</u> | = | <u>31</u> | <u>(153)</u> | <u>(122)</u> |
| Total gain (loss) on related derivatives | = | <u>(344)</u> | <u>450</u> | <u>106</u> | <u>(1)</u> | <u>108</u> | <u>(307)</u> | <u>(200)</u> |

| | | | | | | | | |
|---|--------|----------|---------|-------|-------|--------|-------|--------|
| Gain (loss) on instruments designated at fair value and related derivatives | \$ 258 | \$ (437) | \$ (22) | (201) | (197) | \$ 289 | \$ 29 | \$ 121 |
|---|--------|----------|---------|-------|-------|--------|-------|--------|

12. Income Taxes

The following table presents our effective tax rates.

| <u>Three months ended September 30,</u> | <u>2009</u> | <u>2008</u> | | |
|---|---------------------------|-------------|---------|---------|
| | (dollars are in millions) | | | |
| Statutory federal income taxes and rates | \$ 80 | 35.0% | \$ (66) | (35.0)% |
| Increase (decrease) in rate resulting from: | | | | |
| State and local taxes, net of federal benefit and state valuation allowance | 4 | 1.8 | 3 | 1.4 |
| Goodwill impairment charge | - | - | 19 | 10.1 |
| Adjustment to valuation allowance on deferred tax assets | 16 | 6.9 | - | - |
| Tax exempt income | (4) | (1.7) | (3) | (2.0) |
| Low income housing and other tax credits | (23) | (10.3) | (10) | (5.8) |
| Effects of foreign operations | - | - | 9 | 4.8 |
| Uncertain tax provision | (1) | (.2) | (1) | (.2) |
| State rate change effect on net deferred tax assets | (1) | (.6) | (2) | (.8) |
| Other | (2) | (1.2) | (1) | (.2) |
| | | | \$ | |
| Effective tax rate | \$ 69 | 29%.7 | (52) | (27)%. |

| <u>Nine months ended September 30,</u> | <u>2009</u> | <u>2008</u> | | |
|--|---------------------------|-------------|----------|---------|
| | (dollars are in millions) | | | |
| Statutory federal income taxes and rates | \$ (42) | (35.0)% | \$ (323) | (35.0)% |
| Increase (decrease) in rate resulting from: | | | | |
| State and local taxes, net of federal benefits and state valuation allowance | 14 | 11.2 | 13 | 1.4 |
| Goodwill impairment charge | - | - | 19 | 2.1 |
| Sale of minority stock interest | 74 | 61.3 | - | - |
| | 93 | 76.7 | - | - |

| | | | | |
|--|-------|--------|-------|---------|
| Adjustment to valuation allowance on deferred tax assets | | | | |
| Tax exempt income | (12) | (9.5) | (11) | (1.2) |
| Validation of deferred tax balances | - | - | (8) | (.8) |
| Low income housing and other tax credits | (54) | (45.1) | (37) | (4.0) |
| Effects of foreign operations | (1) | (.4) | 21 | 2.3 |
| Uncertain tax provision | (1) | (1.2) | (4) | (.4) |
| IRS audit effective settlement | (8) | (6.8) | - | - |
| State rate change effect on net deferred tax assets | (1) | (.5) | - | - |
| Other | (6) | (4).4 | (4) | (.6) |
| | | | \$ | |
| Effective tax rate | \$ 56 | 46%.3 | (334) | (36)%.2 |

In 2009, the effective tax rate in both periods was significantly impacted by the incremental valuation allowance on deferred tax assets and, in the nine month period, the sale of a minority interest investment as discussed below. The effective tax rate in both years was also impacted by the benefit associated with low income housing and other tax credits and in 2008, the non-deductible impairment of goodwill.

HSBC North America Consolidated Income Taxes

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

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

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

In conjunction with the HNAH Group deferred tax evaluation process, based on our forecasts of future taxable income, which include assumptions about the depth and severity of further home price depreciation and the U.S. economic downturn including unemployment levels and their related impact on credit losses, we currently

anticipate that our results of future operations will generate sufficient taxable income to allow us to realize our deferred tax assets. However, since the recent market conditions have created significant downward pressure and volatility on our near-term pre-tax book income, our analysis of the realizability of the deferred tax assets significantly discounts any future taxable income expected from operations and relies to a greater extent on continued capital support from our parent, HSBC, including tax planning strategies implemented in relation to such support. HSBC has indicated they remain fully committed and have the capacity to provide capital as needed to run operations, maintain sufficient regulatory capital, and fund certain tax planning strategies.

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

Currently, it has been determined that the HNAH Group's primary tax planning strategy related to capital support from HSBC, in combination with other tax planning strategies, provides support for the realization of net deferred tax assets of approximately \$5.9 billion for the HNAH Group. Such determination is based on HSBC's business forecasts and assessment as to the most efficient and effective deployment of HSBC capital, most importantly including the length of time such capital will need to be maintained in the U.S. for purposes of the tax planning strategy. As it relates to the growth in the HNAH consolidated deferred tax asset, HSBC decided to limit the level and duration of excess HNAH Group capital it will reinvest in the U.S. operations in future years as part of the primary tax planning strategy.

Therefore, although a significant part of the net deferred tax assets are supported by the aforementioned tax planning strategies, it has been determined that for the residual portion of the net deferred tax assets, it is not more-likely-than-not that the expected benefits to be generated by the various tax planning strategies are sufficient to ensure full realization. As such, a valuation allowance has been recorded by the HNAH Group relative to growth in the deferred tax asset in excess of the level discussed above.

The aforementioned HNAH Group valuation allowance recorded has been allocated to its principal subsidiaries, including HSBC USA Inc. The methodology allocates the valuation allowance to the principal subsidiaries based primarily on the entity's relative contribution to the growth of the HNAH consolidated deferred tax asset against which the valuation allowance is being recorded.

The HNAH Group expects to record significant additional valuation allowances against further growth in the deferred tax assets through the remainder of 2009 and 2010, and perhaps longer.

If future results differ from the HNAH Group's current forecasts or the primary tax planning strategy were to change, a valuation allowance against the remaining net deferred tax assets may need to be established which could have a material adverse effect on HSBC USA Inc.'s results of operations, financial condition and capital position.

The HNAH Group will continue to update its assumptions and forecasts of future taxable income and assess the need for such incremental valuation allowances.

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

HSBC USA Inc. Income Taxes

We recognize deferred tax assets and liabilities for the future tax consequences related to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, and for tax credits and net operating and other losses. Our net deferred tax assets, including deferred tax liabilities and valuation allowances, totaled \$1.5 billion and \$1.4 billion as of September 30, 2009 and December 31, 2008 respectively. The valuation allowance at September 30, 2009 and December 31, 2008 related primarily to the potential limitation on the utilization of excess foreign and other tax credits as well as foreign losses with limited possibility of recovery.

To the extent that we contribute to the growth in the HNAH Group deferred tax assets in future periods, we expect to be allocated and record a part of any HNAH Group valuation allowances in those periods.

In March 2009, as part of a corporate restructuring within HSBC's Private Banking business, our 5.24% indirect interest in HSBC Private Bank (Suisse) S.A. ("PBRs") was sold to HSBC Private Bank Holdings (Suisse) S.A., the majority shareholder, for cash proceeds of \$350 million. A gain of \$33 million was reported for book purposes during the first quarter of 2009. For U.S. tax purposes, the transaction is treated as a dividend in the amount of the sale proceeds to the extent of PBRs' earnings and profits.

The Internal Revenue Service's audit of our 2004 and 2005 federal income tax returns was effectively settled during the first quarter of 2009, resulting in an \$8 million decrease in tax expense. We are currently under audit by various state and local tax jurisdictions, and although one or more of these audits may be concluded within the next 12 months, it is not possible to reasonably estimate the impact on our uncertain tax positions at this time. The Internal Revenue Service began its audit of our 2006 and 2007 returns in the second quarter.

13. Pensions and other Post-retirement Benefits

The components of pension expense for the domestic defined benefit pension plan reflected in our consolidated statement of income (loss) are shown in the table below and reflect the portion of the pension expense of the combined HSBC North America pension plan which has been allocated to HSBC USA Inc.

| | Three Months Ended | | Nine Months Ended | |
|--|-----------------------------|--------------------|-----------------------------|--------------------|
| | <u>September 30,</u> | | <u>September 30,</u> | |
| | <u>2009</u> | <u>2008</u> | <u>2009</u> | <u>2008</u> |
| | (in millions) | | | |
| Service cost – benefits earned during the period | \$ 6 | \$ 7 | \$ 19 | \$ 23 |
| Interest cost on projected benefit obligation | 18 | 20 | 55 | 58 |
| Expected return on assets | (13) | (22) | (38) | (67) |
| Recognized losses | 10 | - | 28 | 1 |
| Partial plan termination | 5 | = | 5 | = |
| Pension expense | \$ 26 | \$ 5 | \$ 69 | \$ 15 |

The overall increase in pension expense during 2009 was due to the amortization of a portion of the actuarial losses incurred by the plan and reduced expectations of returns on plan assets as a result of the volatile capital markets that occurred in 2008.

Effective September 30, 2009, HSBC North America voluntarily chose to allow all plan participants whose employment was terminated as a result of the strategic restructuring of its businesses between 2007 and 2009 to become fully vested in their accrued pension benefit, resulting in a partial termination of the plan. In accordance with interpretations of the Internal Revenue Service relating to partial plan terminations, plan participants who voluntarily left the employment of HSBC North America or its subsidiaries during this period will also be deemed to have vested in their accrued pension benefit through the date their employment ended. As a result, incremental pension expense of \$5 million, representing our share of the partial plan termination cost, was recognized during the three months ended September 30, 2009.

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

| | Three Months Ended | | Nine Months Ended | |
|--|-----------------------------|--------------------|-----------------------------|--------------------|
| | <u>September 30,</u> | | <u>September 30,</u> | |
| | <u>2009</u> | <u>2008</u> | <u>2009</u> | <u>2008</u> |
| | | | (in millions) | |
| Service cost – benefits earned during the period | \$ - | \$ 1 | \$ - | \$ 1 |
| Interest cost | 1 | 1 | 4 | 4 |
| Recognized losses | 1 | - | 2 | - |
| Transition amount amortization | <u>(1)</u> | <u>1</u> | <u>(2)</u> | <u>2</u> |
| Net periodic post-retirement benefit cost | \$ 1 | \$ 3 | \$ 4 | \$ 7 |

14. Related Party Transactions

In the normal course of business, we conduct transactions with HSBC and its subsidiaries. These transactions occur at prevailing market rates and terms. All extensions of credit by HSBC Bank USA to other HSBC affiliates (other than FDIC-insured banks) are legally required to be secured by eligible collateral. The following table presents related party balances and the income and expense generated by related party transactions:

| | September 30 | | December 31, | |
|---|----------------------|--|---------------------|--|
| | <u>2009</u> | | <u>2008</u> | |
| | (in millions) | | | |
| Assets: | | | | |
| Cash and due from banks | \$ 296 | | \$ 157 | |
| Interest bearing deposits with banks | 243 | | 138 | |
| Federal funds sold and securities purchased under resale agreements | 490 | | 346 | |
| Trading assets(1) | 15,569 | | 32,445 | |
| Loans | 1,839 | | 2,586 | |
| Other | <u>557</u> | | <u>733</u> | |
| | \$ | | \$ | |
| Total assets | 18,994 | | 36,405 | |
| Liabilities: | | | | |
| | | | \$ | |
| Deposits | \$ 8,956 | | 10,285 | |
| Trading liabilities(1) | 20,398 | | 36,589 | |
| Short-term borrowings | 443 | | 1,831 | |
| Other | <u>1,243</u> | | <u>162</u> | |

| | | |
|-------------------|---------------------|--------------|
| Total liabilities | \$ 31,040 | \$ 48,867 |
|-------------------|---------------------|--------------|

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

| | Three Months Ended | | Nine Months Ended | |
|---|-----------------------------------|--------------------|------------------------------|--------------------|
| | <u>September 30,</u> | | | |
| | <u>2009</u> | <u>2008</u> | <u>2009</u> | <u>2008</u> |
| | (in millions) | | | |
| Income/(Expense): | | | | |
| Interest income | \$ 44 | \$ 51 | \$ 141 | 159 |
| Interest expense | <u>7</u> | <u>43</u> | <u>19</u> | <u>169</u> |
| Net interest income (loss) | \$ 37 | \$ 8 | \$ 122 | (10) |
| HSBC affiliate income: | | | | |
| Fees and commissions: | | | | |
| HSBC Finance | 2 | 2 | 7 | 8 |
| HSBC Markets (USA) Inc. ("HMUS") | 5 | 4 | 14 | 9 |
| Other HSBC affiliates | 15 | 19 | 53 | 65 |
| Gains on sales of refund anticipation loans to HSBC Finance | - | - | 11 | 13 |
| Other HSBC affiliates income | <u>2</u> | <u>5</u> | <u>10</u> | <u>14</u> |
| Total affiliate income | \$ 24 | \$ 30 | \$ 95 | 109 |
| Support services from HSBC affiliates: | | | | |
| HSBC Finance | \$ 175 | \$ 116 | \$ 548 | 353 |
| HMUS | 50 | 54 | 187 | 166 |
| HSBC Technology & Services (USA) Inc. ("HTSU") | 106 | 61 | 353 | 187 |
| Other HSBC affiliates | <u>56</u> | <u>69</u> | <u>140</u> | <u>185</u> |
| Total support services from HSBC affiliates | \$ 387 | \$ 300 | \$ 1,228 | 891 |
| Stock based compensation expense with HSBC | \$ 15 | \$ 16 | \$ 48 | \$ 54 |

Transactions Conducted with HSBC Finance Corporation

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- In January 2009, we purchased the GM and UP Portfolios from HSBC Finance, with an outstanding principal balance of \$12.4 billion at the time of sale, at a total net premium of \$113 million. Premiums paid are amortized to interest income over the estimated life of the receivables purchased. HSBC Finance retained the customer account relationships associated with these credit card portfolios. On a daily basis we purchase all new credit card loan originations for the GM and UP Portfolios from HSBC Finance. HSBC Finance continues to service these credit card loans for us for a fee. Information regarding these loans is summarized in the table below.
- In January 2009, we also purchased certain auto finance loans, with an outstanding principal balance of \$3.0 billion from HSBC Finance at the time of sale, at a total net discount of \$226 million. Discounts are amortized to interest income over the estimated life of the receivables purchased. HSBC Finance continues to service the auto finance loans for us for a fee. Information regarding these loans is summarized in the table below.
- In July 2004, we sold the account relationships associated with \$970 million of credit card receivables to HSBC Finance and on a daily basis, we purchase new originations on these credit card receivables. HSBC Finance continues to service these loans for us for a fee. Information regarding these loans is summarized in the table below.
- In December 2004, we purchased the private label credit card receivable portfolio as well as private label commercial and closed end loans from HSBC Finance. HSBC Finance retained the customer account relationships and by agreement we purchase on a daily basis substantially all new private label originations from HSBC Finance. HSBC Finance continues to service these loans for us for a fee. Information regarding these loans is summarized in the table below.
- In 2003 and 2004, we purchased approximately \$3.7 billion of residential mortgage loans from HSBC Finance. HSBC Finance continues to service these loans for us for a fee. Information regarding these loans is summarized in the table below.

The following table summarizes the private label card, private label commercial and closed end loans, credit card (including the GM and UP credit card portfolios), auto finance and real estate secured loans serviced for us by HSBC Finance as well as the daily loans purchased during the three and nine months ended September 30, 2009 and 2008:

| | <u>Private Label</u> | | <u>Credit Cards</u> | | | | | <u>Total</u> |
|--|----------------------|-------------------|---------------------|--------------|------------------|--------------|--------------------|--------------|
| | <u>Cards</u> | <u>Commercial</u> | <u>General</u> | <u>Union</u> | <u>Other</u> | <u>Auto</u> | <u>Residential</u> | |
| | | | <u>and</u> | <u>Moto</u> | <u>Privilege</u> | <u>Finan</u> | <u>Mortgage</u> | |
| | | | <u>Closed</u> | | | | | |
| | | | <u>End</u> | | | | | |
| | | | <u>Loans(1)</u> | | | | | |
| | (in billions) | | | | | | | |
| Receivables serviced by HSBC Finance: | | | | | | | | \$ |
| September 30, 2009 | \$ 14.6 | \$.6 | \$ 5.4 | \$ 5.6 | \$ 2.0 | \$ 2.3 | \$ 1.8 | 32.3 |
| December 31, 2008 | 17.1 | .9 | - | - | 2.1 | - | 2.1 | 22.2 |
| Daily receivables purchased from HSBC Finance during the three months ended: | | | | | | | | |
| September 30, 2009 | 3.6 | - | 3.7 | .9 | 1.1 | - | - | 9.3 |
| September 30, 2008 | 4.7 | - | - | - | 1.2 | - | - | 5.9 |

Daily receivables purchased from HSBC Finance during the nine months ended:

| | | | | | | | | |
|--------------------|------|---|------|-----|-----|---|---|------|
| September 30, 2009 | 11.0 | - | 10.8 | 2.7 | 3.2 | - | - | 27.7 |
| September 30, 2008 | 14.2 | - | - | - | 3.6 | - | - | 17.8 |

- (1) Private label commercial are included in other commercial loans and private label closed end loans are included in other consumer loans in Note 5, “Loans.”

During the three and nine months ended September 30, 2009, fees paid for servicing these loan portfolios totaled \$170 million and \$530 million, respectively, as compared to \$107 million and \$330 million during the year-ago periods.

- Support services from HSBC affiliates include charges by HSBC Finance under various service level agreements for loan origination and servicing, including the servicing of the portfolios previously discussed, as well as other operational and administrative support. Fees paid for these services totaled \$175 million and \$548 million for the three and nine months ended September 30, 2009, respectively. During the three and nine months ended September 30, 2008, fees paid for these services totaled \$116 million and \$353 million, respectively.

- In the second quarter of 2008, HSBC Finance launched a new program with HSBC Bank USA to sell loans originated in accordance with the Federal Home Loan Mortgage Corporation’s (“Freddie Mac”) underwriting criteria to HSBC Bank USA who then sells them to Freddie Mac under its existing Freddie Mac program. During the three months ended March 31, 2009, \$51 million of real estate secured loans were purchased by HSBC Bank USA under this program. During the third quarter of 2008, \$68 million of real estate secured loans were purchased by HSBC Bank USA under this program. This program was discontinued in February 2009 as a result of the decision to discontinue new receivable originations in HSBC Finance’s Consumer Lending business.

- Our wholly-owned subsidiaries, HSBC Bank USA and HSBC Trust Company (Delaware), N.A. (“HTCD”), are the originating lenders for a federal income tax refund anticipation loan program for clients of third party tax preparers, which are managed by HSBC Finance. By agreement, HSBC Bank USA and HTCD process applications, fund and subsequently sell these loans to HSBC Finance. HSBC Bank USA and HTCD originated approximately \$9.0 billion and \$12.6 billion of loans during the nine months ended September 30, 2009 and 2008, respectively, that were sold to HSBC Finance. This resulted in gains of \$11 million and \$13 million during the nine months ended September 30, 2009 and 2008, respectively.

- Certain of our consolidated subsidiaries have revolving lines of credit totaling \$1.0 billion with HSBC Finance. There were no balances outstanding under any of these lines of credit at September 30, 2009 or December 31, 2008.

- We extended a secured \$1.5 billion uncommitted credit facility to HSBC Finance in December 2008. This is a 364 day credit facility and there were no balances outstanding at September 30, 2009 or December 31, 2008.

- We extended a \$1.0 billion committed credit facility to HSBC Bank Nevada, a subsidiary of HSBC Finance, in December 2008. This is a 364 day credit facility and there were no balances outstanding at September 30, 2009 or December 31, 2008.

- We service a portfolio of residential mortgage loans owned by HSBC Finance with an outstanding principal balance of \$1.6 billion and \$2.1 billion at September 30, 2009 and December 31, 2008, respectively. The related servicing fee income was \$1 million and \$6 million during the three and nine months ended September 30, 2009, respectively, and \$3 million and \$10 million during the three and nine months ended September 30, 2008, respectively which is included in residential mortgage banking revenue in the consolidated statement of income (loss).
- In the third quarter of 2009, we purchased \$86 million of Low Income Housing Tax Credit Investment Funds from HSBC Finance.

Transactions Conducted with HMUS and Subsidiaries

We utilize HSBC Securities (USA) Inc. (“HSI”) for broker dealer, debt and preferred stock underwriting, customer referrals, loan syndication and other treasury and traded markets related services, pursuant to service level agreements. Fees charged by HSI for broker dealer, loan syndication services, treasury and traded markets related services are included in support services from HSBC affiliates. Debt underwriting fees charged by HSI are deferred as a reduction of long-term debt and amortized to interest expense over the life of the related debt. Preferred stock issuance costs charged by HSI are recorded as a reduction of capital surplus. Customer referral fees paid to HSI are netted against customer fee income, which is included in other fees and commissions.

We have extended loans and lines, some of them uncommitted, to HMUS and its subsidiaries in the amount of \$4.1 billion, of which \$1.3 billion and \$1.5 billion was outstanding at September 30, 2009 and December 31, 2008, respectively. Interest income on these loans and lines for the three and nine months ended September 30, 2009 totaled \$8 million and \$28 million, respectively. Interest income for the three and nine months ended September 30, 2008 totaled \$12 million and \$28 million, respectively.

Other Transactions with HSBC Affiliates

HSBC North America extended a \$1.0 billion senior note to us in August 2009. This is a five year floating rate note which matures on August 28, 2014 with interest due quarterly beginning in November 2009.

In March 2009, we sold an equity investment in HSBC Private Bank (Suisse) SA to another HSBC affiliate for cash, resulting in a gain of \$33 million in the first quarter of 2009.

We have an unused line of credit with HSBC Bank plc of \$2.5 billion at September 30, 2009 and December 31, 2008.

We have extended loans and lines of credit to various other HSBC affiliates totaling \$1.7 billion, of which \$550 million and \$715 million was outstanding at September 30, 2009 and December 31, 2008, respectively. Interest income on these lines for the three and nine months ended September 30, 2009 totaled \$3 million and \$9 million, respectively. Interest income for the three and nine months ended September 30, 2008 totaled \$6 million and \$9 million, respectively.

Historically, we have provided support to several HSBC affiliate sponsored asset backed commercial paper (“ABCP”) conduits by purchasing A-1/P-1 rated commercial paper issued by them. At September 30, 2009 and December 31, 2008, no ABCP was held.

We routinely enter into derivative transactions with HSBC Finance and other HSBC affiliates as part of a global HSBC strategy to offset interest rate or other market risks associated with debt issues and derivative contracts with unaffiliated third parties. The notional value of derivative contracts related to these contracts was approximately \$693 billion and \$904 billion at September 30, 2009 and December 31, 2008, respectively. The net credit exposure

(defined as the recorded fair value of derivative receivables) related to the contracts was approximately \$16 billion and \$32 billion at September 30, 2009 and December 31, 2008, respectively. Our Global Banking and Markets business accounts for these transactions on a mark to market basis, with the change in value of contracts with HSBC affiliates substantially offset by the change in value of related contracts entered into with unaffiliated third parties.

In December 2008, HSBC Bank USA entered into derivative transactions with another HSBC affiliate to offset the risk associated with the contingent “loss trigger” options embedded in certain leveraged super senior (LSS) tranching credit default swaps. These transactions are expected to significantly reduce income volatility for HSBC Bank USA by transferring the volatility to the affiliate. The recorded fair value of derivative assets related to these derivative transactions was approximately \$235 million and \$1,108 million at September 30, 2009 and December 31, 2008, respectively.

Technology and some centralized operational services and beginning in January 2009, human resources, corporate affairs and other shared services in North America are centralized within HSBC Technology and Services (USA) Inc. (“HTSU.”) Technology related assets and software purchased subsequent to January 1, 2004 are generally purchased and owned by HTSU. HTSU also provides certain item processing and statement processing activities which are included in Support services from HSBC affiliates in the consolidated statement of income (loss).

Our domestic employees participate in a defined benefit pension plan sponsored by HSBC North America. Additional information regarding pensions is provided in Note 13, “Pension and Other Post-retirement Benefits” of the consolidated financial statements.

Employees participate in one or more stock compensation plans sponsored by HSBC. Our share of the expense of these plans on a pre-tax basis was approximately \$15 million and \$48 million for the three and nine months ended September 30, 2009, respectively, and \$16 million and \$54 million for the three and nine months ended September 30, 2008, respectively. As of September 30, 2009, our share of compensation cost related to nonvested stock compensation plans was approximately \$76 million, which is expected to be recognized over a weighted-average period of 1.5 years. A description of these stock compensation plans can be found in Note 24, “Share-based Plans,” of the 2008 Form 10-K.

We use HSBC Global Resourcing (UK) Ltd., an HSBC affiliate located outside of the United States, to provide various support services to our operations including among other areas customer service, systems, collection and accounting functions. The expenses related to these services of \$9 million and \$26 million during the three and nine months ended September 30, 2009, respectively are included as a component of *Support services from HSBC affiliates* in the table above. During 2009 billing for these services was processed by HTSU.

15. Business Segments

We have five distinct segments that we utilize for management reporting and analysis purposes, which are generally based upon customer groupings, as well as products and services offered.

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

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

unit in Global Banking and Markets and more appropriately reflect the profitability of segments.

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

Results for each segment on an IFRSs basis, as well as a reconciliation of total results under IFRSs to U.S. GAAP consolidated totals, are provided in the following tables. Descriptions of the significant differences between IFRSs and U.S. GAAP that impact our results follow the tables:

| | <u>IFRSs Consolidated Amounts</u> | | | | | | | | (4) | (5) | U.S. GAAP |
|--|-----------------------------------|-----------|------------------------------------|---------------|-----------|------------------------------|--------------------|------------------------------|------------------------------------|--------------------------------|--------------|
| | <u>PFS</u> | <u>CF</u> | <u>CMB</u> | <u>Global</u> | <u>PB</u> | <u>Other</u> | <u>Adjustments</u> | <u>Total</u> | | | |
| | | | <u>Banking and Markets</u> | | | <u>Reconciling Items</u> | | <u>IFRSs Adjustments</u> | <u>IFRSs Reclassifications</u> | <u>Consolidated Totals</u> | |
| | (In millions) | | | | | | | | | | |
| Three months ended September 30, 2009 | | | | | | | | | | | |
| Net interest income(1) | \$ 238 | \$ 539 | \$ 184 | \$ 201 | \$ 41 | \$ (6) | \$ (4) | \$ 1,193 | \$ (4) | \$ 71 | \$ 1,260 |
| Other operating income | 88 | 98 | 92 | 91 | 23 | (63) | 4 | 333 | 484 | 78 | 895 |
| Total operating income (loss) | 326 | 637 | 276 | 292 | 64 | (69) | - | 1,526 | 480 | 149 | 2,155 |
| Loan impairment charges(3) | 178 | 437 | 51 | 163 | 86 | - | - | 915 | 120 | (29) | 1,006 |
| | 148 | 200 | 225 | 129 | (22) | (69) | - | 611 | 360 | 178 | 1,149 |
| Operating expenses(2) | 306 | 18 | 159 | 180 | 58 | 13 | - | 734 | 7 | 178 | 919 |
| Profit (loss) before tax | \$ (158) | \$ 182 | \$ 66 | \$ (51) | \$ (80) | \$ (82) | \$ - | \$ (123) | \$ 353 | \$ - | \$ 230 |
| Balances at end of period: | | | | | | | | | | | |
| | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ |
| Total assets | 22,025 | 30,227 | 17,393 | 175,845 | 5,220 | \$ 115 | \$ - | 250,825 | (72,378) | \$ (2,938) | 175,509 |
| Total loans | 17,747 | 28,271 | 15,720 | 21,786 | 4,516 | - | - | 88,040 | (3,330) | 659 | 85,369 |
| Goodwill | 876 | - | 368 | 497 | 326 | - | - | 2,067 | 580 | - | 2,647 |
| Total deposits | 47,285 | 43 | 24,680 | 30,939 | 10,665 | - | - | 113,612 | (3,173) | 5,110 | 115,549 |
| Three months ended September 30, 2008 | | | | | | | | | | | |
| Net interest income(1) | \$ 201 | \$ 327 | \$ 195 | \$ 334 | \$ 48 | \$ - | \$ (43) | \$ 1,062 | \$ (57) | \$ 164 | \$ 1,169 |
| Other operating income | 105 | 80 | 94 | (72) | 36 | 181 | 43 | 467 | (139) | (58) | 270 |
| | 306 | 407 | 289 | 262 | 84 | 181 | - | 1,529 | (196) | 106 | 1,439 |

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| | | | | | | | | | | | |
|---|-------------------|---------------------|-------------------|-------------------|-------------------|---------------------|------------------|---------------------|---------------------|---------------------|---------------------|
| Total operating income (loss) | | | | | | | | | | | |
| Loan impairment charges(3) | <u>104</u> | <u>439</u> | <u>71</u> | <u>30</u> | <u>4</u> | = | = | <u>648</u> | <u>4</u> | <u>6</u> | <u>658</u> |
| | 202 | (32) | 218 | 232 | 80 | 181 | - | 881 | (200) | 100 | 781 |
| Operating expenses(2) | <u>417</u> | <u>11</u> | <u>155</u> | <u>201</u> | <u>70</u> | = | = | <u>854</u> | <u>15</u> | <u>100</u> | <u>969</u> |
| Profit (loss) before tax | \$ (215) | \$ (43) | \$ 63 | \$ 31 | \$ 10 | \$ 181 | \$ - | \$ 27 | \$ (215) | \$ - | \$ (188) |
| Balances at end of period: | | | | | | | | | | | |
| | \$ | \$ | \$ | \$ | \$ | | | \$ | \$ | | \$ |
| Total assets | 34,310 | 19,695 | 22,380 | 193,243 | 6,284 | \$ 403 | \$ - | 276,315 | (87,816) | \$ (1,916) | 186,583 |
| Total loans | 25,817 | 19,103 | 19,221 | 38,662 | 5,089 | - | - | 107,892 | (1,982) | (14,250) | 91,660 |
| Goodwill | 876 | - | 368 | 497 | 326 | - | - | 2,067 | 580 | - | 2,647 |
| Total deposits | 44,810 | 32 | 20,962 | 39,801 | 11,893 | 2 | - | 117,500 | (2,661) | 6,947 | 121,786 |
| Nine months ended September 30, 2009 | | | | | | | | | | | |
| Net interest income(1) | \$ 665 | \$ 1,588 | \$ 540 | \$ 655 | \$ 129 | \$ (6) | \$ (18) | \$ 3,553 | \$ 102 | \$ 230 | \$ 3,885 |
| Other operating income | <u>171</u> | <u>263</u> | <u>255</u> | <u>600</u> | <u>85</u> | <u>(406)</u> | <u>18</u> | <u>986</u> | <u>1,031</u> | <u>204</u> | <u>2,221</u> |
| Total operating income (loss) | 836 | 1,851 | 795 | 1,255 | 214 | (412) | - | 4,539 | 1,133 | 434 | 6,106 |
| Loan impairment charges(3) | <u>550</u> | <u>1,468</u> | <u>222</u> | <u>589</u> | <u>90</u> | = | = | <u>2,919</u> | <u>502</u> | <u>(174)</u> | <u>3,247</u> |
| | 286 | 383 | 573 | 666 | 124 | (412) | - | 1,620 | 631 | 608 | 2,859 |
| Operating expenses(2) | <u>936</u> | <u>69</u> | <u>471</u> | <u>615</u> | <u>180</u> | <u>65</u> | = | <u>2,336</u> | <u>36</u> | <u>608</u> | <u>2,980</u> |
| Profit (loss) before tax | \$ (650) | \$ 314 | \$ 102 | \$ 51 | \$ (56) | \$ (477) | \$ - | \$ (716) | \$ 595 | \$ - | \$ (121) |
| Nine months ended September 30, 2008 | | | | | | | | | | | |
| Net interest income(1) | \$ 685 | \$ 926 | \$ 575 | \$ 650 | \$ 144 | \$ (3) | (204) | \$ 2,773 | \$ (66) | \$ 513 | \$ 3,220 |
| Other operating income | <u>405</u> | <u>242</u> | <u>236</u> | <u>(862)</u> | <u>126</u> | <u>261</u> | <u>204</u> | <u>612</u> | <u>(103)</u> | <u>(175)</u> | <u>334</u> |
| Total operating income (loss) | 1,090 | 1,168 | 811 | (212) | 270 | 258 | - | 3,385 | (169) | 338 | 3,554 |
| Loan impairment charges(3) | <u>349</u> | <u>1,188</u> | <u>178</u> | <u>87</u> | <u>5</u> | = | = | <u>1,807</u> | <u>5</u> | <u>(50)</u> | <u>1,762</u> |
| | 741 | (20) | 633 | (299) | 265 | 258 | - | 1,578 | (174) | 388 | 1,792 |
| Operating expenses(2) | <u>1,020</u> | <u>33</u> | <u>446</u> | <u>607</u> | <u>206</u> | = | = | <u>2,312</u> | <u>14</u> | <u>388</u> | <u>2,714</u> |
| Profit (loss) before tax | \$ (279) | \$ (53) | \$ 187 | \$ (906) | \$ 59 | \$ 258 | \$ - | \$ (734) | \$ (188) | \$ - | \$ (922) |

- (1) Net interest income of each segment represents the difference between actual interest earned on assets and interest paid on liabilities of the segment adjusted for a funding charge or credit. Segments are charged a cost to fund assets (e.g. customer loans) and receive a funding credit for funds provided (e.g. customer deposits) based on equivalent market rates.
- (2) Expenses for the segments include fully apportioned corporate overhead expenses.
- (3) The provision assigned to the segments is based on the segments' net charge offs and the change in allowance for credit losses.
- (4) IFRS Adjustments consist of the accounting differences between U.S. GAAP and IFRSs which have been described more fully below.
- (5) Represents differences in balance sheet and income statement presentation between IFRSs and U.S. GAAP.

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

Net interest income

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

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

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

Other operating income (Total other revenues)

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

U.S. GAAP to be different than under IFRSs.

Unquoted equity securities – Under IFRSs, equity securities which are not quoted on a recognized exchange (MasterCard Class B shares and Visa Class B shares), but for which fair value can be reliably measured, are required to be measured at fair value. Securities measured at fair value under IFRSs are classified as either available-for-sale securities, with changes in fair value recognized in shareholders' equity, or as trading securities, with changes in fair value recognized in income. Under U.S. GAAP, equity securities that are not quoted on a recognized exchange are not considered to have a readily determinable fair value and are required to be measured at cost, less any provisions for known impairment, and classified in other assets.

Loans held for sale – IFRSs requires loans designated as held for sale at the time of origination to be treated as trading assets and recorded at their fair market value. Under U.S. GAAP, loans designated as held for sale are reflected as loans and recorded at the lower of amortized cost or fair value. Under IFRSs, the income and expenses related to receivables held for sale are reported in net interest income on trading. Under U.S. GAAP, the income and expenses related to receivables held for sale are reported similarly to loans held for investment.

For loans transferred to held for sale subsequent to origination, IFRSs requires these receivables to be reported separately on the balance sheet but does not change the measurement criteria. Accordingly, for IFRSs purposes such loans continue to be accounted for in accordance with IAS 39, "Financial Instruments: Recognition and Measurement" ("IAS 39"), with any gain or loss recorded at the time of sale.

U.S. GAAP requires loans that management intends to sell to be transferred to a held for sale category at the lower of cost or fair value. Under U.S. GAAP, the component of the lower of cost or fair value adjustment related to credit risk is recorded in the consolidated statement of income (loss) as provision for credit losses while the component related to interest rates and liquidity factors is reported in the consolidated statement of income (loss) in other revenues.

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

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

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

Securities – Effective January 1, 2009 under U.S. GAAP, the credit loss component of an other-than-temporary impairment of a debt security is recognized in earnings while the remaining portion of the impairment loss is recognized in accumulated other comprehensive income provided we have concluded we do not intend to sell the security and it is more-likely-than-not that we will have to sell the security prior to recovery. Under IFRSs, there is no bifurcation of other-than temporary impairment and the entire portion is recognized in earnings. There are also less significant differences in measuring other-than-temporary impairment under IFRSs versus U.S. GAAP.

Under IFRSs, securities include HSBC shares held for stock plans at fair value. These shares held for stock plans are recorded at fair value through other comprehensive income. If it is determined these shares have become impaired, the fair value loss is recognized in profit and loss and any fair value loss recorded in other comprehensive income is reversed. There is no similar requirement under U.S. GAAP. During the second quarter of 2009 under IFRSs, we recorded income for the value of additional shares attributed to HSBC shares held for stock plans as a result of HSBC's rights offering earlier in 2009. The additional shares are not recorded under U.S. GAAP.

Loan impairment charges (Provision for credit losses)

IFRSs requires a discounted cash flow methodology for estimating impairment on pools of homogeneous customer loans which requires the incorporation of the time value of money relating to recovery estimates. Also under IFRSs, future recoveries on charged-off loans are accrued for on a discounted basis and a recovery asset is recorded. Subsequent recoveries are recorded to earnings under U.S. GAAP, but are adjusted against the recovery asset under IFRSs. Interest is recorded based on collectability under IFRSs.

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

Operating expenses

Pension costs – Costs under U.S. GAAP are higher than under IFRSs as a result of the amortization of the amount by which actuarial losses exceed gains beyond the 10 percent “corridor.”

Property – Under IFRSs, the value of property held for own use reflects revaluation surpluses recorded prior to January 1, 2004. Consequently, the values of tangible fixed assets and shareholders' equity are lower under U.S. GAAP than under IFRSs. There is a correspondingly lower depreciation charge and higher net income as well as higher gains (or smaller losses) on the disposal of fixed assets under U.S. GAAP. For investment properties, net income under U.S. GAAP does not reflect the unrealized gain or loss recorded under IFRSs for the period.

Assets

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

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

16. Regulatory Capital

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

| | <u>September 30, 2009</u> | | | <u>December 31, 2008</u> | | |
|---------------------------|---------------------------|-------------------------|---------------|--------------------------|-------------------------|---------------|
| | <u>Capita</u> | <u>Well-Capitalized</u> | <u>Actual</u> | <u>Capita</u> | <u>Well-Capitalized</u> | <u>Actual</u> |
| | <u>Amount</u> | <u>Minimum</u> | <u>Ratio</u> | <u>Amount</u> | <u>Minimum</u> | <u>Ratio</u> |
| | | <u>Ratio(1)</u> | | | <u>Ratio(1)</u> | |
| (dollars are in millions) | | | | | | |
| Total capital ratio: | | | | | | |
| | \$ | | | \$ | | |
| HSBC USA Inc. | 19,216 | 10.00% | 13.68% | 17,691 | 10.00% | 12.04% |
| HSBC Bank USA | 19,623 | 10.00 | 14.21 | 17,395 | 10.00 | 12.04 |
| Tier 1 capital ratio: | | | | | | |
| HSBC USA Inc. | 12,988 | 6.00 | 9.25 | 11,156 | 6.00 | 7.60 |
| HSBC Bank USA | 13,366 | 6.00 | 9.68 | 10,822 | 6.00 | 7.49 |
| Tier 1 leverage ratio: | | | | | | |
| HSBC USA Inc. | 12,988 | 3.00(2) | 7.65 | 11,156 | 3.00(2) | 5.96 |
| HSBC Bank USA | 13,366 | 5.00 | 8.08 | 10,822 | 5.00 | 5.90 |
| Risk weighted assets: | | | | | | |
| HSBC USA Inc. | 140,437 | | | 146,878 | | |
| HSBC Bank USA | 138,091 | | | 144,507 | | |

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

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

In the first nine months of 2009, we received capital contributions from HSBC North America Inc. (“HNAI”) in an aggregate amount of \$2.2 billion (\$1.1 billion received in each of the first two quarters) in exchange for 3 shares of common stock. During the first nine months of 2009, we contributed \$2.7 billion to our subsidiary, HSBC Bank USA, in part to provide capital support for receivables purchased from our affiliate, HSBC Finance Corporation. See Note 5, “Loans,” for additional information.

As part of the regulatory approvals with respect to the aforementioned receivable purchases completed in January 2009, HSBC Bank USA and its ultimate parent HSBC committed that HSBC Bank USA will maintain a Tier 1 risk-based capital ratio of at least 7.62 percent, a total capital ratio of at least 11.55 percent and a Tier 1 leverage ratio of at least 6.45 percent for one year following the date of transfer. In addition, HSBC Bank USA and HSBC made certain additional capital commitments to ensure that HSBC Bank USA holds sufficient capital with respect to the purchased receivables that are or may become “low-quality assets,” as defined by the Federal Reserve Act. In May 2009, we received further clarification from the Federal Reserve regarding HSBC Bank USA’s regulatory reporting requirements with respect to these capital commitments in that the additional capital requirements, (which require a risk-based capital charge of 100 percent for each “low-quality asset” transferred or arising in the purchased portfolios rather than the eight percent capital charge applied to similar assets that are not part of the transferred portfolios),

should be applied both for purposes of satisfying the terms of the commitments and for purposes of measuring and reporting HSBC Bank USA's risk-based capital and related ratios. This treatment applies as long as the low-quality assets are owned by an insured bank. During the third quarter of 2009, HSBC Bank USA sold low-quality auto finance loans with a net book value of approximately \$165 million to a non-bank subsidiary of HSBC USA Inc. to reduce this capital requirement. Capital ratios and amounts at June 30, 2009 in the table above reflect this revised regulatory reporting. At September 30, 2009, we have exceeded our committed ratios and would have done so without the benefit associated with these low-quality asset sales.

In February 2009, the U.S. Treasury Department announced that U.S. regulators would conduct a stress test of all U.S. bank holding companies with assets in excess of \$100 billion. These tests have resulted in additional regulatory capital requirements for the companies that were subjected to the test. As a result of foreign ownership, we were not included in the group of bank holding companies subject to the regulatory stress test.

Regulatory guidelines impose certain restrictions that may limit the inclusion of deferred tax assets in the computation of regulatory capital. Continued losses, including losses associated with FVO elections, coupled with bad debt provisions that exceed charge-offs are creating additional deferred tax assets, which could, from time to time, result in such exclusion. We closely monitor the deferred tax assets for potential limitations or exclusions. At September 30, 2009, deferred tax assets of \$241 million were excluded in the computation of regulatory capital.

17. Special Purpose Entities

In the ordinary course of business, we have historically organized special purpose entities ("SPEs") primarily to structure financial products to meet our clients' investment needs and to securitize financial assets held to meet our own funding needs. For disclosure purposes, we aggregate SPEs based on the purpose of organizing the entities, the risk characteristics and the business activities of the SPEs. Special purpose entities can be a variable interest entity ("VIE"), a qualifying special purpose entity ("QSPE") or neither. A VIE is an entity that lacks sufficient equity at risk or whose equity investors do not have a controlling interest. A QSPE is an unconsolidated off-balance sheet entity whose activities are restricted and limited to holding and servicing financial assets and it meets certain other criteria in accordance with accounting principles related to transfers of financial assets.

Variable Interest Entities We consolidate VIEs in which we hold variable interests that absorb a majority of the risks and/or receive a majority of the benefits and therefore are deemed to be the primary beneficiary. We take into account all of our involvements in a VIE in identifying variable interests (explicit or implicit) that individually or in the aggregate could be significant enough to warrant our designation as the primary beneficiary and hence require us to consolidate the VIE or otherwise require us to make appropriate disclosures. We consider our involvement to be significant where we, among other things, (i) provide liquidity put options or other liquidity facilities to support the VIE's debt issuances, (ii) enter into derivative contracts to absorb the risks and benefits from the VIE or from the assets held by the VIE, (iii) provide a financial guarantee that covers assets held or liabilities issued and (iv) help structure the transaction and retain a financial or servicing interest in the VIE.

In most cases, a qualitative analysis of our involvement in the entity provides sufficient evidence to determine whether we are the primary beneficiary. In rare cases, a more detailed analysis to quantify the extent of variability to be absorbed by each variable interest holder is required to determine the primary beneficiary. The quantitative analysis provides probability-weighted estimates of a range of potential outcomes and management judgment is required in determining the primary beneficiary.

Consolidated VIEs The following table summarizes the assets and liabilities of our consolidated VIEs as of September 30, 2009 and December 31, 2008:

| | <u>September 30, 2009</u> | | <u>December 31, 2008</u> | |
|----------------|----------------------------|---------------------------------|----------------------------|---------------------------------|
| | <u>Consolidated Assets</u> | <u>Consolidated Liabilities</u> | <u>Consolidated Assets</u> | <u>Consolidated Liabilities</u> |
| | (in millions) | | | |
| Securitization | \$ | \$ | \$ | \$ |
| vehicles | 4,000 | 3,003 | 1,588 | 1,200 |
| Structured | | | | |
| note | | | | |
| vehicles | 80 | 25 | 147 | 124 |
| Low | | | | |
| income | | | | |
| housing | | | | |
| limited | | | | |
| liability | | | | |
| partnership | 691 | 684 | = | = |
| | \$ | \$ | \$ | \$ |
| Total | <u>4,771</u> | <u>3,712</u> | <u>1,735</u> | <u>1,324</u> |

Securitization Vehicles We utilize entities that are structured as trusts to securitize certain private label and other credit card receivables where securitization provides an attractive source of low cost funding. We transfer certain credit card receivables to these trusts which in turn issue debt instruments collateralized by the transferred receivables. These trusts are considered VIEs and are consolidated as we are the primary beneficiary at September 30, 2009 and December 31, 2008.

At September 30, 2009 and December 31, 2008, the consolidated assets of these trusts were \$4.0 billion and \$1.6 billion, respectively and were reported in loans and securities available-for-sale. Debt securities issued by these VIEs are reported as secured financings in long-term debt. The increase in the consolidated assets of these trusts since December 31, 2008 largely reflect securitization vehicles associated with the credit card receivables purchased from HSBC Finance in January 2009.

Structured Note Vehicles In the normal course of business, we enter into derivative transactions with special purpose entities organized by HSBC affiliates and by third parties for the purpose of issuing structured debt instruments to facilitate clients' investment demand. These entities, which are deemed to be VIEs, are organized as trusts and issue fixed or floating rate debt instruments backed by the financial assets they hold. They were established to create investments with specific risk profiles for investors.

At September 30, 2009 and December 31, 2008, we held all or substantially all of the debt securities issued by several VIE trusts that were organized by an affiliate and by third parties to issue structured notes. The consolidated assets of these VIEs were \$80 million and \$147 million at September 30, 2009 and December 31, 2008, respectively, and are reported in trading assets. Debt instruments issued by these VIEs and held by us were eliminated in consolidation. Debt instruments issued by these VIEs and held by third parties were not material.

The assets of consolidated VIEs serve as collateral for the obligations of the VIEs. The holders of debt instruments issued by consolidated VIEs have no recourse to our general credit. There are no communications or contractual arrangements that constitute an obligation by us to provide financial support to the VIEs or the holders of debt securities issued by the VIEs.

Low Income Housing Limited Liability Partnership During the third quarter of 2009, certain low income housing investments held by us were transferred to a Limited Liability Partnership (“LLP”) in exchange for debt and equity while a non-affiliated third party invested cash for an equity interest that is mandatory redeemable at a future date. The LLP was created in order to ensure the utilization of future tax benefits from these low income housing tax projects. The LLP was deemed to be a VIE as it does not have sufficient equity investment at risk to finance its activities. We have concluded that we are the primary beneficiary of the LLP as a result of the nature of our continuing involvement and, as a result, consolidate the LLP and report the equity interest issued to the third party investor as a liability in our consolidated financial statements.

Unconsolidated VIEs We also had significant involvement with other VIEs that were not consolidated at September 30, 2009 or December 31, 2008 because we were not the primary beneficiary. The following table provides additional information on those unconsolidated VIEs, the variable interests held by us and our maximum exposure to loss arising from our involvements in those VIEs as of September 30, 2009 and December 31, 2008:

| | <u>September 30, 2009</u> | | | <u>December 31, 2008</u> | | |
|--------------|---|--|--|---------------------------------|--|---------------------------------|
| | <u>Variable Interests Held Classified as Assets</u> | <u>Variable Interests Held Classified as Liabilities</u> | <u>Total Assets in Unconsolidated VIEs</u> | <u>Maximum Exposure to Loss</u> | <u>Total Assets in Unconsolidated VIEs</u> | <u>Maximum Exposure to Loss</u> |
| | | | (in millions) | | | |
| Asset-backed | | | | | | |
| commercial | | | | | | |
| paper | | | | | | |
| conduits | \$ 129 | \$ - | \$ 11,447 | \$ 5,688 | \$ 28,112 | \$ 7,782 |
| Structured | | | | | | |
| investment | | | | | | |
| vehicles | | | | | | |
| Structured | 15 | - | 5,309 | 28 | 4,768 | 34 |
| note | | | | | | |
| vehicles | 133 | 354 | 7,679 | 670 | 8,221 | 1,842 |

| | | | | | | |
|--------------|------------|------------|---------------|--------------|---------------|--------------|
| Low | | | | | | |
| income | | | | | | |
| housing | | | | | | |
| partnerships | <u>13</u> | = | <u>175</u> | <u>30</u> | <u>211</u> | <u>40</u> |
| | \$ | \$ | \$ | \$ | \$ | \$ |
| Total | <u>290</u> | <u>354</u> | <u>24,610</u> | <u>6,416</u> | <u>41,312</u> | <u>9,698</u> |

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

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

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

Each seller of assets to an ABCP conduit typically provides collateral in the form of excess assets and therefore bears the risk of first loss related to the specific assets transferred. We do not transfer our own assets to the conduits. We have no ownership interests in, perform no administrative duties for, and do not service any of the assets held by the conduits. We are not the primary beneficiary and do not consolidate any of the ABCP conduits to which we provide liquidity facilities. Credit risk related to the liquidity facilities provided is managed by subjecting them to our normal underwriting and risk management processes. The \$5,688 billion maximum exposure to loss presented in the table above represents the maximum amount of loans and asset purchases we could be required to fund under the liquidity facilities. The maximum loss exposure is estimated assuming the facilities are fully drawn and the underlying collateralized assets are in default with zero recovery value.

Structured Investment Vehicles We provide a liquidity facility to a single structured investment vehicle (“SIV”) sponsored by a third party. This entity, which is deemed to be a VIE, seeks to earn a profit by investing in mostly highly rated longer-dated fixed income instruments and funding those investments by issuing cheaper short-term,

highly rated commercial paper and medium term notes. We do not transfer our own assets to the SIV. We have no ownership interests in, perform no administrative duties for, and do not service any of the assets the SIV holds. We are not the primary beneficiary of the SIV and therefore do not consolidate the SIV. Credit risk related to the liquidity facility provided is managed through our normal underwriting and risk management processes. The maximum exposure to loss presented in the preceding table represents a \$28 million liquidity facility which was fully funded, and is recorded as a loan, as of September 30, 2009. This loan was considered in the determination of our allowance for loan losses and a \$13 million specific reserve was established against this facility during the third quarter of 2009 in accordance with our credit policies.

Structured Note Vehicles Our involvement in structured note vehicles include entering into derivative transactions such as interest rate and currency swaps, and investing in their debt instruments. With respect to several of these VIEs, we hold variable interests in the form of total return swaps entered into in connection with the transfer of certain assets to the VIEs. In these transactions, we transferred financial assets from our trading portfolio to the VIEs and entered into total return swaps under which we receive the total return on the transferred assets and pay a market rate of return. The transfers of assets in these transactions do not qualify as sales under the applicable accounting literature and are accounted for as secured borrowings. Accordingly, the transferred assets continue to be recognized as trading assets on our balance sheet and the funds received are recorded as liabilities in long-term debt. As of September 30, 2009, we recorded approximately \$209 million of trading assets and \$266 million of long-term liabilities on our balance sheet as a result of “failed sale” accounting treatment for certain transfers of financial assets. As of December 31, 2008, we recorded approximately \$539 million of trading assets and \$829 million of long-term liabilities on our balance sheet as a result of “failed sale” accounting treatment. The financial assets and financial liabilities were not legally ours and we have no control over the financial assets which are restricted solely to satisfy the liability.

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

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

Low Income Housing Partnerships Separately from the formation of the LLC discussed above, we invest as a limited partner in a number of low-income housing partnerships that operate qualified affordable housing projects and generate tax benefits, including federal low-income housing tax credits, for investors. Some of the partnerships are deemed to be VIEs because they do not have sufficient equity investment at risk or are structured with non-substantive voting rights. We are not the primary beneficiary of these VIEs and do not consolidate them.

These investments in low-income housing partnerships are recorded using the equity method of accounting and are included in other assets on the consolidated balance sheet. The maximum exposure to loss shown in the table represents the recorded investment net of estimated expected reductions in future tax liabilities and potential recapture of tax credits allowed in prior years.

Unconsolidated QSPEs

We historically organized special purpose entities to securitize residential mortgage loans. In these cases, we purchase and transfer residential mortgage loans into a trust which is designed and structured as a QSPE. The QSPE issues debt securities to investors to finance the purchase of the residential mortgage loans. The securitizations are non-recourse

in that the risk of future loss in the transferred residential mortgages has been transferred to the investors and the investors' recourse is limited to the transferred assets. The transfers are accounted for as sales in accordance with accounting principles related to transfers of financial assets.

Neither the transferor nor its consolidated affiliates have any continuing involvement with the transferred assets. We do not provide any liquidity arrangement or financial support (through written or unwritten communications) to, enter into any derivative transactions with, or have any obligation to repurchase financial assets from the QSPE or the investors. Neither the transferor nor its consolidated affiliates retains any residual interests in the transferred financial assets. On limited occasions, we transfer residential mortgage loans we originated to the QSPE and retain the right to service the transferred assets. In those cases, the transferred residential mortgages for which we retain the servicing rights represent an insignificant portion of the entire transferred asset portfolio.

18. Guarantee Arrangements and Pledged Assets

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

The following table presents total carrying value and contractual amounts of our major off-balance sheet guarantee arrangements as of September 30, 2009 and December 31, 2008. Following the table is a description of the various arrangements.

| | <u>September 30 2009</u> | | <u>December 31, 2008</u> | |
|-------------------|--------------------------|--|--------------------------|--|
| | <u>Carrying Value</u> | <u>Notional/Maximum Exposure to Loss</u> | <u>Carrying Value</u> | <u>Notional/Maximum Exposure to Loss</u> |
| | (in millions) | | | |
| Credit | \$ | \$ | \$ | \$ |
| derivatives(4) | (10,534) | 406,228(1) | (59,640) | 493,583(1) |
| Financial | | | | |
| standby | | | | |
| letters | | | | |
| of | | | | |
| credit, | | | | |
| net | | | | |
| of | | | | |
| participations(3) | - | 4,296(2) | - | 4,444(2) |
| Performance | - | 3,231(2) | - | 3,800(2) |

(non-financial)

guarantees

Liquidity

asset

purchase

agreements(3)

| | | | | |
|-------|------------------------|-----------------------|------------------------|-----------------------|
| | = | <u>5,688</u> | = | <u>7,782</u> |
| | <u>\$</u> | | <u>\$</u> | |
| | | <u>\$</u> | | <u>\$</u> |
| Total | <u>(10,534)</u> | | <u>(59,640)</u> | <u>509,609</u> |
| |) | <u>419,443</u> |) | |

- (1) Includes \$58.7 billion and \$103.4 billion issued for the benefit of HSBC affiliates at September 30, 2009 and December 31, 2008, respectively.
- (2) Includes \$722 million and \$732 million issued for the benefit of HSBC affiliates at September 30, 2009 and December 31, 2008, respectively.
- (3) For standby letters of credit and liquidity asset purchase agreements, maximum loss represents losses to be recognized assuming the letter of credit and liquidity facilities have been fully drawn and the obligors have defaulted with zero recovery.
- (4) For credit derivatives, the maximum loss is represented by the notional amounts without consideration of mitigating effects from collateral or recourse arrangements.

Credit-Risk Related Guarantees:

Credit Derivatives Credit derivatives are financial instruments that transfer the credit risk of a reference obligation from the credit protection buyer to the credit protection seller who is exposed to the credit risk without buying the reference obligation. We sell credit protection on underlying reference obligations (such as loans or securities) by entering into credit derivatives, primarily in the form of credit default swaps, with various institutions. We account for all credit derivatives at fair value. Where we sell credit protection to a counterparty that holds the reference obligation, the arrangement is effectively a financial guarantee on the reference obligation. Although we do not specifically identify whether the derivative counterparty retains the reference obligation, we have disclosed information about all credit derivatives that could meet the accounting definition of a financial guarantee. Under a credit derivative contract, the credit protection seller will reimburse the credit protection buyer upon occurrence of a credit event (such as bankruptcy, insolvency, restructuring or failure to meet payment obligations when due) as defined in the derivative contract, in return for a periodic premium. Upon occurrence of a credit event, we will pay the counterparty the stated notional amount of the derivative contract and receive the underlying reference obligation. The recovery value of the reference obligation received could be significantly lower than its notional principal amount when a credit event occurs.

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

We manage our exposure to credit derivatives using a variety of risk mitigation strategies where we enter into offsetting hedge positions or transfer the economic risks, in part or in entirety, to investors through the issuance of structured credit products. We actively manage the credit and market risk exposure in the credit derivative portfolios on a net basis and, as such, retain no or a limited net sell protection position at any time. The following table summarizes our net credit derivative positions as of September 30, 2009 and December 31, 2008:

| | <u>September 30, 2009</u> | | <u>December 31, 2008</u> | |
|-----------------|---------------------------|-----------------|--------------------------|-----------------|
| | Carrying (Fair) | | Carrying (Fair) | |
| | <u>Value</u> | <u>Notional</u> | <u>Value</u> | <u>Notional</u> |
| | (in millions) | | | |
| Sell-protection | | | | |
| credit | | | | |
| derivative | | | | |
| positions | \$ | \$ | \$ | \$ |
| | (10,534) | 406,228 | (59,640) | 493,583 |
| Buy-protection | | | | |
| credit | | | | |
| derivative | | | | |
| positions | | | | |
| | <u>11,239</u> | <u>499,394</u> | <u>59,737</u> | <u>474,677</u> |
| Net | | \$ | | \$ |
| position | \$ | (93,166) | \$ | \$ |
| | <u>705</u> |) | <u>97</u> | <u>18,906</u> |

Standby Letters of Credit A standby letter of credit is issued to a third party for the benefit of a customer and is a guarantee that the customer will perform or satisfy certain obligations under a contract. It irrevocably obligates us to pay a specified amount to the third party beneficiary if the customer fails to perform the contractual obligation. We issue two types of standby letters of credit: performance and financial. A performance standby letter of credit is issued where the customer is required to perform some nonfinancial contractual obligation, such as the performance of a specific act, whereas a financial standby letter of credit is issued where the customer's contractual obligation is of a financial nature, such as the repayment of a loan or debt instrument. As of September 30, 2009, the total amount of outstanding financial standby letters of credit (net of participations) and performance guarantees were \$4.3 billion and \$3.2 billion, respectively. As of December 31, 2008, the total amount of outstanding financial standby letters of credit

(net of participations) and performance guarantees were \$4.4 billion and \$3.8 billion, respectively.

The issuance of a standby letter of credit is subject to our credit approval process and collateral requirements. We charge fees for issuing letters of credit commensurate with the customer's credit evaluation and the nature of any collateral. Included in other liabilities are deferred fees on standby letters of credit, which represent the fair value of the stand-ready obligation to perform under these guarantees, amounting to \$43 million and \$33 million at September 30, 2009 and December 31, 2008, respectively. Also included in other liabilities is an allowance for credit losses on unfunded standby letters of credit of \$29 million and \$30 million at September 30, 2009 and December 31, 2008, respectively.

Below is a summary of the credit ratings of credit risk related guarantees including the credit ratings of counterparties against which we sold credit protection and financial standby letters of credit as of September 30, 2009 as an indicative proxy of payment risk:

| <u>Notional/Contractual Amounts</u> | <u>Average Credit Ratings of the Obligors or the Transactions</u> | | | <u>Total</u> |
|-------------------------------------|---|-------------------------|-----------------------------|--------------|
| | <u>Life (in years)</u> | <u>Investment Grade</u> | <u>Non-Investment Grade</u> | |
| | | <u>(in millions)</u> | | |
| Sell-protection | | | | |
| Credit | | | | |
| Derivatives(1) | | | | |
| Single | | | | |
| name | | | | |
| | | | \$ | \$ |
| CDS | | | | |
| | 3.5 | 159,728 | 71,123 | 230,851 |
| Structured | | | | |
| CDS | | | | |
| | 3.4 | 49,674 | 2,818 | 52,492 |
| Index | | | | |
| credit | | | | |
| derivatives | | | | |
| | 3.8 | 104,528 | 4,895 | 109,423 |
| Total | | | | |
| return | | | | |
| swaps | | | | |
| | 7 | 12,262 | 1,200 | 13,462 |
| Subtotal | | | | |
| | | 326,192 | 80,036 | 406,228 |
| Financial | 1.1 | 6,779 | 748 | 7,527 |

Standby

Letters

of

Credit(2)

| | | | |
|-------|----------------|---------------|----------------|
| | \$ | \$ | \$ |
| Total | <u>332,971</u> | <u>80,784</u> | <u>413,755</u> |

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

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

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

Liquidity Asset Purchase Agreements We provide liquidity facilities to a number of multi-seller and single-seller asset-backed commercial paper conduits sponsored by affiliates and third parties. The conduits finance the purchase of individual assets by issuing commercial paper to third party investors. Each liquidity facility is transaction specific and has a maximum limit. Pursuant to the liquidity agreements, we are obligated, subject to certain limitations, to purchase the eligible assets from the conduit at an amount not to exceed the face value of the commercial paper in the event the conduit is unable to refinance its commercial paper. A liquidity asset purchase agreement is essentially a conditional written put option issued to the conduit where the exercise price is the face value of the commercial paper. As of September 30, 2009 and December 31, 2008, we have issued \$5.7 billion and \$7.8 billion, respectively, of liquidity facilities to provide liquidity support to the commercial paper issued by various conduits.

Principal Protected Products We structure and sell products that guarantee the return of principal to investors on a future date. These structured products have various reference assets and we are obligated to cover any shortfall between the market value of the underlying reference portfolio and the principal amount at maturity. We manage such shortfall risk by, among other things, establishing structural and investment constraints. Additionally, the structures

require liquidation of the underlying reference portfolio when certain pre-determined triggers are breached and the proceeds from liquidation are required to be invested in zero-coupon bonds that would generate sufficient funds to repay the principal amount upon maturity. We may be exposed to market (gap) risk at liquidation and, as such, may be required to make up the shortfall between the liquidation proceeds and the purchase price of the zero coupon bonds. These principal protected products are accounted for on a fair value basis. The notional amounts of these principal protected products were not material as of September 30, 2009 and December 31, 2008, respectively. We have not made any payment under the terms of these structured products and we consider the probability of payments under these guarantees to be remote.

Sale of Mortgage Loans We originate and sell mortgage loans to government sponsored entities and provide various representations and warranties related to, among other things, the ownership of the loans, the validity of the liens, the loan selection and origination process, and the compliance to the origination criteria established by the agencies. In the event of a breach of our representations and warranties, we may be obligated to repurchase the loans with identified defects or to indemnify the buyers. Our contractual obligation arises only when the representations and warranties are breached. Our liability for obligations arising from the breach of representations and warranties was \$45 million and \$13 million as of September 30, 2009 or December 31, 2008, respectively.

Visa Covered Litigations We are an equity member of Visa Inc. (“Visa”). Prior to its initial public offering (“IPO”) on March 19, 2008, Visa completed a series of transactions to reorganize and restructure its operations and to convert membership interests into equity interests. Pursuant to the restructuring, we, along with all the Class B shareholders, agreed to indemnify Visa for the claims and obligations arising from certain specific covered litigations. Class B shares are convertible into listed Class A shares upon (i) settlement of the covered litigations or (ii) the third anniversary of the IPO, whichever is earlier. The indemnification is subject to the accounting and disclosure requirements. Visa used a portion of the IPO proceeds to establish a \$3.0 billion escrow account to fund future claims arising from those covered litigations (the escrow was subsequently increased to \$4.1 billion). In July 2009, Visa exercised its rights to sell shares of existing Class B shareholders in order to increase the escrow account and announced that it had deposited an additional \$700 million into the escrow account. As a result, we re-evaluated the contingent liability we have recorded relating to this litigation and reduced our liability by \$8.6 million during the third quarter of 2009.

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

Pledged Assets

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

| | September 30, December 31, | |
|--------------------------------------|-----------------------------------|--------------------|
| | <u>2009</u> | <u>2008</u> |
| | (in millions) | |
| Interest bearing deposits with banks | \$ 1,467 | \$ 3,338 |
| Trading assets(1) | 2 | 1,085 |
| Securities available- for-sale(2) | 12,412 | 9,919 |
| Securities held to maturity | 483 | 623 |

| | | |
|-----------------|---------------------|--------------|
| Loans(3) | 4,485 | 3,926 |
| Other assets(4) | <u>2,291</u> | <u>6,872</u> |
| | | \$ |
| Total | \$ 21,140 | 25,763 |

- (1) Trading assets are primarily pledged against liabilities associated with consolidated variable interest entities at December 31, 2008 and pledged against short-term borrowings at September 30, 2009.
- (2) Securities available-for-sale are primarily pledged against various short-term borrowings and public fund deposits.
- (3) Loans are primarily private label and other credit card receivables pledged against long-term secured borrowings and residential mortgage loans pledged against long-term borrowings from the Federal Home Loan Bank.
- (4) Other assets represent cash on deposit with non-banks related to derivative collateral support agreements.

19. Fair Value Measurements

Accounting principles related to fair value measurements provide a framework for measuring fair value and focuses on an exit price in the principal (or alternatively, the most advantageous) market accessible in an orderly transaction between willing market participants (the "Fair Value Framework"). The Fair Value Framework establishes a three-tiered fair value hierarchy with Level 1 representing quoted prices (unadjusted) in active markets for identical assets or liabilities. Fair values determined by Level 2 inputs are inputs that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are disorderly, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. Level 3 inputs are unobservable inputs for the asset or liability and include situations where there is little, if any, market activity for the asset or liability.

Assets and Liabilities Recorded at Fair Value on a Recurring Basis The following table presents information about our assets and liabilities measured at fair value on a recurring basis as of September 30, 2009 and December 31, 2008, and indicates the fair value hierarchy of the valuation techniques utilized to determine such fair value.

Fair Value Measurements on a Recurring Basis as of September 30,
2009

| | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Gross</u> <u>Balance</u> | <u>Netting(1)</u> | <u>Net</u> <u>Balance</u> |
|--|----------------|----------------|----------------|--------------------------------|-------------------|------------------------------|
|--|----------------|----------------|----------------|--------------------------------|-------------------|------------------------------|

(in millions)

Assets:

Trading Securities:

U.S. Treasury. U.S. Government agencies

and sponsored enterprises

| | | | | | | |
|--|--------|-------|------|--------|------|--------|
| | \$ 285 | \$ 21 | \$ - | \$ 306 | \$ - | \$ 306 |
|--|--------|-------|------|--------|------|--------|

Obligations of U.S. states and political subdivisions

| | | | | | | |
|--|---|---|---|---|---|---|
| | - | - | - | - | - | - |
|--|---|---|---|---|---|---|

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| | | | | | | |
|---|--------|-----------|-------|-----------|----------|----------|
| Residential mortgage-backed securities | - | 153 | 674 | 827 | - | 827 |
| Commercial mortgage-backed securities | - | - | - | - | - | - |
| Collateralized debt obligations | - | - | 817 | 817 | - | 817 |
| Other asset-backed securities | - | 8 | 32 | 40 | - | 40 |
| Other domestic debt securities | - | 129 | 1,218 | 1,347 | - | 1,347 |
| Debt Securities issued by foreign entities | - | 653 | 203 | 856 | - | 856 |
| Equity securities | - | 408 | 26 | 434 | - | 434 |
| Precious metals trading | - | 8,587 | - | 8,587 | - | 8,587 |
| Derivatives(2) | 275 | 73,270 | 3,464 | 77,009 | (64,502) | 12,507 |
| Securities available-for-sale: | | | | | | |
| U.S. Treasury, U.S. Government agencies and sponsored enterprises | 10,960 | 11,236 | 3 | 22,199 | - | 22,199 |
| Obligations of U.S. states and political subdivisions | - | 752 | - | 752 | - | 752 |
| Residential mortgage-backed securities | - | 389 | 521 | 910 | - | 910 |
| Commercial mortgage-backed securities | - | 951 | 7 | 958 | - | 958 |
| Collateralized debt obligations | - | - | - | - | - | - |
| Other asset-backed securities | - | 293 | 226 | 519 | - | 519 |
| Other domestic debt securities | - | 864 | - | 864 | - | 864 |
| Debt Securities issued by foreign entities | - | 2,500 | - | 2,500 | - | 2,500 |
| Equity securities | - | 861 | - | 861 | - | 861 |
| Loans(3) | - | 1,009 | 129 | 1,138 | - | 1,138 |
| Intangible(4) | = | = | 394 | 394 | = | 394 |
| | \$ | \$ | \$ | \$ | \$ | \$ |
| Total assets | 11,520 | 102,084 | 7,714 | 121,318 | (64,502) | 56,816 |
| Liabilities: | | | | | | |
| | | | \$ | | | |
| Deposits in domestic offices(5) | \$ - | \$ 2,673 | 1,211 | \$ 3,884 | \$ - | \$ 3,884 |
| Trading liabilities, excluding derivatives | 411 | 2,320 | - | 2,731 | - | 2,731 |
| Derivatives(2) | 274 | 74,708 | 1,747 | 76,729 | (68,645) | 8,084 |
| Long-term debt(6) | = | 4,248 | 367 | 4,615 | = | 4,615 |
| | | | \$ | | \$ | \$ |
| Total liabilities | \$ 685 | \$ 83,949 | 3,325 | \$ 87,959 | (68,645) | 19,314 |

Fair Value Measurements on a Recurring Basis as of
December 31, 2008

| | <u>Level 1</u> | <u>Level 2</u> | <u>Level 3</u> | <u>Gross</u> | <u>Netting(1)</u> | <u>Net</u> |
|---------------------------------------|----------------|----------------|----------------|----------------|-------------------|------------|
| | | | | <u>Balance</u> | | |
| | | | | (in millions) | | |
| | | | | <u>Balance</u> | | |
| Assets: | | | | | | |
| Trading assets, excluding derivatives | \$ 74 | \$ 8,051 | \$ 1,893 | \$ 10,018 | \$ - | 10,018 |
| Derivatives(2) | 523 | 145,259 | 7,837 | 153,619 | (130,936) | 22,683 |
| Securities available-for-sale | 4,856 | 19,581 | 471 | 24,908 | - | 24,908 |
| Loans(3) | - | 738 | 136 | 874 | - | 874 |
| Intangible assets(4) | = | = | 333 | 333 | = | 333 |
| | \$ | \$ | \$ | \$ | \$ | \$ |
| Total assets | 5,453 | 173,629 | 10,670 | 189,752 | (130,936) | 58,816 |

Liabilities:

| | | | | | | |
|--|--------|--------------|-----------|--------------|-----------|--------------|
| Deposits in domestic offices(5) | \$ - | \$ 2,059 | \$ 234 | \$ 2,293 | \$ - | \$ 2,293 |
| Trading liabilities, excluding derivatives | 206 | 1,799 | - | 2,005 | - | 2,005 |
| Derivatives(2) | 412 | 148,819 | 2,554 | 151,785 | (136,686) | 15,099 |
| Long-term debt(6) | = | <u>2,570</u> | <u>57</u> | <u>2,627</u> | = | <u>2,627</u> |
| | | \$ | | \$ | \$ | \$ |
| Total liabilities | \$ 618 | 155,247 | \$ 2,845 | 158,710 | (136,686) | 22,024 |

- (1) Represents counterparty and cash collateral netting which allow the offsetting of amounts relating to certain contracts if certain conditions are met.
- (2) Includes trading derivative assets of \$11.6 billion and \$21.3 billion and trading derivative liabilities of \$7.8 billion and \$14.3 billion as of September 30, 2009 and December 31, 2008, respectively, as well as derivatives held for hedging and commitments accounted for as derivatives.
- (3) Includes leveraged acquisition finance and other commercial loans held for sale or risk-managed on a fair value basis for which we have elected to apply the fair value option. See Note 7, "Loans Held for Sale," of the consolidated financial statements for further information.
- (4) Represents residential mortgage servicing rights. See Note 8, "Intangible Assets," of the consolidated financial statements for further information on residential mortgage servicing rights.
- (5) Represents structured deposits risk-managed on a fair value basis for which we have elected to apply the fair value option.
- (6) Includes structured notes and own debt issuances which we have elected to measure on a fair value basis.

The following table summarizes additional information about changes in the fair value of Level 3 assets and liabilities during the three and nine months ended September 30, 2009 and 2008. As a risk management practice, we may risk manage the Level 3 assets and liabilities, in whole or in part, using securities and derivative positions that are classified as Level 1 or Level 2 measurements within the fair value hierarchy. Since those Level 1 and Level 2 risk management positions are not included in the table below, the information provided does not reflect the effect of such risk management activities related to the Level 3 assets and liabilities.

| | <u>Total Gains and (Losses)</u> | | Net Transfers | | |
|---------|---------------------------------|---------------|---------------|-----------|------------|
| | <u>Included in(1)</u> | | | | |
| | Trading | Other | Purchases | Into or | Current |
| July 1, | (Loss) | Other | Issuances | Out | Period |
| 2009 | Revenue | Comprehensive | and | Sept. 30, | Unrealized |
| | | Income | Settlements | 2009 | Gains |
| | | | of Level | | (Losses) |
| | | | 3 | | |

(in millions)

Assets:

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| | | | | | | | | |
|---|-------|----------|------|--------|-------|-------|----------|---------|
| Trading assets, excluding derivatives | | | | | | | | |
| U.S. Treasury, U.S. Government agencies and sponsored enterprises | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - |
| Obligations of U.S. states and political subdivisions | - | - | - | - | - | - | - | - |
| Residential mortgage-backed securities | 577 | 46 | - | - | (44) | 95 | 674 | 32 |
| Commercial mortgage-backed securities | - | - | - | - | - | - | - | - |
| Collateralized debt obligations | 678 | (43) | - | - | 182 | - | 817 | (59) |
| Other asset-backed securities | 32 | 14 | - | - | (14) | - | 32 | 6 |
| Other domestic debt securities | 1,009 | 188 | - | - | 21 | - | 1,218 | 179 |
| Debt Securities issued by foreign entities | 138 | 65 | - | - | - | - | 203 | 65 |
| Equity securities | 26 | - | - | - | - | - | 26 | - |
| Precious metals | - | - | - | - | - | - | - | - |
| Derivatives, net(2) | 3,109 | (1,157) | 9 | - | (271) | 27 | 1,717 | (720) |
| Securities available-for-sale | | | | | | | | |
| U.S. Treasury, U.S. Government agencies and sponsored enterprises | 3 | - | - | - | - | - | 3 | - |
| Obligations of U.S. states and political subdivisions | - | - | - | - | - | - | - | - |
| Residential mortgage-backed securities | 318 | - | - | 56 | (39) | 186 | 521 | 50 |
| Commercial mortgage-backed securities | 5 | - | - | 2 | - | - | 7 | 2 |
| Collateralized debt obligations | - | - | - | - | - | - | - | - |
| Other asset-backed securities | 239 | - | - | 47 | (60) | - | 226 | 42 |
| Other domestic debt securities | - | - | - | - | - | - | - | - |
| Debt Securities issued by foreign entities | - | - | - | - | - | - | - | - |
| Equity securities | - | - | - | - | - | - | - | - |
| Loans(3) | 128 | - | 1 | - | - | - | 129 | 1 |
| Other assets, excluding derivatives(4) | 434 | = | (62) | = | 22 | = | 394 | (54) |
| | \$ | | \$ | | \$ | | \$ | \$ |
| Total assets | 6,696 | \$ (887) | (52) | \$ 105 | (203) | 308 | \$ 5,967 | (456) |
| Liabilities: | | | | | | | | |
| Deposits in domestic offices | (720) | (36) | - | - | (462) | 7 | (1,211) | (35) |
| Long-term debt | (216) | (35) | = | = | (129) | 13 | (367) | (31) |
| | \$ | | | | \$ | | \$ | \$ |
| Total liabilities | (936) | \$ (71) | \$ - | \$ - | (591) | \$ 20 | (1,578) | \$ (66) |

**Total Gains and
(Losses) Included in(1)**

| | July 1, 2008 | Trading (Loss) | Other Revenue | Other Comprehensive Income | Net Purchases, Issuances and of Settlements Level 3 | Into or Out | Sept. 30, 2008 | Current Period Unrealized Gains (Losses) |
|--|-------------------------|---------------------------|--------------------------|---|--|------------------------|---------------------------|---|
|--|-------------------------|---------------------------|--------------------------|---|--|------------------------|---------------------------|---|

| | July 1, 2008 | Trading (Loss) | Other Revenue | Other Comprehensive Income | Net Purchases, Issuances and of Settlements Level 3 | Into or Out | Sept. 30, 2008 | Current Period Unrealized Gains (Losses) |
|--|-------------------------|---------------------------|--------------------------|---|--|------------------------|---------------------------|---|
| Assets: | | | | | | | | |
| Trading assets, excluding derivatives | \$ 1,738 | \$ (540) | \$ - | \$ - | \$ 517 | \$ - | \$ 1,715 | \$ (389) |
| Derivatives, net(2) | 1,962 | 477 | (3) | - | 94 | 42 | 2,572 | 327 |
| Securities available for sale | 97 | - | - | 3 | (24) | - | 76 | 4 |
| Loans(3) | 810 | - | (11) | - | (531) | - | 268 | - |
| Other assets, excluding derivatives(4) | <u>546</u> | = | <u>(55)</u> | = | <u>31</u> | = | <u>522</u> | <u>(29)</u> |
| | \$ | | \$ | | | | \$ | |
| Total | 5,153 | \$ (63) | (69) | \$ 3 | \$ 87 | \$ 42 | 5,153 | \$ (87) |
| Liabilities: | | | | | | | | |
| Deposits in domestic offices | \$ (131) | \$ 6 | \$ - | \$ - | \$ (53) | \$ 41 | \$ (137) | \$ 7 |
| Long-term debt | <u>(340)</u> | <u>2</u> | = | = | <u>209</u> | <u>62</u> | <u>(60)</u> | <u>2</u> |
| | \$ | | | | | | \$ | |
| Total | (471) | \$ 15 | \$ - | \$ - | \$ 156 | 103 | (197) | \$ 16 |

**Total Gains and (Losses)
Included in(1)**

| | January 1, 2009 | Trading (Loss) | Other Revenue | Other Comprehensive Income | Net Purchases and Settlements of Level 3 | Into or Out | Sept. 30, 2009 | Current Periods Unrealized Gains (Losses) |
|--|----------------------------|---------------------------|--------------------------|---|---|------------------------|---------------------------|--|
|--|----------------------------|---------------------------|--------------------------|---|---|------------------------|---------------------------|--|

| | January 1, 2009 | Trading (Loss) | Other Revenue | Other Comprehensive Income | Net Purchases and Settlements of Level 3 | Into or Out | Sept. 30, 2009 | Current Periods Unrealized Gains (Losses) |
|---|----------------------------|---------------------------|--------------------------|---|---|------------------------|---------------------------|--|
| Assets: | | | | | | | | |
| Trading assets, excluding derivatives | | | | | | | | |
| U.S. Treasury. U.S. Government agencies and sponsored enterprises | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - |
| Obligations of U.S. states and political subdivisions | - | - | - | - | - | - | - | - |
| Residential mortgage-backed securities | 475 | 2 | - | - | (55) | 252 | 674 | (5) |

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| | | | | | | | | |
|---|-------|---------|------|--------|---------|-------|----------|---------|
| Commercial mortgage-backed securities | - | - | - | - | - | - | - | - |
| Collateralized debt obligations | 668 | (272) | - | - | 421 | - | 817 | (109) |
| Other asset-backed securities | 36 | 8 | - | - | (21) | 9 | 32 | 4 |
| Other domestic debt securities | 480 | 358 | - | - | 35 | 345 | 1,218 | 345 |
| Debt Securities issued by foreign entities | 87 | 116 | - | - | - | - | 203 | 116 |
| Equity securities | 147 | (94) | - | - | (28) | 1 | 26 | (94) |
| Precious metals | - | - | - | - | - | - | - | - |
| Derivatives, net(2) | 5,283 | (3,256) | (4) | - | (286) | (20) | 1,717 | (2,468) |
| Securities available-for-sale | | | | | | | | |
| U.S. Treasury, U.S. Government agencies and sponsored enterprises | - | - | - | - | - | 3 | 3 | - |
| Obligations of U.S. states and political subdivisions | - | - | - | - | - | - | - | - |
| Residential mortgage-backed securities | 164 | - | - | 71 | (83) | 369 | 521 | 63 |
| Commercial mortgage-backed securities | - | - | - | 2 | - | 5 | 7 | 2 |
| Collateralized debt obligations | - | - | - | - | - | - | - | - |
| Other asset-backed securities | 307 | - | - | 64 | (123) | (22) | 226 | 26 |
| Other domestic debt securities | - | - | - | - | - | - | - | - |
| Debt Securities issued by foreign entities | - | - | - | - | - | - | - | - |
| Equity securities | - | - | - | - | - | - | - | - |
| Loans(3) | 136 | - | 12 | - | (19) | - | 129 | 8 |
| Other assets, excluding derivatives(4) | 333 | = | (26) | = | 87 | = | 394 | 6 |
| | \$ | \$ | \$ | | \$ | \$ | \$ | \$ |
| Total assets | 8,116 | (3,138) | (18) | \$ 137 | \$ (72) | 942 | \$ 5,967 | (2,106) |
| Liabilities: | | | | | | | | |
| Deposits in domestic offices | (234) | (29) | - | - | (964) | 16 | (1,211) | (28) |
| Long-term debt | (57) | (46) | = | = | (281) | 17 | (367) | (44) |
| | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ |
| Total liabilities | (291) | \$ (75) | \$ - | \$ - | (1,245) | \$ 33 | (1,578) | \$ (72) |

| | <u>Total Gains and (Losses)</u> | | | | | | | Current Period Unrealized <u>Gains</u> <u>(Losses)</u> |
|--|-------------------------------------|-------------------------|--|--|--|--------------------------|-------------|--|
| | <u>Included in(1)</u> | | | | | | | |
| January 1, <u>2008</u> | Trading (Loss) <u>Revenue</u> | Other <u>Revenue</u> | Other <u>Comprehensive</u> <u>Income</u> | Net Purchases, Issuances and <u>Settlements</u> (in millions) | Transfers Into or Out <u>of Level 3</u> | Sept. 30, <u>2008</u> | | |
| Assets: | | | | | | | | |
| Trading assets, excluding derivatives | \$ 77 | (728) | \$ - | \$ - | \$ 994 | 1,372 | 1,715 | \$ (602) |
| Derivatives, net(2) | 709 | (34) | 2 | - | 157 | 1,738 | 2,572 | (423) |
| Securities available for sale | 1 | - | - | 9 | (58) | 124 | 76 | 10 |
| Loans(3) | 829 | - | (75) | - | (484) | (2) | 268 | (3) |
| Other assets, excluding derivatives(4) | <u>489</u> | = | <u>(80)</u> | = | <u>113</u> | = | <u>522</u> | <u>(4)</u> |
| | \$ | \$ | \$ | | \$ | \$ | \$ | \$ |
| Total | 2,105 | (762) | (153) | \$ 9 | \$ 722 | 3,232 | 5,153 | (1,022) |
| Liabilities: | | | | | | | | |
| Deposits in domestic offices | (192) | \$ 18 | \$ - | \$ - | \$ (82) | \$ 119 | (137) | \$ 8 |
| Long-term debt | <u>(63)</u> | <u>26</u> | = | = | <u>42</u> | <u>(65)</u> | <u>(60)</u> | <u>10</u> |
| | \$ | \$ | \$ | | \$ | \$ | \$ | \$ |
| Total | (255) | \$ 44 | \$ - | \$ - | \$ (40) | \$ 54 | (197) | \$ 18 |

- (1) Includes realized and unrealized gains and losses.
- (2) Level 3 net derivatives included derivative assets of \$3.5 billion and \$4.4 billion and derivative liabilities of \$1.7 billion and \$1.8 billion as of September 30, 2009 and 2008, respectively.
- (3) Includes Level 3 corporate lending activities risk-managed on a fair value basis for which we have elected the fair value option.
- (4) Represents residential mortgage servicing activities. See to Note 8, "Intangible Assets," of this Form 10-Q.

Assets and Liabilities Recorded at Fair Value on a Non-recurring Basis Certain financial and non-financial assets are measured at fair value on a non-recurring basis and therefore, are not included in the tables above. These assets include (a) mortgage and consumer loans classified as held for sale reported at the lower of cost or fair value and (b) impaired loans or assets that are written down to fair value based on the valuation of underlying collateral during the period. These instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustment in certain circumstances (e.g., impairment). The following table presents the fair value hierarchy level within which the fair value of the financial and non-financial assets has been recorded as of September 30, 2009 and 2008. The gains (losses) for the three and nine months ended September 30, 2009 and 2008 are also included.

| | Non-Recurring Fair Value Measurements | | | | Total Gains | Total Gains |
|---|--|----------------|----------------|----------------------|----------------------|---------------------|
| | as of September 30, 2009 | | | | (Losses) For | (Losses) For |
| | Level 1 | Level 2 | Level 3 | Total | the | the |
| | | | | Three Months | Nine Months | |
| | | | | Ended | Ended | |
| | | | | September 30, | September 30, | |
| | | | | 2009 | 2009 | |
| (in millions) | | | | | | |
| Loans: | | | | | | |
| Residential mortgage loans held for sale(1) | \$ - | \$ 36 | \$ 889 | \$ 925 | \$ (15) | \$ (174) |
| Auto finance loans held for sale(1) | - | - | 353 | 353 | - | - |
| Repossessed vehicles | - | 7 | - | 7 | - | - |
| Other consumer loans held for sale(1) | - | - | 32 | 32 | (13) | (13) |
| Impaired loans(2) | - | - | 371 | 371 | 46 | 136 |
| Real estate owned(3) | - | 77 | - | 77 | 1 | 3 |
| Building held for use | = | = | 15 | 15 | = | (20) |
| Total assets at fair value on a non-recurring basis | \$ - | \$ 120 | 1,660 | 1,780 | \$ 19 | \$ (68) |

| | Non-Recurring Fair Value Measurements | | | | Total Gains | Total Gains |
|---|--|----------------|----------------|---------------------------|---------------------------|--------------------------|
| | as of September 30, 2008 | | | | (Losses) For the | (Losses) For the |
| | Level 1 | Level 2 | Level 3 | Total | Three Months Ended | Nine Months Ended |
| | | | | September 30, 2008 | September 30, 2008 | |
| (in millions) | | | | | | |
| Loans: | | | | | | |
| Residential mortgage loans held for sale(1) | \$ - | \$ 182 | \$ 1,505 | \$ 1,687 | \$ (84) | \$ (340) |
| Impaired loans(2) | - | - | 89 | 89 | (7) | (25) |
| Real estate owned(3) | = | 63 | = | 63 | = | = |
| | \$ | \$ | \$ | \$ | \$ | \$ |
| Total assets at fair value on a non-recurring basis | = | 245 | 1,594 | 1,839 | (91) | (365) |

(1) As of September 30, 2009 and 2008, the fair value of the loans held for sale was below cost.

(2) Represents impaired commercial loans. We use the fair value estimate of the underlying collateral to approximate the fair value of the commercial loans.

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

During the second quarter of 2009, we wrote down the carrying value of a data center building held for use to its fair value. The fair value was determined based on management's best estimate of the exit price that would be received in a current transaction with market participants at the reporting date. In determining the fair value, management considered, among other things, the features of the property, potential uses of the property that could maximize value to market participants, estimated marketing period given the current economic conditions and challenges for market participants to secure financing. Changes in fair value of this asset are reflected in occupancy expense in the consolidated statement of income (loss).

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

The following table summarizes the carrying value and estimated fair value of our financial instruments at September 30, 2009 and December 31, 2008.

| | <u>September 30, 2009</u> | | <u>December 31, 2008</u> | |
|---|---------------------------|--------------|--------------------------|--------------|
| | Carrying | Fair | Carrying | Fair |
| | <u>Value</u> | <u>Value</u> | <u>Value</u> | <u>Value</u> |
| | (in millions) | | | |
| Financial assets: | | | | |
| | \$ | \$ | \$ | \$ |
| Short-term financial assets | 21,849 | 21,849 | 19,845 | 19,845 |
| Federal funds sold and securities purchased under resale agreements | 4,463 | 4,463 | 10,813 | 10,813 |
| Non-derivative trading assets | 13,214 | 13,214 | 10,018 | 10,018 |
| Derivatives | 12,507 | 12,507 | 22,683 | 22,683 |
| Securities | 32,355 | 32,510 | 27,783 | 27,843 |
| Commercial loans, net of allowance for credit losses | 31,428 | 31,142 | 36,857 | 33,822 |
| Commercial loans designated under fair value option and held for sale | 1,138 | 1,138 | 874 | 874 |
| Consumer loans, net of allowance for credit losses | 47,271 | 43,091 | 41,859 | 35,309 |
| Consumer loans held for sale: | | | | |
| Residential mortgages | 1,280 | 1,289 | 3,512 | 3,521 |
| Auto finance | 353 | 353 | - | - |
| Other consumer | 32 | 32 | 45 | 45 |
| Financial liabilities: | | | | |
| | \$ | \$ | \$ | \$ |
| Short-term financial liabilities | 12,269 | 12,269 | 14,701 | 14,701 |
| Deposits: | | | | |
| Without fixed maturities | 102,757 | 102,757 | 103,207 | 103,207 |
| Fixed maturities | 8,908 | 8,953 | 13,538 | 13,608 |
| Deposits designated under fair value option | 3,884 | 3,884 | 2,293 | 2,293 |
| Non-derivative trading liabilities | 2,731 | 2,731 | 2,005 | 2,005 |
| Derivatives | 8,084 | 8,084 | 15,099 | 15,099 |

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| | | | | |
|---|---------------|---------------|--------|--------|
| Long-term debt | 16,817 | 17,181 | 19,462 | 19,331 |
| Long-term debt designated under fair value option | 4,615 | 4,615 | 2,627 | 2,627 |

Loan values presented in the table above were determined using the Fair Value Framework for measuring fair value, which is based on our best estimate of the amount within a range of value we believe would be received in a sale as of the balance sheet date (i.e. exit price). The unprecedented developments in the mortgage lending industry and the current economic conditions have resulted in a significant reduction in the secondary market demand for assets not guaranteed or eligible for guarantee by the Federal government or a governmental agency. The estimated fair values at September 30, 2009 and December 31, 2008 for our loans reflect these market conditions. For certain consumer loans, potential investors often assume a higher charge-off level and lower overall cash flows than what we, as the servicer of these loans, believe will ultimately be the case, and most asset values reflect a significant pricing discount resulting from the lack and/or high cost of leverage available to most buyers of whole loan assets. This creates a value that is substantially lower than would otherwise be reported under more normal marketplace conditions.

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

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

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

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

- **Mortgage Loans Held for Sale** – Certain residential mortgage loans are classified as held for sale and are recorded at the lower of cost or fair value. As of September 30, 2009, the fair value of these loans is below their amortized cost. The fair value of these mortgage loans is determined based on the valuations observed in the securitization market, which is deemed to be the principal exit market for these loans. Where mortgage securitization does not regularly occur, we utilize valuation information observed in alternative exit markets such as the whole loan market. In any event, the determination of fair value for mortgage loans takes into account factors such as the location of the collateral, the loan-to-value ratio, the estimated rate and timing of default, the probability of foreclosure and loss severity if foreclosure does occur.

- **Leveraged Loans** – We record leveraged loans and revolvers held for sale at fair value. Where available, market consensus pricing obtained from independent sources are used to estimate the fair value of the leveraged loans and revolvers. In determining the fair value, we take into consideration the number of participants submitting pricing information, the range of pricing information and distribution, the methodology applied by the pricing services to cleanse the data and market liquidity. Where consensus pricing information is not available, fair value is estimated using observable market prices of similar instruments or inputs, including bonds, credit derivatives, and loans with similar characteristics. Where observable market parameters are not available, fair value is determined based on contractual cash flows adjusted for defaults and recoveries, discounted at the rate demanded by market participants under current market conditions. In those cases, we also consider the specific loan characteristics and inherent credit risk and risk mitigating factors such as collateral arrangements in determining fair value.
- **Commercial Loans** – Commercial loans and commercial real estate loans are valued by discounting the contractual cash flows, adjusted for prepayments and borrower’s credit risks, using a discount rate that reflects the current rates offered to borrowers of similar credit standing for the remaining term to maturity and our own estimate of liquidity premium.
- **Consumer Loans** – The estimated fair value of our consumer loans were determined by developing an estimated range of value from a mix of various sources as appropriate for the respective pool of assets. These sources included, among other things, value estimates from an HSBC affiliate which reflect over-the-counter trading activity and where appropriate, the impact of current estimated rating agency credit tranching levels with the associated benchmark credit spreads, forward looking discounted cash flow models using assumptions we believe are consistent with those which would be used by market participants in valuing such receivables; trading input from other market participants which includes observed primary and secondary trades; and general discussions held directly with potential investors.

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

Lending-related Commitments – The fair value of commitments to extend credit, standby letters of credit and financial guarantees are not included in the table. The majority of the lending related commitments are not carried at fair value on a recurring basis nor are they actively traded. These instruments generate fees, which approximate those currently charged to originate similar commitments, which are recognized over the term of the commitment period. Deferred fees on commitments and standby letters of credit totaled \$43 million and \$33 million at September 30, 2009 and December 31, 2008, respectively.

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

- **U.S. Treasury, U.S. Government agency issued or guaranteed and Obligations of U.S. state and political subdivisions** – As these securities transact in an active market, fair value measurements are based on quoted prices for the identical

security or quoted prices for similar securities with adjustments as necessary made using observable inputs which are market corroborated.

- U.S. Government sponsored enterprises – For certain government sponsored mortgage-backed securities which transact in an active market, fair value measurements are based on quoted prices for the identical security or quoted prices for similar securities with adjustments as necessary made using observable inputs which are market corroborated. For government sponsored mortgage-backed securities which do not transact in an active market, fair value is determined primarily based on pricing information obtained from pricing services and is verified by internal review processes.
- Asset-backed securities – Fair value is primarily determined based on pricing information obtained from independent pricing services adjusted for the characteristics and the performance of the underlying collateral. We determine whether adjustments to independent pricing information are necessary as a result of investigations and inquiries about the reasonableness of the inputs used and the methodologies employed by the independent pricing services.
- Other domestic debt and foreign debt securities – For non-callable corporate securities, a credit spread scale is created for each issuer. These spreads are then added to the equivalent maturity U.S. Treasury yield to determine current pricing. Credit spreads are obtained from the new market, secondary trading levels and dealer quotes. For securities with early redemption features, an option adjusted spread (“OAS”) model is incorporated to adjust the spreads determined above. Additionally, we survey the broker/dealer community to obtain relevant trade data including benchmark quotes and updated spreads.
- Equity securities – Since most of our securities are transacted in active markets, fair value measurements are determined based on quoted prices for the identical security.

We perform periodic validations of the fair values obtained from independent pricing services. Such validations primarily include sourcing security prices from other independent pricing services or broker quotes. As the pricing for mortgage and other asset-backed securities became less transparent during the credit crisis, we have developed internal valuation techniques to validate the fair value. The internal validation techniques utilize inputs derived from observable market data, make reference to external analysts’ estimates such as probability of default, loss recovery and prepayment speeds and apply discount rates that would be demanded by investors under the current market conditions given the specific characteristics and inherent risks of the underlying collateral. In addition, we also consider whether the volume and level of activity for a security has significantly decreased and whether the transaction is orderly. Depending on the results of the validation, additional information may be gathered from other market participants to support the fair value measurements. A determination is made as to whether adjustments to the observable inputs are necessary as a result of investigations and inquiries about the reasonableness of the inputs used and the methodologies employed by the independent pricing services.

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

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

We may adjust valuations derived using the methods described above in order to ensure that those values represent appropriate estimates of fair value. These adjustments, which are applied consistently over time, are generally required to reflect factors such as bid-ask spreads and counterparty credit risk that can affect prices in arms-length transactions with unrelated third parties.

Real Estate Owned – Fair value is determined based on third party appraisals obtained at the time we take title to the property and, if less than the carrying value of the loan, the carrying value of the loan is adjusted to the fair value. After three months on the market the carrying value is further reduced, if necessary, to reflect observable local market data including local area sales data.

Mortgage Servicing Rights – We elected to measure residential mortgage servicing rights, which are classified as intangible assets, at fair value when we adopted accounting principles related to the servicing of financial assets effective January 1, 2006. The fair value for the residential mortgage servicing rights is determined based on an option adjusted approach which involves discounting servicing cash flows under various interest rate projections at risk-adjusted rates. The valuation model also incorporates our best estimate of the prepayment speed of the mortgage loans and discount rates. As changes in interest rates is a key factor affecting the prepayment speed and hence the fair value of the mortgage servicing rights, we use various interest rate derivatives and forward purchase contracts of mortgage-backed securities to risk-manage the mortgage servicing rights.

Structured Notes – Certain structured notes were elected to be measured at fair value in their entirety under fair value option accounting principles. As a result, derivative features embedded in the structured notes are included in the valuation of fair value. Cash flows of the funded notes are discounted at the appropriate rate for the applicable duration of the instrument adjusted for our own credit spreads. The credit spreads applied to these instruments are derived from the spreads at which institutions of similar credit standing would offer for issuing similar structured instruments as of the measurement date. The market spreads for structured notes are generally lower than the credit spreads observed for plain vanilla debt or in the credit default swap market.

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

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

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

Valuation Adjustments – Due to judgment being more significant in determining the fair value of Level 3 instruments, additional factors for Level 3 instruments are considered that may not be considered for Level 1 and Level 2 valuations and we record additional valuation adjustments as a result of these considerations. Some of the valuation adjustments are:

- Credit risk adjustment – an adjustment to reflect the creditworthiness of the counterparty for OTC products where the market parameters may not be indicative of the creditworthiness of the counterparty. For derivative instruments, the market price implies parties to the transaction have credit ratings equivalent to AA. Therefore, we will make an appropriate credit risk adjustment to reflect the counterparty credit risk if different from an AA credit rating.

- Market data/model uncertainty – an adjustment to reflect uncertainties in the fair value measurements determined based on unobservable market data inputs. Since one or more significant parameters may be unobservable and must be estimated, the resultant fair value estimates have inherent measurement risk. In addition, the values derived from valuation techniques are affected by the choice of valuation model. When different valuation techniques are available, the choice of valuation model can be subjective and in those cases, an additional valuation adjustment may be applied to mitigate the potential risk of measurement error. In most cases, we perform analysis on key unobservable inputs to determine the appropriate parameters to use in estimating the fair value adjustments.
- Liquidity adjustment – a type of bid-offer adjustment to reflect the difference between the mark-to-market valuation of all open positions in the portfolio and the close out cost. The liquidity adjustment is a portfolio level adjustment and is a function of the liquidity and volatility of the underlying risk positions.

20. New Accounting Pronouncements

Business combinations in consolidated financial statements

In December 2007, the FASB issued guidance on the accounting and reporting of business combinations which requires recognition of all assets acquired, liabilities assumed and any noncontrolling interest in an acquiree at fair value as of the date of acquisition. This guidance also changes the recognition and measurement criteria for certain assets and liabilities including those arising from contingencies, contingent consideration, and bargain purchases and is effective for business combinations with an effective date beginning January 1, 2009 or later.

Non-controlling interests in consolidated financial statements

In December 2007, the FASB issued guidance on the accounting and reporting of noncontrolling interests in consolidated financial statements which requires entities report noncontrolling interests in subsidiaries as equity in the consolidated financial statements and to account for the transactions with noncontrolling interest owners as equity transactions provided the parent retains controlling interests in the subsidiary. The guidance also requires new and expanded disclosure and was effective from fiscal years beginning on or after December 15, 2008. Adoption did not have a material impact on our financial position or results of operations.

Transfers of financial assets

In February 2008, the FASB issued guidance on the accounting for transfers of financial assets and repurchase financing transactions. Under this guidance, the initial transfer of a financial asset and a repurchase financing involving the same asset that is entered into contemporaneously with, or in contemplation of, the initial transfer, is presumptively linked and are considered part of the same arrangement. This guidance was effective for new transactions entered into in fiscal years beginning after November 15, 2008. Our adoption on January 1, 2009 did not have a material impact on our financial position or results of operations.

Disclosures about derivative instruments and hedging activities

In March 2008, the FASB issued guidance which amended the existing derivative and hedging disclosure requirements, requiring increased disclosures about derivative instruments and hedging activities and their effects on an entity's financial position, financial performance and cash flows. This guidance was effective for fiscal years beginning after November 15, 2008. We adopted the guidance effective January 1, 2009. See Note 10, "Derivative Financial Instruments," in these consolidated financial statements.

Financial guarantee contracts

In May 2008, the FASB issued guidance on the accounting and reporting for financial guarantee insurance contracts which applies to certain financial guarantee insurance (and reinsurance) contracts issued by enterprises that are not accounted for as derivative instruments. This guidance also requires expanded disclosures about financial guarantee insurance contracts and is effective for financial statements issued for fiscal years beginning after December 15, 2008, and all interim periods within those fiscal years. Our adoption on January 1, 2009 did not have an impact on our financial position or our results of operations.

Employers' disclosures about postretirement benefit plan assets

In December 2008, the FASB issued guidance which requires more detailed disclosures about employers' plan assets, including investment strategies, major categories of plan assets, concentrations of risk within plan assets, and valuation techniques used to measure the fair value of plan assets. These new disclosures are applicable for the first fiscal year ending after December 15, 2009.

Interim disclosures about fair value of financial instruments

In April 2009, the FASB issued guidance that fair value disclosures required for financial instruments on an annual basis be presented for all interim reporting periods beginning with the first interim period ending after June 15, 2009 with earlier application permitted. We have adopted the disclosure requirements effective January 1, 2009. See Note 19, "Fair Value Measurements", in these consolidated financial statements.

Determining fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not orderly

In April 2009, the FASB issued additional guidance for estimating fair value when the volume and level of activity for the asset and liability have significantly decreased and also on identifying circumstances that indicate a transaction is not orderly. This guidance also requires expanded disclosure about how fair value is measured, changes to valuation methodologies, and additional disclosures for debt and equity securities. This guidance was effective for reporting periods ending after June 15, 2009 with earlier adoption permitted. We adopted this guidance effective January 1, 2009. See Note 19, "Fair Value Measurements", in these consolidated financial statements for the expanded disclosure.

The recognition and presentation of other-than-temporary impairment

In April 2009, the FASB issued guidance which amends the recognition and presentation of other-than-temporary impairments of debt securities. Under this guidance, if we do not have the intention to sell and it is more-likely-than-not we will not be required to sell the debt security, we are required to segregate the difference between fair value and amortized cost into credit loss and other losses with only the credit loss recognized in earnings and other losses recorded to other comprehensive income. Where our intent is to sell the debt security or where it is more-likely-than-not that we will be required to sell the debt security, the entire difference between the fair value and

the amortized cost basis is recognized in earnings. The guidance also requires additional disclosures regarding the calculation of credit losses and the factors considered in reaching a conclusion that the investment is not other-than-temporarily impaired and is effective for all reporting periods ending after June 15, 2009, with earlier adoption permitted. We adopted this guidance effective January 1, 2009. The cumulative effect of applying this guidance was recorded to opening retained earnings upon adoption. As a result, on January 1, 2009 we reclassified \$15 million, net of taxes, from retained earnings to accumulated other comprehensive income (loss) related to the non-credit loss portion of other-than-temporary impairments on debt securities. See Note 4, "Securities," in these consolidated financial statements for additional information on other-than-temporary impairments.

Subsequent events

In May 2009, the FASB issued guidance which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. This guidance was effective for interim or annual financial periods ending after June 15, 2009, and shall be applied prospectively. Adoption did not have an impact on our financial position or results of operations.

Accounting for transfers of financial assets

In June 2009, the FASB issued guidance which amends the accounting for transfers of financial assets by eliminating the concept of a qualifying special-purpose entity ("QSPE") and providing additional guidance with regard to accounting for transfers of financial assets. The guidance is effective for all interim and annual periods beginning after November 15, 2009. Earlier application is prohibited. We believe the adoption of this guidance will not have a material impact on our financial position and results of operations.

Accounting for consolidation of variable interest entities

In June 2009, the FASB issued guidance which amends the accounting rules related to the consolidation of variable interest entities ("VIE"). The guidance changes the approach for determining the primary beneficiary of a VIE from a quantitative risk and reward model to a qualitative model, based on control and economics. On the effective date, certain VIEs which are not consolidated currently may be required to be consolidated. The guidance is effective for all interim and annual periods beginning after November 15, 2009. Earlier application is prohibited. We are currently evaluating the impact adoption of this guidance will have on our financial position and results of operations.

Determination of fair value of financial liabilities

In August 2009, the FASB issued guidance to clarify how the fair value of liabilities should be determined when a quoted price for an identical liability is not available. The guidance requires in these circumstances that the fair value of financial liabilities be determined using either the quoted price of a similar liability, the quoted price of an identical or similar liability when traded as an asset or any other valuation methodology consistent with the Fair Value Framework. This guidance is effective for fiscal years beginning after the issuance of this guidance with early adoption encouraged. We adopted this guidance during the third quarter of 2009. Adoption did not have an impact on our financial position or results of operations.

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

Forward-Looking Statements

Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") should be read in conjunction with the consolidated financial statements, notes and tables included elsewhere in this report and with our Annual Report on

Form 10-K for the year ended December 31, 2008 (the "2008 Form 10-K"). MD&A may contain certain statements that may be forward-looking in nature within the meaning of the Private Securities Litigation Reform Act of 1995. In addition, we may make or approve certain statements in future filings with the SEC, in press releases, or oral or written presentations by representatives of HSBC USA Inc. that are not statements of historical fact and may also constitute forward-looking statements. Words such as "may", "will", "should", "would", "could", "intend", "believe", "estimate", "target", "plan", "anticipate", "goal" and similar expressions are intended to identify forward-looking statements and should not be considered as the only means through which these statements may be made. These matters or statements will relate to our future financial condition, results of operations, plans, objectives, performance or business developments and will involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from that which was expressed or implied by such forward-looking statements. Forward-looking statements are based on our current views and assumptions and speak only as of the date they are made. HSBC USA Inc. undertakes no obligation to update any forward-looking statement to reflect subsequent circumstances or events.

Executive Overview

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

Current Environment

During the first nine months of 2009, economic conditions in the U.S. continued to be challenged by tighter credit conditions, reduced economic growth and continued declines in the housing market. While the on-going financial market disruptions continued to impact credit spreads and liquidity during the period, beginning in the second quarter and continuing into the third quarter of 2009, we have seen an improvement in marketplace liquidity and credit spreads have narrowed considerably due to increased market confidence stemming largely from the various government actions taken to restore faith in the capital markets. The narrowing of credit spreads enabled many businesses to issue debt and raise new capital resulting in improving capital markets and a recovery in the stock market which is bolstering consumer and business sentiment.

U.S. unemployment rates, however, which have been and will continue to be a major factor in the deterioration of credit quality in the U.S., increased to 9.8 percent in September 2009, an increase of 30 basis points during the quarter and 260 basis points since December 2008. Unemployment rates in nine states are greater than the U.S. national average and unemployment rates in seven states are at or above 11 percent. Additionally, personal bankruptcy filings in the U.S. have continued to increase throughout the year. This has resulted in higher provisions for credit losses in our loan portfolios and in loan portfolios across the industry. Concerns about the future of the U.S. economy, including the length and depth of the current economic downturn, consumer confidence, volatility in energy prices, adverse developments in the credit markets and mixed corporate earnings continue to negatively impact the stability of both the U.S. economy and the capital markets. These adverse conditions continue to impact the carrying value of several asset classes including asset-backed securities held for both trading purposes and as available-for-sale, subprime residential mortgage loans held for sale and credit derivative products including derivative products with monoline insurance companies, although the dollar magnitude of the impact on these assets has slowed considerably in 2009 and as it relates to the third quarter, in many cases have actually begun to reverse. Despite this positive trend, however, we remain cautious as volatility with respect to certain capital markets activities remains elevated and we

expect these conditions, together with continued weakness in the overall economy, to continue to impact our results throughout the remainder of 2009.

Improvement in unemployment rates and a recovery of the housing market, including stabilization in home prices, continue to remain critical components of a broader U.S. economic recovery. Further weakening in these components as well as in consumer confidence may result in additional deterioration in consumer payment patterns and increased delinquencies and charge-off rates in loan portfolios across the industry including our own and, as a consequence, higher allowances for credit losses in future periods. Although consumer confidence has improved since earlier in 2009, it remains very low consistent with weak consumer fundamentals including declines in wage income, declines in wealth and a difficult job market.

The U.S. Federal government and banking regulators continued their efforts to stabilize the U.S. economy in 2009. On June 17, 2009, the Administration unveiled its proposal for sweeping overhaul of the financial regulatory system. The Financial Regulatory Reform proposals are comprehensive and include the creation of an inter-agency Financial Services Oversight Council to, among other things, identify emerging risks and advise the Federal Reserve Board regarding institutions whose failure could pose a threat to financial stability; expand the Federal Reserve Board’s powers to regulate these systemically-important institutions and impose more stringent capital and risk management requirements; create a Consumer Financial Protection Agency (the “CFPA”) as a single primary Federal consumer protection supervisor that will regulate credit, savings, payment and other consumer financial products and services and providers of those products and services; and impose comprehensive regulation of OTC derivatives markets, including credit default swaps, and prudent supervision of OTC derivatives dealers. Draft legislation implementing all of these initiatives has been released by the Administration, with the portions implementing the CFPA supervision of OTC derivatives transactions under active consideration in the House Financial Services Committee. It is likely that some portion of the financial regulatory reform proposals will be adopted and that reform is expected to have a significant impact on the operations of financial institutions in the U.S., including us and our affiliates. It is not possible to assess the impact of financial regulatory reform, however, until final legislation has been enacted and related regulations have been adopted.

Performance, Developments and Trends

Our net income was \$161 million during the three months ended September 30, 2009 compared to a net loss of \$136 million in the prior year quarter. Our net loss was \$177 million during the nine months ended September 30, 2009 compared to a net loss of \$588 million in the prior year period. Our income before tax was \$230 million during the three months ended September 30, 2009 compared to a net loss of \$188 million in the year ago period. Our loss before tax was \$121 million for the nine months ended September 30, 2009 as compared to \$922 million in the year ago period. Our results in both periods were significantly impacted by the change in the fair value of our own debt and the related derivatives for which we have elected fair value option due largely to improved credit spreads and several other non-recurring items which distort the comparison of the underlying performance of our business. The following table summarizes the collective impact of these items on our income (loss) before income tax for all periods presented:

| Three Months Ended September 30, 2009 | Nine Months Ended September 30, 2009 | 2008 | 2008 |
|--|---|-------------|-------------|
| (in millions) | | | |

Income
 (loss)
 before
 income
 tax,
 as
 reported
 Change
 in
 value
 of
 fair
 value
 option
 long-term
 debt
 and
 related
 derivatives
 Gain
 on
 sale
 of
 MasterCard
 Class B
 or

| | \$ | \$ | \$ | \$ |
|--|------------|-------|--------------|-------|
| | 230 | (188) | (121) | (922) |
| | 43 | (199) | 437 | (289) |
| | - | - | (48) | (217) |

Visa
 Class B
 shares
 Gain
 relating
 to
 resolution
 of
 lawsuit(1)

- - (85) -

Release

of

VISA

litigation

accrual

(9) - (9) (23)

Gain

= = (33) =

)

on

sale

of

equity

interest

in

HSBC

Private

Bank

(Suisse)

S.A.

Income

(loss)

before

income

tax,

excluding

above

| | | |
|----------|-----------------|-------------------|
| | \$ | \$ |
| items(2) | <u>\$ (387)</u> | <u>\$ (1,451)</u> |
| | <u>264</u> | <u>141</u> |

(1) The proceeds of the resolution of this lawsuit were used to redeem 100 preferred shares held by CT Financial Services, Inc. as provided under the terms of the preferred shares.

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

Although our results for the third quarter and first nine months of 2009 adjusted for the amounts described in the table above improved compared to the prior year periods, the year-to-date period in particular continued to be impacted by reductions in other revenues, largely trading revenue associated with credit derivative products due to the adverse financial market conditions discussed above, although the magnitude of such reductions declined significantly from the prior year and, in the third quarter of 2009, in many cases have started to reverse.

A summary of the significant valuation adjustments associated with these market disruptions that impacted revenue for the three and nine months ended September 30, 2009 and 2008 are presented in the following table.

| | Three Months Ended | | Nine Months Ended | |
|--|-------------------------------|--------------------|------------------------------|--------------------|
| | <u>September 30,</u> | | <u>September 30,</u> | |
| <u>Losses (Gains)</u> | <u>2009</u> | <u>2008</u> | <u>2009</u> | <u>2008</u> |
| | (in millions) | | | |
| Insurance monoline structured credit products | \$ (54) | \$ 155 | \$ 104 | \$ 957 |
| Other structured credit products | (38) | (118) | 182 | 144 |
| Mortgage whole loans held for sale | 28 | 87 | 182 | 331 |
| Other-than-temporary impairment on securities available-for-sale | 26 | 180 | 84 | 204 |
| | <u>(128)</u> | <u>94</u> | <u>(258)</u> | <u>197</u> |

Leverage acquisition finance loans
held for sale

| | | | |
|-------|-------|--------|--------------|
| | \$ | | \$ |
| Total | (166) | \$ 398 | \$ 294 1,833 |

In addition to the impacts to revenue described above, we experienced increased fees from the credit card receivable portfolio due largely to the purchase of General Motor (“GM”) MasterCard and AFL-CIO Union Plus (“UP”) MasterCard/Visa credit card receivables (the “GM and UP Portfolios”) and, in the nine-month period, higher gains on sales of mortgage backed and asset backed securities due to our efforts to reduce exposure to these investments as well as higher transaction fees in Global Banking and Markets. We also experienced higher net interest income in both periods due to higher net interest margin driven by a lower cost of funds and higher levels of credit card loans outstanding and, in the three-month period, lower operating expenses due to continued cost management efforts. These improvements were partially offset in both periods by a higher provision for credit losses and in the nine-month period, higher operating expenses as our cost management efforts were more than offset by higher FDIC insurance premiums, including the special assessment recorded in the second quarter and higher support services expense from HSBC affiliates.

The recent market events have created stress for certain counterparties with whom we conduct business as part of our lending and client intermediation activities. We assess, monitor and control credit risk with formal standards, policies and procedures that are designed to ensure credit risks are assessed accurately, approved properly, monitored regularly and managed actively. Consequently, we believe any loss exposure related to counterparties with whom we conduct business has been adequately reflected in our financial statements at September 30, 2009.

As previously reported, in January 2009, we purchased a \$6.3 billion portfolio of GM credit card receivables, a \$6.1 billion portfolio of UP credit card receivables and a \$3 billion portfolio of auto finance receivables from HSBC Finance at fair market value in order to maximize the efficient use of liquidity at each entity. HSBC Finance retained the customer account relationships associated with the credit card portfolios. We purchase additional credit card loan originations generated under new and existing accounts on a daily basis at fair market value. HSBC Finance continues to service the purchased portfolios for a fee. In connection with the purchases, we received capital contributions from HNAI in an aggregate amount of approximately \$1.1 billion in January 2009. This amount, along with an additional \$0.6 billion received by us from HNAI in December 2008, was subsequently contributed to our subsidiary, HSBC Bank USA, to provide capital support for the receivables purchased. While the receivable purchases have resulted in increases to our net interest margin and other revenues, they have also contributed to higher credit loss provisions and higher operating expenses compared to the prior year periods.

Net interest income was \$1,260 million and \$3,885 million during the three and nine months ended September 30, 2009, respectively, an increase of 8 percent and 21 percent over the year-ago periods. This increase in both periods primarily reflects the impact of higher credit card receivable levels due to the purchase of the GM and UP Portfolios in January 2009, the impact of commercial loan re-pricings, lower promotional balances on private label credit cards and a reduction in the amortization of private label credit card premiums due largely to lower premiums being paid. These increases were partially offset by narrowing of interest rate spreads on deposit products primarily due to lower market interest rates, competitive pressures as customers migrated to higher yielding deposit products, higher amortization of credit card premium due to the purchase of the GM and UP portfolios and the runoff of the residential mortgage and other consumer loan portfolios.

Our provision for credit losses was \$1,006 million during the three months ended September 30, 2009 as compared to \$658 million in the prior year quarter. Our provision for credit losses was \$3,247 million during the nine months ended September 30, 2009 as compared to \$1,762 million in the prior year period. The increase in both periods was primarily due to a higher provision for credit card receivables due to the purchase of the GM and UP Portfolios from

HSBC Finance, higher delinquency and credit loss estimates relating to prime residential mortgage loans as conditions in the housing markets worsened and the U.S. economy deteriorated, higher credit loss provision in our commercial loan portfolio and, in the year-to-date period, higher delinquencies and charge-offs within the private label and co-brand credit card portfolio due to higher levels of personal bankruptcy filing and the impact from a weakened U.S. economy, partially offset by lower receivable levels. Partially offsetting these increases in the three month period was a lower credit loss provision on private label credit card loans due to recent stabilization in credit performance and an improved outlook on future loss estimates as the impact of higher unemployment levels on losses has not been as severe as previously anticipated. Provision for credit losses increased for both loans and loan commitments in the commercial loan portfolio due to higher delinquency and loss estimates and higher levels of criticized assets caused by customer credit downgrades and deteriorating economic conditions, particularly in real estate lending.

Operating expenses totaled \$919 million and \$2,980 million in the three and nine months ended September 30, 2009. While operating expenses declined 5 percent in the three-month period compared to a year ago, they increased 10 percent in the year-to-date period, a majority of which was due to increased FDIC assessment charges. Lower salaries and employee benefit expense in both periods due to continued cost management efforts which have resulted in lower headcount including the impact of global resourcing initiatives were partially offset in the three month period by higher servicing fees paid to HSBC Finance as a result of the purchase of the GM and UP Portfolios, higher fees paid to HTSU, higher expenses due to the expansion of the core banking and commercial lending networks and higher FDIC insurance premiums. In the year-to-date period, the lower salaries and employee benefit expense was more than offset by higher FDIC insurance premiums which include \$82 million relating to a special assessment recorded in the second quarter of 2009, higher expenses associated with expansion and higher servicing fees to HSBC Finance as the receivable volumes being serviced were much higher earlier in the year. The year-to date period also reflects an impairment write down of a data center building as part of our ongoing strategy to consolidate operations and improve efficiencies. In addition, the prior year periods include a goodwill impairment charge of \$54 million relating to the residential mortgage reporting unit in PFS and, in the year to date period, a net reduction to the VISA litigation accrual which reduced operating expenses by \$23 million in 2008.

Our efficiency ratio was 42.64 percent for the three months ended September 30, 2009 as compared to 67.32 percent in the prior year quarter. Our efficiency ratio was 48.80 percent for the nine months ended September 30, 2009 as compared to 76.35 percent in the year-ago period. The improvement in the efficiency ratio in both periods of 2009 resulted primarily from the significant increase in revenues as compared to the year ago periods as discussed above.

The financial information set forth below summarizes selected financial highlights as of September 30, 2009 and December 31, 2008 and for the three and nine months ended September 30, 2009 and 2008.

| | Three Months Ended September 30, 2009 | | Nine Months Ended September 30, 2008 | |
|--------|--|--------------|---|--------------|
| | 2009 | 2008 | 2009 | 2008 |
| Net | | | | |
| income | \$ | \$ | \$ | \$ |
| (loss) | | | | |
| Rate | 161 | (136) | (177) | (588) |

(dollars are in millions)

| | | | | |
|---------------|--------------|--------|---------------|--------|
| of | | | | |
| return | | | | |
| on | | | | |
| average: | | | | |
| Total | | | | |
| assets | | | | |
| Total | .37% | (.31)% | (.13)% | (.43)% |
| common | | | | |
| shareholder's | | | | |
| equity | | | | |
| Net | 4.25 | (5.95) | (2.47) | (8.53) |
| interest | | | | |
| margin | | | | |
| to | | | | |
| average | | | | |
| earning | | | | |
| assets | | | | |
| Efficiency | 3.31 | 3.14 | 3.39 | 2.86 |
| ratio | | | | |
| Commercial | 42.64 | 67.32 | 48.80 | 76.35 |
| loan | | | | |
| net | | | | |
| charge-off | | | | |
| ratio(1) | | | | |
| Consumer | .72 | .54 | .72 | .37 |
| loan | 6.32 | 3.01 | 5.04 | 2.68 |

net
charge-off
ratio(1)

September 30, December 31,
2009 2008
(dollars are in millions)

| | | |
|---------------------|----------------------|----------------------|
| Loans: | | |
| Commercial | | |
| | \$ | \$ |
| loans | 32,373 | 37,429 |
| Consumer | | |
| loans | <u>50,193</u> | <u>43,684</u> |
| Total | | |
| | \$ | \$ |
| loans | <u>82,566</u> | <u>81,113</u> |
| Loans | | |
| held | | |
| for | | |
| | \$ | \$ |
| sale | <u>2,803</u> | <u>4,431</u> |
| Commercial | | |
| allowance | | |
| as | | |
| a | | |
| percent | | |
| of | | |
| loans(1) | 2.92% | 1.53% |
| Commercial | 2.80 | 1.01 |
| two-months-and-over | | |

contractual

delinquency

Consumer

allowance

as

a

percent

of

loans(1)

| | | |
|--|-------------|------|
| | 5.82 | 4.18 |
|--|-------------|------|

Consumer

two-months-and-over

contractual

delinquency

| | | |
|--|-------------|------|
| | 5.64 | 4.57 |
|--|-------------|------|

Loans

to

deposits

ratio(2)

| | | |
|--|---------------|--------|
| | 104.60 | 120.89 |
|--|---------------|--------|

Total

shareholders'

equity

to

total

assets

| | | |
|--|-------------|------|
| | 8.66 | 6.85 |
|--|-------------|------|

Total

| | | |
|--|--------------|-------|
| | 13.68 | 12.04 |
|--|--------------|-------|

capital

to

risk

weighted

assets

Tier 1

capital

to

risk

weighted

assets

| | | |
|--|-------------|------|
| | 9.25 | 7.60 |
|--|-------------|------|

Loans excluding loans held for sale were \$82.6 billion, \$85.9 billion and \$81.1 billion at September 30, 2009, June 30, 2009 and December 31, 2008, respectively. Loans declined compared to the prior quarter largely due to lower credit card and private label credit card balances due to lower consumer spending as well as actions previously taken to reduce risk in these portfolios including the tightening of underwriting criteria and as it relates to private label credit cards, including the exit of certain merchant relationships. Also contributing to the decrease was lower residential mortgage loans as we continue to sell a majority of our residential mortgage loan originations through the secondary markets and allow the existing loan portfolio to run off. Loans increased modestly from year-end as higher receivable levels due to the purchase of the GM and UP Portfolios and the auto finance loans previously described were largely offset by decreases in residential mortgage loans, including the sale of approximately \$4.0 billion of prime adjustable and fixed rate residential mortgage loans since December 31, 2008 and reductions in private label credit card receivables, as discussed above. Commercial loans are lower in both periods due to increased paydowns on loans across all commercial businesses, managed reductions in exposures, including higher underwriting standards, as well as lower overall demand from our core customer base. See "Balance Sheet Review" for a more detailed discussion of the changes in loan balances.

Our allowance for credit losses as a percentage of total loans increased at September 30, 2009, as compared to both June 30, 2009 and December 31, 2008. The increase in this percentage compared to the prior quarter largely reflects a higher allowance on our residential mortgage loan portfolio due to the continued deterioration of the housing market, particularly as it relates to our prime residential mortgage loans and home equity lines of credit, as well as a higher allowance on commercial loans, including our commercial real estate portfolio due to higher charge-off levels, customer credit downgrades and economic pressures, coupled with declining balances in these portfolios. These increases were partially offset by a lower allowance on credit card and private label credit card receivables due to lower outstanding balances, recent stability in delinquency levels and an improved outlook on future loss estimates as previously discussed. The increase in this percentage compared to year-end reflects a higher allowance on our residential mortgage loan and commercial loan portfolios and lower outstanding balances in these portfolios as discussed above, as well as higher charge-off levels in our private label card portfolio due to portfolio seasoning, continued deterioration in the U.S. economy including rising unemployment rates and lower balances outstanding due largely to the actions previously taken to lower the risk profile of the portfolio and lower customer spending. These increases were partially offset by a lower credit card percentage reflecting the impact of our prime GM and UP

Portfolios on credit card mix.

Our consumer two-months-and-over contractual delinquency ratio increased compared to both the prior quarter and year-end due largely to higher residential mortgage loan delinquency as a result of continued deterioration in the housing markets, as well as the overall continued deterioration in the U.S. economy including rising unemployment rates which impacted all of our consumer portfolios. The ratio was also impacted by lower levels of private label credit card and residential mortgage loans outstanding and, as it relates to the prior quarter, lower credit card loans outstanding. Commercial two-months-and-over contractual delinquency increased due to continued deterioration of economic conditions. Criticized asset balances also increased \$304 million during the three months ended September 30, 2009 to \$9.6 billion largely due to deteriorating economic conditions. See “Credit Quality” for a more detailed discussion of the increase in our delinquency ratios.

Net charge-offs as a percentage of average loans (“Net Charge-off Ratio”) increased compared to both the prior quarter and prior year quarter due to continued deterioration in the U.S. economy including continued declines in the housing markets, rising unemployment rates, the impact from lower outstanding loan balances as discussed above and as it relates to the prior year, higher bankruptcy filings. The net charge-off ratio for our credit card portfolio in the quarter was negatively impacted by the GM and UP portfolio acquired from HSBC Finance, a portion of which was subject to the application of accounting principles which require that certain loans with evidence of credit deterioration since origination be recorded at an amount based on the net cash flows expected to be collected which reduced the overall level of charge-off reported in the first half of 2009. The portion of the portfolio not subject to this accounting is now seasoning resulting in increased charge-offs during the third quarter. See “Credit Quality” for a more detailed discussion of the increase in the Net Charge-off Ratio and criticized asset balances.

In October 2009, we announced that we had agreed to sell our 452 Fifth Avenue property in New York City, including the 1W. 39th Street building, for \$330 million in cash. Under the terms of the deal, we will lease back the entire 452 Fifth Avenue building for one year and floors one to eleven for 10 years. The decision to sell these buildings is consistent with HSBC’s strategy to lease office buildings rather than own. The transaction is expected to close in the first quarter of 2010. We currently estimate the sale will result in a gain of approximately \$116 million, however it will be deferred and recognized over a number of years due to our continuing involvement. The headquarters of HSBC Bank USA will continue to remain in New York.

Funding and Capital

Capital amounts and ratios are calculated in accordance with current banking regulations. Our Tier 1 capital ratio was 9.25 percent at September 30, 2009 and 7.60 percent at December 31, 2008. Our capital levels remain well above levels established by current banking regulations as “well capitalized.” We received capital contributions from our immediate parent, HSBC North America Inc. (“HNAI”) of \$2.2 billion during the nine months ended September 30, 2009 as compared to \$1.5 billion in the year-ago period.

As part of the regulatory approvals with respect to the aforementioned receivable purchases completed in January 2009, we and our ultimate parent HSBC committed that HSBC Bank USA will maintain a Tier 1 risk-based capital ratio of at least 7.62 percent, a total capital ratio of at least 11.55 percent and a Tier 1 leverage ratio of at least 6.45 percent for one year following the date of transfer. In addition, we and HSBC have made certain additional capital commitments to ensure that HSBC Bank USA holds sufficient capital with respect to purchased receivables that are or may become “low-quality assets,” as defined by the Federal Reserve Act. In May 2009, we received further clarification from the Federal Reserve regarding HSBC Bank USA’s regulatory reporting requirements with respect to these capital commitments in that the additional capital requirements, (which require a risk-based capital charge of 100 percent for each “low-quality asset” transferred or arising in the purchased portfolios rather than the eight percent capital charge applied to similar assets that are not part of the transferred portfolios), should be applied both for purposes of satisfying the terms of the commitments and for purposes of measuring and reporting HSBC Bank USA’s risk-based capital and related ratios. During the third quarter of 2009, HSBC Bank USA sold low-quality auto finance

loans with a net book value of approximately \$165 million to a non-bank subsidiary of HSBC USA Inc. to reduce this capital requirement. Capital ratios at September 30, 2009 reflect this revised regulatory reporting. At September 30, 2009, we have exceeded our committed ratios and would have done so without the benefit associated with these low-quality asset sales.

In March 2009, Moody's Investors Services ("Moody's") downgraded the long-term debt ratings of both HUSI and HSBC Bank USA by one level to A1 and Aa3, respectively and reaffirmed the short-term ratings for each entity at Prime-1. Moody's also changed their outlook for both entities from "stable" to "negative." In April 2009, DBRS re-affirmed the long and short-term debt ratings of HUSI and HSBC Bank USA at AA and R-1, respectively, with a "negative" outlook. In August 2009, Standard and Poor's re-affirmed the long-term and short-term debt ratings of both HUSI and HSBC Bank USA at AA-/A-1+ (HUSI) and AA/A-1+ (HSBC Bank USA).

Income Before Income Tax Expense – Significant Trends

Income before income tax expense, and various trends and activity affecting operations, are summarized in the following table.

| | Three Months Ended | | Nine Months Ended | |
|------------|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| | (in millions) | | | |
| Income | | | | |
| (loss) | | | | |
| before | | | | |
| income | | | | |
| tax | | | | |
| from | | | | |
| year-ago | | | | |
| period | \$ | \$ | \$ | \$ |
| Increase | (188) | 4 | (922) | 822 |
| (decrease) | | | | |
| in | | | | |
| income | | | | |
| before | | | | |

income

tax

expense

attributable

to:

Balance

sheet

management

activities(1)

| | | | |
|------------|------|------------|----|
| 152 | (79) | 682 | 26 |
|------------|------|------------|----|

Trading

related

activities(2)

| | | | |
|------------|------|--------------|---------|
| 475 | (43) | 1,298 | (1,179) |
|------------|------|--------------|---------|

Loans

held

for

sale(3)

| | | | |
|-----------|-----|------------|------|
| 55 | 133 | 144 | (35) |
|-----------|-----|------------|------|

Residential

mortgage

banking

related

revenue(4)

| | | | |
|----------|----|-----------|------|
| 2 | 11 | 75 | (16) |
|----------|----|-----------|------|

Gain

| | | | |
|-------------|-----|--------------|-----|
| (67) | 111 | (322) | 121 |
|-------------|-----|--------------|-----|

(loss)

on

instruments

designated

| | | | | |
|----------------|--------------|--------------|----------------|----------------|
| at | | | | |
| fair | | | | |
| value | | | | |
| and | | | | |
| related | | | | |
| derivatives(5) | | | | |
| Provision | | | | |
| for | | | | |
| credit | | | | |
| losses(6) | | | | |
| | (348) | (256) | (1,485) | (891) |
| Credit | | | | |
| card | | | | |
| fees(7) | | | | |
| | 118 | (5) | 379 | 73 |
| Goodwill | | | | |
| impairment | | | | |
| loss(8) | | | | |
| | - | (54) | - | (54) |
| All | | | | |
| other | | | | |
| activity(9) | | | | |
| | 31 | <u>(10)</u> | 30 | <u>211</u> |
| Change | | | | |
| during | | | | |
| period | | | | |
| | 418 | <u>(192)</u> | 801 | <u>(1,744)</u> |
| Income | <u>\$</u> | <u>\$</u> | <u>\$</u> | <u>\$</u> |
| (loss) | 230 | <u>(188)</u> | (121) | <u>(922)</u> |
| before | | | | |
| income | | | | |

tax
for
current
period

- (1) Balance sheet management activities are comprised primarily of net interest income and gains on sales of investments resulting from management of interest rate risk associated with the repricing characteristics of balance sheet assets and liabilities. See additional discussion regarding Global Banking and Markets in the MD&A portion of this Form 10-Q under the caption “Segment Results – IFRSs Basis.”
- (2) See additional discussion regarding trading revenue (loss) in the MD&A portion of this Form 10-Q under the caption “Results of Operations.”
- (3) See additional discussion regarding loans held for sale the MD&A portion of this Form 10-Q under the caption “Balance Sheet Review.”
- (4) See additional discussion regarding residential mortgage banking revenue in the MD&A portion of this Form 10-Q under the caption “Results of Operations.”
- (5) See additional discussion in Note 11, “Fair Value Option,” and Note 19, “Fair Value Measurements,” in the accompanying consolidated financial statements.
- (6) See additional discussion regarding provision for credit losses the MD&A portion of this Form 10-Q under the caption “Results of Operations.”
- (7) See additional discussion regarding credit card fees in the MD&A portion of this Form 10-Q under the caption “Results of Operations.”
- (8) Represents the entire amount of goodwill allocated to the Residential Mortgage reporting unit.
- (9) Represents other core banking activities.

Basis of Reporting

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States (“U.S. GAAP”). Certain reclassifications have been made to prior year amounts to conform to the current year presentation.

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

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|------------------|---|--------------|--|--------------|
| | 2009 | 2008 | 2009 | 2008 |
| | (in millions) | | | |
| Net | | | | |
| income | | | | |
| (loss) - | | | | |
| U.S. | | | | |
| GAAP | | | | |
| basis | \$ | \$ | \$ | \$ |
| Adjustments, | 161 | (136) | (177) | (588) |
| net | | | | |
| of | | | | |
| tax: | | | | |
| Unquoted | | | | |
| equity | | | | |
| securities | | | | |
| Reclassification | - | (25) | (20) | (55) |
| of | | | | |
| financial | | | | |
| assets | | | | |
| Securities | (244) | 158 | (390) | 158 |
| Derivatives | 3 | (14) | (101) | - |
| | 6 | 5 | 11 | 11 |

| | | | | |
|-------------|--------------|-----------|--------------|--------------|
| Loan | | | | |
| impairment | | | | |
| | 2 | 3 | 9 | 1 |
| Property | | | | |
| | 7 | 2 | 14 | 7 |
| Pension | | | | |
| costs | | | | |
| | 17 | 1 | 31 | 3 |
| Purchased | | | | |
| loan | | | | |
| portfolios | | | | |
| | - | - | 73 | - |
| Servicing | | | | |
| assets | | | | |
| | (13) | 2 | (3) | 2 |
| Return | | | | |
| of | | | | |
| capital | | | | |
| | - | - | (55) | - |
| Interest | | | | |
| recognition | | | | |
| | (1) | 1 | (1) | 3 |
| Other | | | | <u>(11)</u> |
| | 15 | <u>6</u> | 2 |) |
| Net | | | | |
| income | | | | |
| (loss) - | | | | |
| IFRSs | | | | |
| basis | <u>(47)</u> | | <u>(607)</u> | <u>(469)</u> |
| |) | <u>3</u> |) |) |
| Tax | | | | |
| benefit | <u>(76)</u> | | <u>(109)</u> | <u>(265)</u> |
| |) | <u>24</u> |) |) |
| Profit | <u>\$</u> | <u>\$</u> | <u>\$</u> | <u>\$</u> |
| (loss) | <u>(123)</u> | <u>27</u> | <u>(716)</u> | <u>(734)</u> |
| |) |) |) |) |

before

tax

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

Unquoted equity securities – Under IFRSs, equity securities which are not quoted on a recognized exchange (MasterCard Class B shares and Visa Class B shares), but for which fair value can be reliably measured, are required to be measured at fair value. Securities measured at fair value under IFRSs are classified as either available-for-sale securities, with changes in fair value recognized in shareholders' equity, or as trading securities, with changes in fair value recognized in income. Under U.S. GAAP, equity securities that are not quoted on a recognized exchange are not considered to have a readily determinable fair value and are required to be measured at cost, less any provisions for known impairment, in other assets.

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

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

Securities – Effective January 1, 2009 under U.S. GAAP, the credit loss component of an other-than-temporary impairment of a debt security is recognized in earnings while the remaining portion of the impairment loss is recognized in accumulated other comprehensive income provided we have concluded we do not intend to sell the security and it is more-likely-than-not that we will have to sell the security prior to recovery. Under IFRSs, there is no bifurcation of other-than-temporary impairment and the entire portion is recognized in earnings. There are also less significant differences in measuring other-than-temporary impairment under IFRSs versus U.S. GAAP.

Under IFRSs, securities include HSBC shares held for stock plans at fair value. These shares held for stock plans are recorded at fair value through other comprehensive income. If it is determined these shares have become impaired, the fair value loss is recognized in profit and loss and any fair value loss recorded in other comprehensive income is reversed. There is no similar requirement under U.S. GAAP. During the second quarter of 2009 under IFRSs, we recorded income for the value of additional shares attributed to HSBC shares held for stock plans as a result of HSBC's rights offering earlier in 2009. The additional shares are not recorded under U.S. GAAP.

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

Loan impairment – IFRSs requires a discounted cash flow methodology for estimating impairment on pools of homogeneous consumer loans which requires the incorporation of the time value of money relating to recovery

estimates. Also under IFRSs, future recoveries on charged-off loans are accounted for on a discounted basis and a recovery asset is recorded. Subsequent recoveries are recorded to earnings under U.S. GAAP, but are adjusted against the recovery asset under IFRSs. Interest is recorded based on collectability under IFRSs.

Property – Under IFRSs, the value of property held for own use reflects revaluation surpluses recorded prior to January 1, 2004. Consequently, the values of tangible fixed assets and shareholders' equity are lower under U.S. GAAP than under IFRSs. There is a correspondingly lower depreciation charge and higher net income as well as higher gains (or smaller losses) on the disposal of fixed assets under U.S. GAAP. For investment properties, net income under U.S. GAAP does not reflect the unrealized gain or loss recorded under IFRSs for the period.

Pension costs – Net income under U.S. GAAP is lower than under IFRSs as a result of the amortization of the amount by which actuarial losses exceed gains beyond the 10 percent "corridor".

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

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

Return of capital – In 2009, this includes the recognition of \$55 million relating to the payment to CT Financial Services, Inc. in connection with the resolution of a lawsuit which for IFRS was treated as the satisfaction of a liability and not as revenue and a subsequent capital transaction as was the case under U.S. GAAP.

Interest recognition – The calculation of effective interest rates under IAS 39 requires an estimate of "all fees and points paid or recovered between parties to the contract" that are an integral part of the effective interest rate be included. U.S. GAAP generally prohibits recognition of interest income to the extent the net interest in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation. Also under U.S. GAAP, prepayment penalties are generally recognized as received.

Other – Other includes the net impact of certain adjustments which represent differences between U.S. GAAP and IFRSs that were not individually material for the three or nine months ended September 30, 2009 and 2008, including deferred loan origination costs and fees and loans held for sale. In 2008, other includes the impact of differences associated with a difference in the write off amount of goodwill related to our residential mortgage banking business unit and a timing difference with respect to the adoption of fair value measurement accounting principles for U.S. GAAP which resulted in the recognition of \$10 million of net income relating to structured products.

Balance Sheet Review

We utilize deposits and borrowings from various sources to provide liquidity, fund balance sheet growth, meet cash and capital needs, and fund investments in subsidiaries. Balance sheet totals at September 30, 2009, and increases (decreases) over prior periods, are summarized in the following table.

| | <u>September 30,</u> <u>2009</u> | <u>Increase (Decrease) from</u> | | | |
|---------------------------|-------------------------------------|---------------------------------|---------------|------------------------------------|---------------|
| | | <u>June 30,</u> <u>2009</u> | | <u>December 31,</u> <u>2008</u> | |
| | <u>Amount</u> | <u>%</u> | <u>Amount</u> | <u>%</u> | |
| (dollars are in millions) | | | | | |
| Period end assets: | | | | | |
| | \$ | | | | |
| Short-term investments | 25,538 | \$ 7,751 | 43.6% | \$ (4,187) | (14.1)% |
| Loans, net | 78,699 | (3,430) | (4.2) | (17) | - |
| Loans held for sale | 2,803 | (171) | (5.7) | (1,628) | (36.7) |
| Trading assets | 24,848 | 2,267 | 10.0 | (6,444) | (20.6) |
| Securities | 32,355 | 528 | 1.7 | 4,572 | 16.5 |
| | | <u>(367)</u> | <u>(3.2)</u> | <u>(2,356)</u> | <u>(17.3)</u> |
| Other assets | 11,266 |) |) |) |) |
| | \$ | \$ | 3.9 | \$ | (5.4) |
| | | | % | |)% |
| | 175,509 | 6,578 | | (10,060) | |
| | | | |) | |

Funding sources:

| | \$ | | | | |
|-----------------------|----------------|--------------|------------|-----------------|--------------|
| Total deposits | 115,549 | \$ 6,954 | 6.4% | \$ (3,489) | (2.9)% |
| Trading liabilities | 10,510 | 1,844 | 21.3 | (5,813) | (35.6) |
| Short-term borrowings | 8,259 | 281 | 3.5 | (2,236) | (21.3) |
| All other liabilities | 4,563 | (1,137) | (19.9) | (344) | (7.0) |
| Long-term debt | 21,432 | (1,994) | (8.5) | (657) | (3.0) |
| Shareholders' equity | 15,196 | <u>630</u> | <u>4.3</u> | <u>2,479</u> | <u>19.5</u> |
| | \$ | \$ | 3.9 | \$ | (5.4) |
| | | | % | |)% |
| | 175,509 | 6,578 | | (10,060) | |
| | | | |) | |

Short-Term Investments Short-term investments include cash and due from banks, interest bearing deposits with banks, Federal funds sold and securities purchased under resale agreements.

Loans, Net Loan balances at September 30, 2009, and increases (decreases) over prior periods, are summarized in the following table.

| | <u>September 30,</u> <u>2009</u> | <u>Increase (Decrease) from</u> | | | |
|---------------------------|-------------------------------------|---------------------------------|---------------|------------------------------------|---------|
| | | <u>June 30,</u> <u>2009</u> | | <u>December 31,</u> <u>2008</u> | |
| | <u>Amount</u> | <u>%</u> | <u>Amount</u> | <u>%</u> | |
| (dollars are in millions) | | | | | |
| Total commercial loans | \$ | \$ (1,624) | (4.8)% | \$ (5,056) | (13.5)% |

| | | | | | |
|---|---------------|----------------|--------------|--------------|---------------|
| | 32,373 | | | | |
| Consumer loans: | | | | | |
| Residential mortgages, excluding HELOCs and home equity mortgages | 14,423 | (327) | (2.2) | (3,525) | (19.6) |
| | | <u>(102)</u> | <u>(2.3)</u> | <u>(187)</u> | <u>(4.1)</u> |
| HELOCs and home equity mortgages | 4,362 |) |) |) |) |
| Total residential mortgages | 18,785 | (429) | (2.2) | (3,712) | (16.5) |
| Auto finance | 1,925 | (291) | (13.1) | 1,771 | 100+ |
| Private label | 14,614 | (447) | (3.0) | (2,460) | (14.4) |
| Credit Card | 13,326 | (443) | (3.2) | 11,189 | 100+ |
| | | <u>(69)</u> | <u>(4.3)</u> | <u>(279)</u> | <u>(15.3)</u> |
| Other consumer | 1,543 |) |) |) |) |
| | | <u>(1,679)</u> | <u>(3.2)</u> | | |
| Total consumer loans | 50,193 |) |) | 6,509 | 14.9 |
| Total loans | 82,566 | (3,303) | (3.8) | 1,453 | 1.8 |
| Allowance for credit losses | 3,867 | 127 | 3.4 | 1,470 | 61.3 |
| | | \$ | | \$ | |
| | | \$ | | | |
| | | <u>(3,430)</u> | <u>(4.2)</u> | <u>(17)</u> | |
| Loans, net | 78,699 |) |)% |) | -% |

Commercial loans have decreased compared to both the prior quarter and year-end due to increased paydowns on loans across all commercial businesses, managed reductions in exposures, including higher underwriting standards, as well as lower overall demand from our core customer base.

Residential mortgage loans have decreased as compared to both the prior quarter and prior year end. As a result of balance sheet initiatives to reduce prepayment risk and improve the structural liquidity of HSBC Bank USA, we sell a majority of our new residential loan originations through the secondary markets and have allowed the existing loan portfolio to run off, resulting in reductions in loan balances throughout the first nine months of 2009. Additionally, lower residential mortgage loan balances reflect the sale of approximately \$4 billion of prime adjustable and fixed rate residential mortgage loans since December 31, 2008.

Refreshed loan-to-value ("LTV") ratios for our mortgage loan portfolio, excluding sub-prime residential mortgage loans held for sale, are presented in the table below.

Residential Mortgages

First Lien Second Lien

| | | |
|------|-------------------------------|-------|
| | (Refreshed LTVs(1)(2)) | |
| LTV | 73.4% | 62.4% |
| <80% | | |
| 80% | 14.0 | 15.3 |
| ≤ | | |

| | | |
|---------------|-------|-------|
| LTV | | |
| <90% | | |
| 90% | 7.3 | 10.0 |
| ≤ | | |
| LTV | | |
| <100% | | |
| LTV | 5.3 | 12.4 |
| ≥ | | |
| 100% | | |
| Average | 67.1% | 74.3% |
| LTV | | |
| for portfolio | | |

- (1) Refreshed LTVs for first liens are calculated as a percentage of the current receivable balance. Refreshed LTVs for second liens are calculated as a percentage of the current receivable balance plus the senior lien amount at origination. Property values are derived from property's appraised value at the time of receivable origination updated by the change in the Office of Federal Housing Enterprise Oversight ("OFHEO") House Pricing Index ("HPI") at either a Core Based Statistical Areas ("CBSA") or state level. The estimated value of the homes could vary from actual market values due to changes in condition of the underlying property, variations in housing price changes within metropolitan statistical areas and other factors.
- (2) Refreshed LTVs are calculated using the most current HPIs available and applied on an individual loan basis, which results in an approximately three month delay in the production of reportable statistics. Therefore, the information in the table above reflect HPIs and outstanding receivable balance as of June 30, 2009.

Credit card receivable balances declined from June 30, 2009 reflecting the impact of lower account originations due to the actions taken by HSBC Finance beginning in the fourth quarter of 2007 and continuing into 2009 to manage risk as well as lower customer spending. Higher credit card receivable balances from December 31, 2008 are largely due to the purchase of the GM and UP Portfolios, with an outstanding principal balance of \$12.4 billion at the time of purchase in January 2009 from HSBC Finance as discussed above. Lower balances related to private label credit cards from June 30, 2009 and December 31, 2008 are due primarily to the tightening of underwriting criteria to lower the risk profile of the portfolio, the exit of certain merchant relationships and lower customer spending.

Auto finance loans have increased from December 31, 2008 as a result of the purchase of \$3.0 billion of auto finance loans in January 2009 from HSBC Finance as discussed above, partially offset by the transfer of \$353 million to loans held for sale in 2009. The decrease from June 30, 2009 reflects the run-off of this portfolio, as well as the transfer of \$65 million of auto finance to loans held for sale and the continued run-off of our indirect auto financing loans which we no longer originate.

Other consumer loans have decreased since June 30, 2009 and December 31, 2008 primarily due to the discontinuation of originations of student loans and run-off of our installment loan portfolio.

Loans Held for Sale Loans held for sale at September 30, 2009 and increases (decreases) over prior periods are summarized in the following table.

| | September 30, 2009 | Increase (Decrease) | | December 31, 2008 | |
|---------------------------|-------------------------------|----------------------------|---------------|------------------------------|---------------|
| | | June 30, 2009 | % | Amount | % |
| | | | | | |
| | | (dollars are in millions) | | | |
| | | \$ | | | |
| Total commercial loans | 1,138 | \$ 139 | 13.9% | \$ 264 | 30.2% |
| Consumer loans: | | | | | |
| Residential mortgages | 1,280 | (362) | (22.0) | (2,232) | (63.6) |
| Auto Finance | 353 | 65 | 22.6 | 353 | 100+ |
| | | <u>(13)</u> | <u>(28.9)</u> | <u>(13)</u> | <u>(28.9)</u> |
| Other consumer | 32 |) |) |) |) |
| | | <u>(310)</u> | <u>(15.7)</u> | <u>(1,892)</u> | <u>(53.2)</u> |
| Total consumer loans | 1,665 |) |) |) |) |
| | | \$ | | \$ | |
| | | <u>(171)</u> | <u>(5.7)</u> | <u>(1,628)</u> | <u>(36.7)</u> |
| Total loans held for sale | 2,803 |) |)% |) |)% |

We originate commercial loans in connection with our participation in a number of leveraged acquisition finance syndicates. A substantial majority of these loans were originated with the intent of selling them to unaffiliated third parties and are classified as commercial loans held for sale. Commercial loans held for sale under this program were \$1,138 million, \$999 million and \$874 million at September 30, 2009, June 30, 2009 and December 31, 2008, respectively, all of which are recorded at fair value. Commercial loan balances increased compared to June 30, 2009 and December 31, 2008 primarily due to an increase in the fair value of the loans.

Residential mortgage loans held for sale include sub-prime residential mortgage loans of \$855 million, \$917 million and \$1.2 billion at September 30, 2009, June 30, 2009 and December 31, 2008, respectively, that were acquired from unaffiliated third parties and from HSBC Finance with the intent of securitizing or selling the loans to third parties. Also included in residential mortgage loans held for sale are first mortgage loans originated and held for sale primarily to various governmental agencies. During the nine months ended September 30, 2009, we sold approximately \$4.0 billion of prime adjustable and fixed rate residential mortgage loans which resulted in a \$67 million gain. The gains and losses from the sale of residential mortgage loans is reflected as a component of residential mortgage banking revenue in the accompanying consolidated statement of income (loss). We retained the servicing rights in relation to the mortgages upon sale.

In the third quarter of 2009, we transferred \$65 million of Auto Finance loans to held for sale. During the nine months ended September 30, 2009, we transferred \$353 million of Auto Finance loans to held for sale.

Other consumer loans held for sale consist primarily of student loans.

Residential mortgage and other consumer loans held for sale are recorded at the lower of cost or market value. The cost of loans held for sale exceeded market value at September 30, 2009, resulting in an increase to the related valuation allowance during the three and nine months ended September 30, 2009. This was primarily a result of adverse conditions in the U.S. residential mortgage markets in 2009, although the dollar magnitude of the increases to the valuation allowance has been slowing throughout 2009.

Trading Assets and Liabilities Trading assets and liabilities balances at September 30, 2009, and increases (decreases) over prior periods, are summarized in the following table.

| | <u>September 30,</u> <u>2009</u> | <u>Increase (Decrease) from</u> | | | |
|------------------------------------|-------------------------------------|---------------------------------|---------------|------------------------------------|---------------|
| | | <u>June 30,</u> <u>2009</u> | | <u>December 31,</u> <u>2008</u> | |
| | <u>Amount</u> | <u>%</u> | <u>Amount</u> | <u>%</u> | |
| (dollars are in millions) | | | | | |
| Trading assets: | | | | | |
| Securities(1) | \$ | \$ 519 | 12.6% | \$ (486) | (9.5)% |
| | | 4,627 | | | |
| Precious metals | 8,587 | 2,226 | 35.0 | 3,682 | 75.1 |
| Fair value of derivatives | 11,634 | <u>(478)</u> | <u>(3.9)</u> | <u>(9,640)</u> | <u>(45.3)</u> |
| | |) |) |) |) |
| | \$ | \$ | <u>10.0</u> | \$ | <u>(20.6)</u> |
| | | | % | | % |
| | 24,848 | <u>2,267</u> | | <u>(6,444)</u> | |
| | | | |) | |
| Trading liabilities: | | | | | |
| Securities sold, not yet purchased | \$ | \$ 143 | 37.5% | \$ 118 | 29.1% |
| | | 524 | | | |
| Payables for precious metals | 2,205 | 105 | 5.0 | 606 | 37.9 |
| Fair value of derivatives | 7,781 | <u>1,596</u> | <u>25.8</u> | <u>(6,537)</u> | <u>(45.7)</u> |
| | |) |) |) |) |
| | \$ | \$ | <u>21.3</u> | \$ | <u>(35.6)</u> |
| | | | % | | % |
| | 10,510 | <u>1,844</u> | | <u>(5,813)</u> | |
| | | | |) | |

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

Securities balances increased from June 30, 2009 resulted primarily from increased market values as the market rallied for asset backed securities and an increase in asset backed securities held on the balance sheet from total return swap funding deals being terminated during the third quarter of 2009. Decreases from December 31, 2008 resulted primarily from sales of mortgage backed and asset backed securities held for trading purposes.

Higher precious metals balances at September 30, 2009 as compared to June 30, 2009 and December 31, 2008 were primarily due to higher prices on most metals.

Derivative assets and liabilities balances from June 30, 2009 and December 31, 2008, were impacted by market volatilities as valuations of foreign exchange, interest rate and credit derivatives all reduced from significant spreads

tightening in all sectors. Specifically, credit derivatives had a large decrease as a number of transaction unwinds and commutations reduced the outstanding market value as management sought to actively reduce exposure.

Deposits Deposit balances by major depositor categories at September 30, 2009, and increases (decreases) over prior periods, are summarized in the following table.

| | September 30, 2009 | <u>Increase (Decrease) from</u> | | | |
|--|-------------------------------|--|---------------|------------------------------|--------------|
| | | June 30, 2009 | | December 31, 2008 | |
| | Amount | % | Amount | % | |
| | (dollars are in millions) | | | | |
| | \$ | | | | |
| Individuals, partnerships and corporations | 96,785 | \$ 4,192 | 4.5% | \$ (1,848) | (1.9)% |
| Domestic and foreign banks | 13,502 | 2,344 | 21.0 | (2,974) | (18.1) |
| U.S. Government, states and political subdivisions | 4,121 | 203 | 5.2 | 1,171 | 39.7 |
| Foreign government and official institutions | 1,141 | <u>215</u> | <u>23.2</u> | <u>162</u> | <u>16.5</u> |
| | | | | \$ | |
| | \$ | \$ | | <u>(3,489)</u> | <u>(2.9)</u> |
| Total deposits | 115,549 | <u>6,954</u> | <u>6.4</u> |) |) |
| | \$ | \$ | | \$ | |
| Total core deposits(1) | 77,921 | <u>3,403</u> | <u>4.6</u> | <u>9,141</u> | <u>13.3</u> |
| | | | % | | % |

(1) We monitor “core deposits” as a key measure for assessing results of our core banking network. Core deposits generally include all domestic demand, money market and other savings accounts, as well as time deposits with balances not exceeding \$100,000.

Deposits continued to be a significant source of funding during the three months ended September 30, 2009. However, while total deposits increased 6.4 percent during the three months ended September 30, 2009 as compared to the prior quarter, total deposits decreased 2.9 percent as compared to December 31, 2008 as a result of the maturing of several large time deposits which were not renewed. The increase in deposits during the quarter reflects growth in individual and bank deposits including the impact from management actions to lower June 30, 2009 balances.

Deposits by foreign and domestic banks and financial institutions as well as foreign government and official institution deposits decreased significantly at June 30, 2009 but have now returned to more normalized levels at September 30, 2009. Given our overall liquidity position, we continue to manage down low margin wholesale deposits in order to maximize profitability. This decline was partially offset by growth in branch based savings products as well as the expansion of the core retail banking business and compared to the year-ago period, growth in the online savings product. Our relative liquidity strength has allowed us to lower rates to be in line with our competition on several low margin deposit products. Overall domestic deposits, which are the substantial source of our core liquidity, are significantly higher from December 31, 2008 and June 30, 2009.

We maintain a growth strategy for our core retail banking business, which includes building deposits and wealth management across multiple markets, channels and segments. This strategy includes various initiatives, such as:

- HSBC Premier, HSBC's global banking service which offers internationally minded customers unique international services seamlessly delivered through HSBC's global network coupled with a premium local service with a dedicated premier relationship manager. In the first nine months of 2009, Premier Investor savings has grown by \$1.7 billion to \$7.2 billion and Premier Checking has grown by \$900 million to \$3.5 billion;
- Internet based products, including Online Savings, Online Payment and Online Certificate of Deposit accounts. Since their introduction in 2005, Online Savings balances have grown to \$15.6 billion at September 30, 2009, of which \$1.1 billion was growth in the first nine months of 2009. Online certificates of deposit have decreased slightly during the first nine months of 2009 to \$838 million at September 30, 2009; and
- Retail branch expansion in existing and new geographic markets to largely support the needs of our internationally minded customers. During the first nine months in 2009, we opened 12 new branches.

On August 26, 2009, the FDIC announced that the Transaction Account Guarantee (the "TAG") portion of the Temporary Liquidity Guarantee Program would be extended to June 30, 2010. In connection with the extension, the fee payable to the FDIC under the TAG will be increased from 10 basis points on any deposit amounts exceeding the \$250,000 deposit insurance limit to 15, 20 or 25 basis points depending on the risk category assigned to institution under the FDIC's risk-based premium system. On November 2, 2009, HSBC Bank USA and its affiliated banks advised the FDIC of their election to opt out of the six-month extension of the TAG. Our participation in the TAG will continue under the current terms through December 31, 2009.

Short-Term Borrowings Increased retail deposits and transaction banking sweeps reduced the need for short-term borrowings during the first nine months of 2009. Balances for securities sold under repurchase agreements and precious metals borrowings continued to decrease during the first nine months of 2009.

Long-Term Debt Incremental borrowings from the \$40.0 billion HSBC Bank USA Global Bank Note Program were \$293 million during the first nine months of 2009. Total borrowings outstanding under this program were \$4.8 billion at September 30, 2009 and \$7.3 billion at December 31, 2008.

Incremental long-term debt borrowings from our shelf registration statement with the Securities and Exchange Commission totaled \$1.4 billion during the nine months ended September 30, 2009. There were no new securities issued during the first nine months of 2009 as part of the FDIC's Debt Guarantee Program. Total long-term debt borrowings outstanding under this shelf were \$6.9 billion and \$6.0 billion at September 30, 2009 and December 31, 2008, respectively.

We had borrowings from the Federal Home Loan Bank of New York ("FHLB") of \$1.0 billion and \$2.0 billion at September 30, 2009 and December 31, 2008, respectively. At September 30, 2009, we had access to an additional secured borrowing facility of \$2.6 billion from the FHLB.

In January 2009, as part of the purchase of the GM and UP Portfolio from HSBC Finance, we assumed \$6.1 billion of securities backed by credit card receivables which were accounted for as secured financings. Borrowings under these facilities totaled \$2.5 billion at September 30, 2009.

Beginning in 2005, we entered into a series of transactions with Variable Interest Entities ("VIEs") organized by HSBC affiliates and unrelated third parties. We are the primary beneficiary of these VIEs under the applicable accounting literature and, accordingly, we have consolidated the assets and debt of the VIEs. Debt obligations of the VIEs, which totaled \$3.0 billion and \$1.2 billion at September 30, 2009 and December 31, 2008, respectively, were included in long-term debt. See Note 17, "Special Purpose Entities," in the accompanying consolidated financial statements for

additional information regarding VIE arrangements.

Results of Operations

Net Interest Income An analysis of consolidated average balances and interest rates on a taxable equivalent basis is presented in this MD&A under the caption “Consolidated Average Balances and Interest Rates” in this Form 10-Q.

| | Three Months Ended | | Nine Months Ended | |
|---|----------------------|-------------|----------------------|-------------|
| | <u>September 30,</u> | | <u>September 30,</u> | |
| | <u>2009</u> | <u>2008</u> | <u>2009</u> | <u>2008</u> |
| Yield on total earning assets | 4.43% | 5.44% | 4.69% | 5.46% |
| Rate paid on interest bearing liabilities | <u>1.36</u> | <u>2.60</u> | <u>1.56</u> | <u>2.91</u> |
| Interest rate spread | <u>3.07</u> | 2.84 | <u>3.13</u> | 2.55 |
| Benefit from net non-interest earning or paying funds | <u>.24</u> | <u>.3</u> | <u>.2</u> | <u>.31</u> |
| Net interest margin to earning assets(1) | <u>3.31%</u> | 3.14% | <u>3.39%</u> | 2.86% |

(1) Selected financial ratios are defined in the Glossary of Terms in our 2008 Form 10-K.

Significant trends affecting the comparability of 2009 and 2008 net interest income and interest rate spread are summarized in the following table. Net interest income in the table is presented on a taxable equivalent basis.

| | Three Months Ended | | Nine Months Ended | |
|---|----------------------------------|----------------------|----------------------|----------------------|
| | <u>September 30,</u> | | <u>September 30,</u> | |
| | <u>2009</u> | <u>2009</u> | <u>2009</u> | <u>2009</u> |
| | <u>Amount</u> | <u>Interest Rate</u> | <u>Amount</u> | <u>Interest Rate</u> |
| | <u>Spread</u> | | <u>Spread</u> | |
| | <u>(dollars are in millions)</u> | | | |
| Net interest income/interest rate spread from prior year | \$ 1,176 | 2.84% | \$ 3,242 | 2.55% |
| Increase (decrease) in net interest income associated with: | | | | |
| Trading related activities | (55) | | (100) | |
| Balance sheet management activities(1) | (91) | | (124) | |
| Private label credit card portfolio | 57 | | 191 | |
| Credit card portfolio | 266 | | 816 | |
| Commercial loans | 6 | | 178 | |

| | | | | |
|---|----------|-------|----------|-------|
| Deposits | (53) | | (232) | |
| Other activity | (40) | | (68) | |
| Net interest income/interest rate spread for current year | \$ 1,266 | 3%.07 | \$ 3,903 | 3%.13 |

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

Trading Related Activities Net interest income for trading related activities decreased during the three and nine months ended September 30, 2009 primarily due to tightening spreads.

Balance Sheet Management Activities Lower net interest income from balance sheet management activities during the three and nine months ended September 30, 2009 was due primarily to the sale of securities and the re-investment into lower margin securities. This was partially offset by positions taken in expectation of decreasing short-term rates.

Private Label Credit Card Portfolio Net interest income on private label credit card receivables was higher during both periods as a result of lower funding costs and lower amortization of premiums on the initial purchase as well as lower daily premiums.

Credit Card Portfolios Higher net interest income on credit card receivables during both periods primarily reflects the impact of the purchase of the GM and UP Portfolios from HSBC Finance.

Commercial Loans Net interest income on commercial loans was higher during both periods primarily due to loan repricing as well as lower funding costs on these loans, partially offset by lower balances.

Deposits Lower interest income in both periods related to deposits is primarily due to spread compression on core banking activities in the PFS and CMB business segments. These segments have been affected by falling interest rates, growth in customer deposits in higher yielding deposit products, such as online savings and premier investor accounts, and an overall more competitive retail market.

Other Activity Lower net interest income from other activity during the three and nine months ended September 30, 2009 is related to lower residential mortgage loan balances which was partially offset by increased margins on consumer loans (other than credit card discussed above) due to lower funding costs as well as interest income on a portfolio of auto finance loans purchased in January 2009.

Provision for Credit Losses The provision for credit losses associated with various loan portfolios is summarized in the following table:

| <u>Three Months Ended September 30,</u> | <u>Increase/(Decrease)</u> | | | |
|---|----------------------------------|-------------|---------------|----------|
| | <u>2009</u> | <u>2008</u> | <u>Amount</u> | <u>%</u> |
| | <u>(dollars are in millions)</u> | | | |
| | | | \$ | \$ |
| Commercial | \$ 246 | 124 | 122 | 98%.4 |
| Consumer: | | | | |
| Residential mortgages, excluding HELOCs and home equity | 92 | 71 | 21 | 29.6 |
| HELOCs and home equity mortgages | 79 | 33 | 46 | 100+ |

| | | | | |
|-----------------------------------|-------|-----|------|--------|
| Private label card receivables | 272 | 345 | (73) | (21.1) |
| Credit card receivables | 275 | 58 | 217 | 100+ |
| Auto Finance | 20 | 2 | 18 | 100+ |
| Other consumer | 22 | 25 | (3) | (12).0 |
| Total consumer | 760 | 534 | 226 | 42.3 |
| | \$ | \$ | \$ | |
| Total provision for credit losses | 1,006 | 658 | 348 | 52%.9 |

| <u>Nine Months Ended September 30,</u> | <u>Increase/(Decrease)</u> | | | |
|---|----------------------------|-------------|---------------|----------|
| | <u>2009</u> | <u>2008</u> | <u>Amount</u> | <u>%</u> |
| | (dollars are in millions) | | | |
| Commercial | \$ 560 | \$ 265 | \$ 295 | 100+% |
| Consumer: | | | | |
| Residential mortgages, excluding HELOCs and home equity | 351 | 164 | 187 | 100+ |
| HELOCs and home equity mortgages | 166 | 181 | (15) | (8.3) |
| Private label card receivables | 981 | 929 | 52 | 5.6 |
| Credit card receivables | 1,034 | 153 | 881 | 100+ |
| Auto Finance | 85 | 2 | 83 | 100+ |
| Other consumer | 70 | 68 | 2 | 2.9 |
| Total consumer | 2,687 | 1,497 | 1,190 | 79.5 |
| | \$ | \$ | \$ | |
| Total provision for credit losses | 3,247 | 1,762 | 1,485 | 84%.3 |

Commercial loan provision for credit losses increased for the three and nine months ended September 30, 2009 as compared with the year-ago periods. Provisions on commercial real estate, middle market and corporate banking portfolios increased as a result of higher loss estimates due to higher criticized asset levels reflecting customer downgrades in financial institutions and certain other counterparties due to deteriorating economic conditions. Increased provision in our commercial real estate portfolio was largely due to condominium loans and land loans in the condominium construction market in South Florida and California, as well as in hotel and office construction in all markets, especially in the large metropolitan markets where construction projects have been delayed. Although our middle market portfolio has deteriorated in most industry segments and geographies, consistent with the overall deterioration in the U.S. economy, customers in those areas of the economy that have experienced above average weakness such as apparel, auto related suppliers and construction related businesses have been particularly affected. Commercial loan provision also increased as a result of a specific provision relating to a single client relationship recorded in the third quarter of 2009.

Provision for credit losses on residential mortgages increased \$67 million during the three months ended September 30, 2009 and \$172 million during the nine months ended September 30, 2009 as compared with the year-ago periods. The increase in both periods was attributable to increased delinquencies within the prime residential first mortgage loan portfolio and, in the three month period, higher loss estimates in our HELOC portfolio due primarily to the continued deterioration in real estate values in certain markets.

Provision for credit losses associated with private label and other credit card receivables collectively increased \$144 million during the three months ended September 30, 2009 and increased \$933 million during the nine months ended September 30, 2009 as compared with the year-ago periods. Provision associated with credit card receivables was significantly impacted by the purchase of the GM and UP Portfolios as previously discussed. Excluding these portfolios, provision expense remained higher in the year-to-date period, primarily from higher delinquencies and

charge offs within the private label and co-brand credit card portfolios due to higher levels of personal bankruptcy filings and the impact from a weakened U.S. economy, partially offset by lower receivable levels. Excluding the aforementioned GM and UP Portfolios, provision expense for credit cards including private label credit cards declined during the three month period, driven by a lower provision for credit losses for private label card receivables due to lower receivable levels and an improved outlook on future loss estimates as the impact of higher unemployment levels on losses has not been as severe as previously anticipated, partially offset by slightly higher delinquency levels.

Provision expense associated with our auto finance portfolio increased mainly due to the acquisition of the \$3 billion auto finance loan portfolio from HSBC Finance in January 2009.

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

| <u>Three Months Ended September 30,</u> | | | Increase | |
|--|---------------------------|-------------|-----------------|----------|
| | <u>2009</u> | <u>2008</u> | <u>Amount</u> | <u>%</u> |
| | (dollars are in millions) | | | |
| | \$ | | \$ | |
| Credit card fees | 333 | \$ 215 | 118 | 54.9% |
| Other fees and commissions | 201 | 192 | 9 | 4.7 |
| Trust income | 30 | 44 | (14) | (31.8) |
| Trading revenue (loss) | 353 | (122) | 475 | 100+ |
| Net other-than-temporary impairment losses | (26) | (180) | 154 | 85.6 |
| Other securities gains (losses), net | 5 | 2 | 3 | 100+ |
| HSBC affiliate income: | | | | |
| Fees and commissions | 22 | 25 | (3) | (12.0) |
| Other affiliate income | 2 | 5 | (3) | (60.0) |
| | 24 | 30 | (6) | (20.0) |
| Residential mortgage banking revenue(1) | 15 | 13 | 2 | 15.4 |
| Gain (loss) on instruments designated at fair value and related derivatives(2) | 44 | 111 | (67) | (60.4) |
| Other income (loss): | | | | |
| Valuation of loans held for sale | (40) | (95) | 55 | 57.9 |
| Insurance | 6 | 11 | (5) | (45.5) |
| Earnings from equity investments | 5 | 11 | (6) | (54.5) |
| Miscellaneous income | (55) | 38 | (93) | (100+) |
| | (84) | (35) | (49) | (100+) |
| | \$ | | \$ | |
| Total other revenues | 895 | \$ 270 | 625 | 100+% |

| <u>Nine Months Ended September 30,</u> | | | Increase | |
|--|---------------------------|-------------|-----------------|----------|
| | <u>2009</u> | <u>2008</u> | <u>Amount</u> | <u>%</u> |
| | (dollars are in millions) | | | |
| | \$ | | | |
| Credit card fees | 1,032 | \$ 653 | \$ 379 | 58.0% |
| Other fees and commissions | 652 | 539 | 113 | 21.0 |

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| | | | | |
|--|--------------|--------------|--------------|---------------|
| Trust income | 92 | 114 | (22) | (19.3) |
| Trading revenue (loss) | 351 | (947) | 1,298 | 100+ |
| Net other-than-temporary impairment losses | (84) | (204) | 120 | 58.8 |
| Other securities gains (losses), net | 299 | 76 | 223 | 100+ |
| HSBC affiliate income: | | | | |
| Fees and commissions | 85 | 95 | (10) | (10.5) |
| Other affiliate income | 10 | 14 | (4) | (28).6 |
| | 95 | 109 | (14) | (12.8) |
| Residential mortgage banking revenue(1) | 139 | 64 | 75 | (100+) |
| Gain (loss) on instruments designated at fair value and related derivatives(2) | (201) | 121 | (322) | (100+) |
| Other income (loss): | | | | |
| Valuation of loans held for sale | (195) | (339) | 144 | 42.5 |
| Insurance | 19 | 29 | (10) | (34.5) |
| Earnings from equity investments | 25 | 49 | (24) | (49.0) |
| Miscellaneous income | (3) | 70 | (73) | (100+) |
| | (154) | (191) | 37 | 19.4 |
| | \$ | | \$ | |
| Total other revenues | 2,221 | \$ 334 | 1,887 | 100+% |

- (1) Includes Servicing fees received from HSBC Finance Corporation of \$3 million during the three months ended September 30, 2009 and September 30, 2008 and \$10 million for the nine months ended September 30, 2009 and September 30, 2008.
- (2) Includes gains and losses associated with financial instruments elected to be measured at fair value under fair value option accounting principles, and the associated economically hedging derivatives. See Note 11, "Fair Value Option," in the accompanying consolidated financial statements for additional information.

Credit Card Fees Higher credit card fees during the three and nine months ended September 30, 2009 were due primarily to substantially higher outstanding credit card balances due to the purchase of the GM and UP Portfolios as previously discussed. Also contributing to the increase are higher late fees on private label cards due to increased delinquency levels partially offset by higher fee charge-offs due to increased loan defaults.

Other Fees and Commissions Other fee-based income increased during the three and nine months ended September 30, 2009 due to higher customer referral fees, commercial loan commitment fees, loan syndication fees and fees generated by the Payments and Cash Management business.

Trust Income Trust income declined in both periods primarily due to lower domestic custody fees from lower assets under management and margin pressures as money market assets have shifted from higher fee asset classes to lower fee institutional class funds.

Trading Revenue (Loss) is generated by participation in the foreign exchange, rates, credit and precious metals markets.

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

| <u>Three Months Ended September 30,</u> | | | Increase | |
|---|---------------------------|-------------|-----------------|---------------|
| | <u>2009</u> | <u>2008</u> | <u>Amount</u> | <u>%</u> |
| | (dollars are in millions) | | | |
| | \$ | \$ | \$ | |
| Trading revenue (loss) | 353 | (122) | 475 | 100+% |
| Net interest income | <u>34</u> | <u>89</u> | <u>(55)</u> | <u>(62)</u> |
| | \$ | | \$ | |
| Trading related revenue (loss) | 387 | \$ (33) | 420 | 100+ |
| Business: | | | \$ | |
| Derivatives | \$ 86 | \$ (40) | 126 | 100+ |
| Balance sheet management | 18 | (83) | 101 | 100+ |
| Foreign exchange and banknotes | 98 | 130 | (32) | (25.0) |
| Precious metals | 3 | 1 | 2 | 100+ |
| Global banking | 185 | (46) | 231 | 100+ |
| Other trading | <u>(3)</u> | <u>5</u> | <u>(8)</u> | <u>(100+)</u> |
| | \$ | | \$ | |
| Trading related revenue (loss) | 387 | \$ (33) | 420 | 100+% |

| <u>Nine Months Ended September 30,</u> | | | Increase | |
|--|---------------------------|-------------|-----------------|---------------|
| | <u>2009</u> | <u>2008</u> | <u>Amount</u> | <u>%</u> |
| | (dollars are in millions) | | | |
| Trading revenue (loss) | \$ 351 | \$ | \$ | 100+% |
| | | (947) | 1,298 | |
| Net interest income | <u>76</u> | <u>176</u> | <u>(100)</u> | <u>(57)</u> |
| Trading related revenue (loss) | \$ 427 | \$ | \$ | 100+ |
| | | (771) | 1,198 | |
| Business: | | | | |
| Derivatives | \$ | \$ | \$ 678 | 75 |
| | (224) | (902) | | |
| Balance sheet management | 32 | (213) | 245 | 100+ |
| Foreign exchange and banknotes | 307 | 337 | (30) | (9) |
| Precious metals | 36 | 44 | (8) | (18) |
| Global banking | 279 | (46) | 325 | 100+ |
| Other trading | <u>(3)</u> | <u>9</u> | <u>(12)</u> | <u>(100+)</u> |
| | \$ | | \$ | |
| Trading related revenue (loss) | \$ 427 | \$ | \$ | 100+% |
| | | (771) | 1,198 | |

Trading revenue (loss) during the three and nine months ended September 30, 2009 continued to be affected by reduced liquidity and volatility in the credit markets although the magnitude of such impacts was not as severe when compared to the year-ago periods and in the third quarter of 2009, has begun to reverse in some cases. While liquidity has improved during the quarter ended September 30, 2009, it continues to be lower than in previous years.

Trading revenue related to derivatives improved significantly during the three and nine months ended September 30, 2009. Structured credit products totaled gains of \$92 million and losses of \$286 million during the three and nine months ended September 30, 2009, respectively, as compared to losses of \$37 million and \$1.1 billion in the year-ago periods. The performance of credit derivatives with monolines improved in the third quarter of 2009 due to a combination of tighter credit spreads, improved credit risk on certain monolines and reserve releases from the early termination of several exposures. Consequently, a positive valuation adjustment of \$54 million was recorded for the three months ended September 30, 2009, compared to an increase in provisions of \$155 million in the year ago period. Provisions recorded for monolines resulted in a negative valuation adjustment of \$104 million, compared to an increase in provisions of \$957 million during the nine months ended September 30, 2009 and 2008, respectively. Partially offsetting the above noted improvements were lower results than the year ago period due to the sale of MasterCard B shares during the second quarter of 2008, which resulted in gains of \$134 million.

Trading income related to balance sheet management activities improved to \$18 million and \$32 million during the three and nine months ended September 30, 2009, respectively, as compared to losses of \$83 million and \$213 million in the year-ago periods, primarily due to improved trends in credit spreads on asset backed securities held for trading purposes in both periods and, in the nine-month period, increased sales of mortgage backed and other asset backed securities held for trading purposes.

Foreign exchange and Banknotes revenue declined in both the three and nine month periods ended September 30, 2009, as compared to the year ago periods, primarily due to a reduction in currency arbitrage opportunities in Banknotes and narrower trading spreads in Foreign Exchange.

Precious metals revenue declined in the three and nine months ended September 30, 2009 primarily due to lower volumes of trading activity.

Global banking revenue increased in the three and nine months ended September 30, 2009 primarily due to increased values on corporate bonds. Other trading losses in the three and nine month periods ended September 30, 2008 reflect losses on corporate bonds which was attributable to increased credit risk on those bonds.

Net Other-Than-Temporary Impairment Losses During the nine months ended September 30, 2009, 18 debt securities were determined to be other-than-temporarily impaired (of which six were identified in the third quarter of 2009), in accordance with the recently issued accounting guidance related to the recognition and presentation of other-than-temporary impairments on debt securities. Accordingly, only the credit loss component is shown in earnings effective January 1, 2009. The following table presents the various components of other-than-temporary impairment.

| <u>Three Months Ended September 30,</u> | <u>2009 2008</u> | |
|---|-------------------------|-------|
| | (in millions) | |
| | \$ | |
| Total other-than-temporary impairment losses | \$ (28) | (180) |
| Portion of loss recognized in other comprehensive income (loss), before taxes | <u>2</u> | = |
| Net other-than-temporary impairment losses | | \$ |
| recognized in consolidated statement of income (loss) | \$ (26) | (180) |

| <u>Nine Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> |
|--|----------------------|--------------------|
| | (in millions) | |
| | \$ | \$ |
| Total other-than-temporary impairment losses | (188) | (204) |
| Portion of loss recognized in other comprehensive income (loss), before taxes | <u>104</u> | = |
| Net other-than-temporary impairment losses recognized in consolidated statement of income (loss) | \$ (84) | (204) |

Other Securities Gains, Net We maintain various securities portfolios as part of our balance sheet diversification, liquidity management and risk management strategies. The following table summarizes the net other securities gains (losses) resulting from various strategies.

| <u>Three Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> |
|--|----------------------|--------------------|
| | (in millions) | |
| | \$ | \$ |
| Securities available for sale | <u>5</u> | <u>2</u> |
| Other securities gains (losses), net | <u>\$ 5</u> | <u>\$ 2</u> |

| <u>Nine Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> |
|---|----------------------|--------------------|
| | (in millions) | |
| | \$ | \$ |
| Sale of MasterCard or Visa Class B Shares | \$ 48 | 83 |
| Securities available for sale | <u>251</u> | <u>(7)</u> |
| Other securities gains (losses), net | \$ 299 | 76 |

During the second quarter of 2009, we sold \$10.8 billion of mortgage backed and other asset backed securities as part of a strategy to reduce prepayment risk as well as risk-weighted asset levels and recognized a gain of \$236 million, which is included as a component of other security gains, net above.

HSBC Affiliate Income Affiliate fees and commissions were lower during the three and nine month periods ended September 30, 2009 largely due to lower net sales credits received from affiliates for customer referrals and, in the nine month period, lower gains on tax refund anticipation loans due to lower origination volumes.

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

| <u>Three Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> | <u>Increase</u> | |
|--|-------------|-------------|---------------------------|---------------|
| | | | <u>Amount</u> | <u>%</u> |
| | | | <u>(Decrease)</u> | |
| | | | (dollars are in millions) | |
| Net interest income | \$ 55 | \$ 63 | \$ (8) | (12.7)% |
| Servicing related income: | | | | |
| Servicing fee income | 33 | 34 | (1) | (2.9) |
| Changes in fair value of MSR due to: | | | | |
| Changes in valuation inputs or assumptions used in valuation model | (54) | (39) | (15) | (38.5) |
| Realization of cash flows | (8) | (16) | 8 | 50.0 |
| Trading — Derivative instruments used to offset changes in value of MSRs | <u>59</u> | <u>36</u> | <u>23</u> | <u>63.9</u> |
| | <u>30</u> | <u>15</u> | <u>15</u> | <u>100.0</u> |
| Originations and sales related income: | | | | |
| Gains on sales of residential mortgages | (7) | (6) | (1) | (16.7) |
| Trading and hedging activity | <u>(13)</u> | = | <u>(13)</u> | <u>(100+)</u> |
| | <u>(20)</u> | <u>(6)</u> | <u>(14)</u> | <u>(100+)</u> |
| Other mortgage income | <u>5</u> | <u>4</u> | <u>1</u> | <u>25.0</u> |
| Total residential mortgage banking revenue included in other revenues | <u>15</u> | <u>13</u> | <u>2</u> | <u>15.4</u> |
| Total residential mortgage banking related revenue | \$ 70 | \$ 76 | \$ (6) | (7.9) |
| | \$ | \$ | \$ | |
| Average residential mortgage loans | 17,312 | 26,788 | (9,476) | (35)% .4 |

| <u>Nine Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> | <u>Increase</u> | |
|--|-------------|-------------|---------------------------|---------------|
| | | | <u>Amount</u> | <u>%</u> |
| | | | <u>(Decrease)</u> | |
| | | | (dollars are in millions) | |
| Net interest income | \$ 190 | \$ 188 | \$ 2 | 1.1% |
| Servicing related income: | | | | |
| Servicing fee income | 99 | 96 | 3 | 3.1 |
| Changes in fair value of MSR due to: | | | | |
| Changes in valuation inputs or assumptions used in valuation model | 6 | (14) | 20 | 100+ |
| Realization of cash flows | (32) | (66) | 34 | 51.5 |
| Trading — Derivative instruments used to offset changes in value of MSRs | <u>(4)</u> | <u>6</u> | <u>(10)</u> | <u>(100+)</u> |
| | <u>69</u> | <u>22</u> | <u>47</u> | <u>(100+)</u> |
| Originations and sales related income: | | | | |
| Gains on sales of residential mortgages | 53 | 29 | 24 | 82.8 |
| Trading and hedging activity | <u>3</u> | = | <u>3</u> | <u>100+</u> |

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| | | | | |
|---|------------|-----------|-----------|-------------|
| | <u>56</u> | <u>29</u> | <u>27</u> | <u>93.1</u> |
| Other mortgage income | <u>14</u> | <u>13</u> | <u>1</u> | <u>7.7</u> |
| Total residential mortgage banking revenue included in other revenues | <u>139</u> | <u>64</u> | <u>75</u> | <u>100+</u> |
| Total residential mortgage banking related revenue | \$ 329 | \$ 252 | \$ 77 | 30.6 |
| | \$ | \$ | \$ | |
| Average residential mortgage loans(1) | 19,529 | 28,271 | (8,742) | (30)% .9 |

(1) Represents the average of mortgages originated by our mortgage subsidiary and held in portfolio, as well as mortgages purchased from HSBC Finance in 2003 and 2004.

Lower net interest income during the three months ended September 30, 2009 compared to the year-ago period is primarily due to lower loan balances in 2009, partially offset by reduced funding costs. For the nine month period, net interest income increased as the lower interest income due to lower loan balances was more than offset by reduced funding costs. Reduced funding costs had a bigger impact during the nine month period as our cost of funds was much higher in the third quarter of 2009 as compared to the year-to-date period due to increased short term funding costs. We have continued to sell the majority of new loan originations to government sponsored enterprises and private investors and allow existing loans to runoff.

Servicing related income increased in both periods, resulting from a higher average serviced loan portfolio and better net hedged MSR performance, partially offset in the three month period by higher payments owed to government sponsored enterprises as prepayments increased significantly during this period. We have continued to sell the majority of new loan originations to government sponsored enterprises, but continue to retain servicing rights for the loans sold. The average serviced loans portfolio increased approximately 13 percent since September 30, 2008.

Originations and sales related income decreased during the three months ended September 30, 2009 as compared to the year-ago period due an increase in our reserve for potential repurchase liability exposure. Originations and sales related income increased during the nine month period due primarily to higher loan sales. Loan sales in the nine months ended September 30, 2009 of \$4.0 billion, resulted in a gain of \$67 million as compared with loan sales in the nine months ended September 30, 2008 of \$5.0 billion which resulted in a gain of \$9 million.

Gain (loss) on Instruments Designated at Fair Value and Related Derivatives We have elected to apply the fair value option to commercial leveraged acquisition finance loans, unfunded commitments, certain own fixed-rate debt issuances and all structured notes and structured deposits issued after January 1, 2006 that contain embedded derivatives. We also use derivatives to economically hedge the interest rate risk associated with certain financial instruments for which fair value has been elected. See Note 11, "Fair Value Option," in the accompanying consolidated financial statements for additional information including a breakout of these amounts by individual component.

Valuation of Loans Held for Sale Continued deterioration in the U.S. mortgage markets have resulted in negative valuation adjustments on loans held for sale during the three and nine months ended September 30, 2009 although the severity of the valuation adjustments has improved as compared to the year-ago periods. Valuations on loans held for sale relate primarily to residential mortgage loans purchased from third parties and HSBC affiliates with the intent of securitization or sale. Included in this portfolio are sub-prime residential mortgage loans with a fair value of \$855 million as of September 30, 2009. Loans held for sale are recorded at the lower of their aggregate cost or market value, with adjustments to market value being recorded as a valuation allowance. Overall weakness and illiquidity in the U.S. residential mortgage market and continued delinquencies, particularly in the sub-prime market, resulted in

valuation adjustments totaling \$28 million and \$182 million being recorded on these loans during the three and nine months ended September 30, 2009, respectively, as compared with \$87 million and \$331 million during the year-ago periods. Valuations on residential mortgage loans we originate are recorded as a component of residential mortgage banking revenue in the consolidated statement of income (loss).

In addition, we recorded valuation adjustments on education loans held for sale of \$13 million for both the three and nine months ended September 30, 2009, respectively, as compared to \$8 million for both year ago periods.

Other Income (Loss) Excluding the valuation of loans held for sale as discussed above, other income decreased during both periods due to lower valuations on credit default swaps used to economically hedge credit exposures, combined with lower equity investment income. These decreases were partially offset in the nine month period by an \$85 million gain related to a judgment whose proceeds were used to redeem 100 preferred shares issued to CT Financial Services, Inc.

The obligation to redeem the preferred shares upon our receipt of the proceeds from the judgment represented a contractual arrangement established in connection with our purchase of a community bank from CT Financial Services Inc. in 1997 at which time this litigation remained outstanding. The \$85 million we received, net of applicable taxes, was remitted in April to Toronto Dominion, who now holds beneficial ownership interest in CT Financial Services Inc., and the preferred shares were redeemed.

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

| <u>Three Months Ended</u> <u>September 30,</u> | <u>2009</u> | <u>2008</u> | <u>Increase</u> | |
|---|-------------|-------------|------------------------------------|---------------|
| | | | <u>(Decrease)</u> <u>Amount</u> | <u>%</u> |
| (dollars are in millions) | | | | |
| Salaries and employee benefits: | | | | |
| Salaries | \$ 156 | \$ 181 | \$ (25) | (13.8)% |
| Employee benefits | <u>124</u> | <u>148</u> | <u>(24)</u> | <u>(16).2</u> |
| Total salaries and employee benefits | 280 | 329 | (49) | (14.9) |
| Occupancy expense, net | 59 | 72 | (13) | (18.1) |
| Support services from HSBC affiliates: | | | | |
| Fees paid to HSBC Finance for loan servicing and other administrative support | 175 | 116 | 59 | 50.9 |
| Fees paid to HMUS | 50 | 54 | (4) | (7.4) |
| Fees paid to HTSU | 106 | 61 | 45 | 73.8 |
| Fees paid to other HSBC affiliates | <u>56</u> | <u>69</u> | <u>(13)</u> | <u>(18).8</u> |
| Total support services from HSBC affiliates | 387 | 300 | 87 | 29.0 |
| Other expenses: | | | | |
| Equipment and software | 11 | 11 | - | - |
| Marketing | 28 | 34 | (6) | (17.6) |
| Outside services | 26 | 35 | (9) | (25.7) |

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| | | | | |
|---------------------------------------|---------------|------------|----------------|----------------|
| Professional fees | 20 | 16 | 4 | 25.0 |
| Telecommunications | 4 | 5 | (1) | (20.0) |
| Postage, printing and office supplies | 4 | 9 | (5) | (55.6) |
| Off-balance sheet credit reserves | 1 | (5) | 6 | 100+ |
| FDIC assessment fee | 26 | 20 | 6 | 30.0 |
| Goodwill impairment(1) | - | 54 | (54) | (100+) |
| Insurance business | 4 | 5 | (1) | (20.0) |
| Miscellaneous | 69 | 84 | (15) | (17).9 |
| Total other expenses | 193 | 268 | (75) | (28).0 |
| Total operating expenses | \$ 919 | \$ 969 | (50) | (5)% .2 |
| Personnel – average number | 9,557 | 11,743 | (2,186) | (18.6) |
| Efficiency ratio | 42.64% | 67.32% | | |

| <u>Nine Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> | <u>Increase</u> | |
|---|---------------|-------------|----------------------------------|----------------|
| | | | <u>Amount</u> | <u>%</u> |
| | | | <u>(Decrease)</u> | |
| | | | <u>(dollars are in millions)</u> | |
| Salaries and employee benefits: | | | | |
| Salaries | \$ 464 | \$ 540 | \$ (76) | (14.1)% |
| Employee benefits | 409 | <u>431</u> | (22) | (5).1 |
| Total salaries and employee benefits | 873 | 971 | (98) | (10.1) |
| Occupancy expense, net | 211 | 201 | 10 | 5.0 |
| Support services from HSBC affiliates: | | | | |
| Fees paid to HSBC Finance for loan servicing and other administrative support | 548 | 353 | 195 | 55.2 |
| Fees paid to HMUS | 187 | 166 | 21 | 12.7 |
| Fees paid to HTSU | 353 | 187 | 166 | 88.8 |
| Fees paid to other HSBC affiliates | 140 | <u>185</u> | (45) | (24).3 |
| Total support services from HSBC affiliates | 1,228 | 891 | 337 | 37.8 |
| Other expenses: | | | | |
| Equipment and software | 31 | 33 | (2) | (6.1) |
| Marketing | 95 | 108 | (13) | (12.0) |
| Outside services | 70 | 89 | (19) | (21.3) |
| Professional fees | 54 | 53 | 1 | 1.9 |
| Telecommunications | 12 | 14 | (2) | (14.3) |
| Postage, printing and office supplies | 11 | 27 | (16) | (59.3) |
| Off-balance sheet credit reserves | (1) | 49 | (50) | (100+) |
| FDIC assessment fee | 177 | 34 | 143 | 100+ |
| Goodwill impairment(1) | - | 54 | (54) | (100+) |
| Insurance business | 47 | 12 | 35 | 100+ |
| Miscellaneous | 172 | <u>178</u> | (6) | (3).4 |
| Total other expenses | 668 | <u>651</u> | 17 | 2.6 |
| | \$ | \$ | | |
| Total operating expenses | 2,980 | 2,714 | \$ 266 | 9%.8 |
| Personnel – average number | 9,734 | 11,805 | (2,071) | (17.5) |

| | | |
|------------------|---------------|--------|
| Efficiency ratio | 48.80% | 76.35% |
|------------------|---------------|--------|

- (1) Represents the entire amount of goodwill allocated to the residential mortgage banking reporting unit.

Salaries and Employee Benefits Lower salaries and employee benefits expense during the three and nine months ended September 30, 2009 as compared to the year-ago periods is mainly due to the transfer of support services employees, as described below, to an affiliate as well as continued cost management efforts which have resulted in lower headcount including the impact of global resourcing initiatives undertaken by management.

Occupancy Expense, Net Excluding the impact in the nine month period of an impairment of a data center building held for use of \$20 million as part of our ongoing strategy to consolidate operations and improve efficiencies, occupancy expense declined in both periods due to the transfer of shared services employees and their related workspace expenses to an affiliate as discussed below. This was partially offset by higher occupancy expense due to the expansion of the core banking and commercial lending networks within the PFS and CMB business segments, a key component of recent business expansion initiatives. Subsequent to September 30, 2008, we opened 13 new branches resulting in higher rental expenses, depreciation of leasehold improvements, utilities and other occupancy expenses.

Support services from HSBC affiliates includes technology and some centralized operational services and beginning in January 2009, human resources, corporate affairs and other shared services charged to us by HTSU, which has resulted in a significant increase in fees paid to HTSU in 2009. Support services from HSBC affiliates also includes services charged to us by an HSBC affiliate located outside of the United States which provides operational support to our businesses, including among other areas, customer service, systems, collection and accounting functions.

Higher expenses in both periods is also due to higher servicing fees paid to HSBC Finance largely as a result of the purchase of the GM and UP Portfolios as well as certain auto finance loans purchased from HSBC Finance in early January 2009 and higher fees paid to HTSU. Support services from HSBC affiliates also includes servicing fees paid to HSBC Finance for servicing private label credit card receivables and certain other credit card and nonconforming residential mortgage loans.

Marketing Expenses Lower marketing and promotional expenses in both periods resulted from optimizing marketing spend as a result of general cost saving initiatives. This was partially offset by a continuing investment in HSBC brand activities, promotion of the internet savings account and marketing support for branch expansion initiatives, primarily within the PFS business segment.

Other Expenses Other expenses decreased during the three months ended September 30, 2009 primarily due to \$54 million of goodwill impairment recorded in 2008 and lower miscellaneous expenses. Other expenses increased during the nine months ended September 30, 2009 primarily due to higher FDIC assessment fees, including \$82 million relating to a special assessment recorded in the second quarter of 2009 and higher corporate insurance costs, partially offset by a release of off balance sheet credit reserves related to an advance by a large corporate customer and lower goodwill impairment as discussed above.

Efficiency Ratio Our efficiency ratio, which is the ratio of total operating expenses, reduced by minority interests, to the sum of net interest income and other revenues, was 42.64 percent and 48.80 percent for the three and nine months ended September 30, 2009, respectively, as compared to 67.32 percent and 76.35 percent in the year-ago periods. The improvement in the efficiency ratio in both periods resulted primarily from an increase in other revenues and net

interest income.

Segment Results – IFRSs Basis

We have five distinct segments that are utilized for management reporting and analysis purposes. The segments, which are based upon customer groupings as well as products and services offered, are described under Item 1, “Business” in our 2008 Form 10-K. There have been no changes in the basis of segmentation or measurement of segment profit (loss) as compared with the presentation in our 2008 Form 10-K.

Our segment results are presented on an IFRSs Basis (a non-U.S. GAAP financial measure) as operating results are monitored and reviewed, trends are evaluated and decisions about allocating resources such as employees are made almost exclusively on an IFRSs basis since we report to our parent, HSBC, who prepares its consolidated financial statements in accordance with IFRSs. However, we continue to monitor capital adequacy, establish dividend policy and report to regulatory agencies on a U.S. GAAP basis. The significant differences between U.S. GAAP and IFRSs as they impact our results are summarized in Note 15, “Business Segments,” in the accompanying consolidated financial statements and under the caption “Basis of Reporting” in the MD&A section of this Form 10-Q.

Personal Financial Services (“PFS”)

Resources continued to be directed towards expansion of the core retail banking business, in particular, the growth of HSBC Premier, HSBC’s global banking service which offers customers a seamless international service as well as expansion of the branch network in existing and new geographic markets with international connectivity and investment in the HSBC brand. As a result, at September 30, 2009, total personal deposits increased 7.3 percent as compared to a year ago and total Premier customers increased to 327,000, a 41 percent increase from a year ago.

We continue to sell the majority of new residential mortgage loan originations to government sponsored enterprises and to allow the existing on balance sheet portfolio to run-off. In addition to normal sale activity, during the first half of 2009, we sold approximately \$4.0 billion of prime adjustable and fixed rate residential mortgage loans. Since September 30, 2008, we have sold approximately \$6.0 billion of such loans. We retained the servicing rights in relation to the mortgages upon sale. As a result, average residential mortgage loans at September 30, 2009 decreased approximately 35 percent as compared to September 30, 2008.

In November 2008, we announced that we would exit the wholesale/correspondent and time-share origination channels of our mortgage business and focus attention, resources and investment on our retail sales channel. In the second quarter of 2008, we discontinued originations of education loans and, accordingly, the portfolio of loans has continued to runoff.

U.S. Treasury sponsored programs in the mortgage lending environment have recently been introduced which are focused on reducing the number of foreclosures and potentially making it easier for some customers to refinance loans. One such program intends to help certain at-risk homeowners avoid foreclosure by reducing monthly mortgage payments. This program provides certain incentives to lenders to modify all eligible loans that fall under the guidelines of the program. Another program focuses on homeowners who have a proven payment history on an existing mortgage owned by Fannie Mae or Freddie Mac and provides assistance to eligible homeowners to refinance their mortgage loans to take advantage of current lower mortgage rates or to refinance adjustable rate mortgages into more stable fixed rate mortgages. We have implemented such programs for mortgage loans we service for government sponsored enterprises. We continue to evaluate our consumer relief programs and account management practices to ensure our programs benefit our customers in accordance with their financial needs and our stakeholders as the economy recovers. As a result, to date we have elected not to participate in the U.S. Treasury sponsored programs for our loan portfolios but to focus on expanding and improving our current programs.

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

| <u>Three Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> | <u>Increase (Decrease)</u> | |
|---|---------------------------|--------------|--------------------------------|---------------|
| | | | <u>Amount</u> | <u>%</u> |
| | (dollars are in millions) | | | |
| Net interest income | \$ 201 | | \$ 18.4 | |
| | 238 | | 37 | |
| Other operating income | <u>88</u> | <u>105</u> | <u>(17)</u> | <u>(16.2)</u> |
| | | |) |) |
| Total operating income | 326 | 306 | 20 | 6.5 |
| Loan impairment charges | <u>178</u> | <u>104</u> | <u>74</u> | <u>71.2</u> |
| | 148 | 202 | (54) | (26.7) |
| Operating expenses | <u>306</u> | <u>417</u> | <u>(111)</u> | <u>(26.6)</u> |
| | | |) |) |
| Loss before tax | \$ | \$ | \$ <u>26.5</u> | |
| | (158) | (215) | 57 | |
| |) |) | | |

| <u>Nine Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> | <u>Increase (Decrease)</u> | |
|--|---------------------------|--------------|--------------------------------|---------------|
| | | | <u>Amount</u> | <u>%</u> |
| | (dollars are in millions) | | | |
| Net interest income | \$ 685 | | \$ (2.9) | |
| | 665 | | (20) | |
| Other operating income | <u>171</u> | <u>405</u> | <u>(234)</u> | <u>(57.8)</u> |
| | | |) |) |
| Total operating income | 836 | 1,090 | (254) | (23.3) |
| Loan impairment charges | <u>550</u> | <u>349</u> | <u>201</u> | <u>57.6</u> |
| | 286 | 741 | (455) | (61.4) |
| Operating expenses | <u>936</u> | <u>1,020</u> | <u>(84)</u> | <u>(8.2)</u> |
| | | |) |) |
| Loss before tax | \$ | \$ | \$ <u>(100+</u> | |
| | (650) | (279) | (371) | |
| |) |) |) | |

Net interest income improved during the three months ended September 30, 2009 primarily due to reductions in customer rates on several key deposit products driven by more aggressive pricing as competitive pricing pressures on savings and certificate of deposit products eased in the quarter. This was partially offset by lower levels of mortgage loans outstanding as discussed below. In the nine month period, net interest income decreased primarily due to lower levels of mortgage loans outstanding driven by mortgage loan sales of approximately \$6.0 billion since September 30, 2008 and the narrowing of deposit spreads driven by competitive pricing pressures and declines in market rates. This was partially offset by lower funding costs on the loans held for sale, widening spreads on the remaining adjustable rate portfolio and lower amortization of deferred origination costs. Additionally, there were widening interest rate spreads on credit card balances due to reduced funding costs in the lower short term rate environment.

Other operating income decreased in both the three and nine month periods ending September 30, 2009 primarily due to lower personal service charges, ATM and other fees, as well as a reclassification of loyalty program expenses for cards as a reduction to revenue beginning in 2009. Also contributing to lower other operating income in the year-to-date period was higher mortgage reinsurance costs and break funding charges from the Global Banking and Markets segment of \$163 million in the nine month period relating to costs associated with early termination of the funding associated with residential mortgage loan sales compared with a similar charge of \$14 million and \$45 million during the three and nine months ended September 30, 2008, respectively. These charges were partially offset by net gains on the sales of these residential mortgage loans of \$70 million during the nine months ended September 30, 2009, compared to a loss of \$4 million and gain of \$12 million, respectively, during the three and nine months ended September 30, 2008. Additionally, the nine month period ended September 30, 2008 benefited from an \$83 million gain on the sale of Visa Class B shares recorded in the first quarter of 2008.

Deterioration in credit quality, particularly on prime residential mortgage loans and credit cards has negatively impacted results. Higher loan impairment charges in both periods were driven by an increase in delinquencies which resulted in significantly increased loan loss reserves as well as increased charge offs within the home equity line of credit ("HELOC"), home equity loan and the residential first mortgage loan portfolios due to increased loss severities as real estate values continued to deteriorate in certain markets. Loan impairment charges on credit card receivables and other consumer loans have also risen. Increased levels of personal bankruptcy filings and deterioration in the U.S. economy, including rising unemployment rates, have resulted in a deterioration in credit quality across all products as compared to the prior year.

Operating expenses decreased in the third quarter of 2009 as a result of efficiency programs in the branch network and lower customer loyalty expenses for credit cards which more than offset growth in costs from branch expansion initiatives and higher FDIC assessment fees. Operating expenses in the quarter also benefited from a \$9 million recovery related to the VISA litigation accrual set up in 2007 and a \$54 million goodwill impairment charge taken relating to the residential mortgage reporting unit in the third quarter of 2008. For the nine month period ended September 30, 2009, these reductions were partially offset by higher FDIC assessment fees, including the impact of the special assessment in the second quarter of 2009. Additionally, the year-ago period benefited from a recovery of \$23 million related to the Visa legal accrual set up in 2007. Customer loyalty program expenses for credit cards were included in operating expense in the year-ago periods but were reclassified as reduction to revenue beginning in the first quarter of 2009.

Consumer Finance ("CF")

The CF segment includes the private label and co-brand credit cards, as well as other loans acquired from HSBC Finance or its correspondents, including the GM and UP Portfolios and auto finance loans purchased in January 2009 and portfolios of nonconforming residential mortgage loans (the "HMS Portfolio") purchased in 2003 and 2004.

On January 6, 2009 we received regulatory approval to purchase the General Motors MasterCard receivables portfolio, the AFL-CIO Union Plus MasterCard/Visa portfolio and certain auto finance receivables from HSBC Finance. As a result, the following transactions occurred:

• *GM Portfolio and UP Portfolio.* On January 8, 2009, we purchased the GM Portfolio from HSBC Finance for aggregate consideration of approximately \$6.2 billion, which included the assumption of approximately \$2.7 billion of indebtedness. The GM Portfolio purchased consisted of receivables with an aggregate balance of approximately \$6.3 billion. On January 9, 2009, we purchased the UP Portfolio from HSBC Finance for aggregate consideration of approximately \$6.0 billion, which included the assumption of approximately \$3.4 billion of indebtedness. The UP Portfolio consisted of receivables with an aggregate balance of approximately \$6.1 billion. HSBC Finance retained the customer account relationships and now sells additional receivable originations generated under existing and future GM and UP accounts to us daily at fair market value.

• *Auto Finance Receivables.* On January 9, 2009, we purchased auto finance receivables with an aggregate balance of approximately \$3.0 billion from HSBC Finance for an aggregate purchase price of approximately \$2.8 billion.

The consideration for each purchase was determined on the basis of an independent valuation opinion. HSBC Finance services the receivables purchased for a fee. While the receivable purchases in 2009 have resulted in increases to our net interest income and other operating income, they have also contributed to higher loan impairment charges and, to a lesser extent, higher operating expenses.

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

| <u>Three Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> | Increase (Decrease) | |
|--|--------------------|--------------------|--------------------------------|-----------------|
| | | | <u>Amount</u> | <u>%</u> |
| (dollars are in millions) | | | | |
| Net interest income | \$ 327 | | \$ 64.8 | |
| | 539 | | 212 | |
| Other operating income | 98 | 80 | 18 | 22.5 |
| Total operating income | 637 | 407 | 230 | 56.5 |
| Loan impairment charges | 437 | 439 | (2) | (.5) |
| | | |) |) |
| | 200 | (32) | 232 | 100+ |
| Operating expenses | 18 | 11 | 7 | 63.6 |
| Profit (loss) before tax | \$ | \$ | \$ | 100+ |
| | 182 | (43) | 225 | |
| | |) | | |

| <u>Nine Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> | Increase (Decrease) | |
|---|--------------------|--------------------|--------------------------------|-----------------|
| | | | <u>Amount</u> | <u>%</u> |
| (dollars are in millions) | | | | |
| Net interest income | \$ 926 | | \$ 71.5 | |
| | 1,588 | | 662 | |

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| | | | | |
|--------------------------|--------------|--------------|------------|-------------|
| Other operating income | <u>263</u> | <u>242</u> | <u>21</u> | <u>8.7</u> |
| Total operating income | <u>1,851</u> | 1,168 | <u>683</u> | <u>58.5</u> |
| Loan impairment charges | <u>1,468</u> | <u>1,188</u> | <u>280</u> | <u>23.6</u> |
| | <u>383</u> | (20) | <u>403</u> | <u>100+</u> |
| Operating expenses | <u>69</u> | <u>33</u> | <u>36</u> | <u>100+</u> |
| Profit (loss) before tax | <u>\$</u> | <u>\$</u> | <u>\$</u> | <u>100+</u> |
| | <u>314</u> | <u>(53</u> | <u>367</u> | |
| | |) | | |

Net interest income increased during the three and nine months ended September 30, 2009 due to higher levels of receivables and lower amortization of premiums paid on the initial bulk and subsequent purchases of receivables associated with the private label portfolio, partially offset by higher charge offs of interest as a result of deterioration in credit quality. The original bulk purchase premium was fully amortized during 2008. Higher net interest income was also impacted by the purchase of the GM and UP Portfolios in January, 2009. Net interest income was also higher during both periods due to higher yields as a result of repricing initiatives on the private label credit card portfolio and a lower cost of funds due to a declining interest rate environment. The higher levels of receivables were a result of the credit card and auto finance receivable purchases described more fully above.

Other operating income increased during the three and nine months ended September 30, 2009 primarily due to higher late fees on higher delinquencies in the private label and credit card portfolios, as well as higher credit card fees associated with the purchase of the GM and UP credit card portfolios. This was partially offset by increased servicing fees on portfolios purchased from and serviced by our affiliate, HSBC Finance (which are recorded as a reduction to other operating income) as well as higher charge off of fees relating to private label cards and credit cards which have been deemed uncollectible.

Loan impairment charges associated with credit card receivables, including private label credit card receivables, were essentially flat during the three month period as compared to the prior year period, however increased substantially during the nine months ended September 30, 2009 due to higher receivable balances driven largely by our purchase of the GM and UP Portfolios from HSBC Finance as previously discussed, increased delinquencies and higher net charge-offs including lower recoveries of previously charged-off balances, and the impact of deterioration in the U.S. economy, including higher levels of personal bankruptcy filings, particularly in the first half of the year. Loan impairment charges were essentially flat in the three month period as increased requirements due to the factors described above were more than offset by an improved outlook on future loss estimates on private label credit card receivables as the impact of higher unemployment levels on losses has not been as severe as previously anticipated, partially offset by slightly higher delinquency levels.

Operating expenses increased in both periods primarily due to higher FDIC insurance premiums, including the special assessment recorded in the second quarter of 2009 and higher expenses related to the higher receivable levels and increased collection costs on late stage delinquent accounts.

On June 1, 2009, General Motors announced its plan to restructure, filing for bankruptcy protection under the Chapter 11 reorganization provisions. While we provide credit under the GM Card Program, GM owns and operates the Earnings/Rewards Program. Concurrently with its bankruptcy filing, GM filed a motion with the bankruptcy court requesting authority to honor the GM Card Program in the ordinary course of business, including allowing the continued redemption of earned rewards points as well as authorizing the continued performance by GM under the card agreements. The court approved this motion on June 2, 2009. In July 2009, the bankruptcy court approved GM's plan to transfer substantially all of GM's assets to New GM, including the assignment and assumption of the GM Card

agreement, and GM was granted permission to exit bankruptcy.

On May 22, 2009, the Credit Card Accountability Responsibility and Disclosure Act of 2009 (the “CARD Act”) was signed into law. The CARD Act modifies and expands upon the amendments to Regulation AA (Unfair or Deceptive Acts or Practices) (“UDAP”) and Regulation Z (Truth in Lending) adopted by the Federal Reserve in December 2008, which among other things, place restrictions on applying interest rate increases on new and existing balances, prescribe the manner in which payments in excess of the minimum payment may be allocated to amounts due and penalty rates may be charged on past due balances, and limit certain fees. Most of the requirements of the CARD Act become effective in February 2010, however, some provisions became effective in August 2009 and a few will not become effective until August 2010. New restrictions introduced by the CARD Act include requiring customers to opt-in to over limit fee assessments and requiring re-priced accounts be evaluated for interest rate decreases every six months. The CARD Act also requires the Federal Reserve to conduct rulemaking to ensure penalty fees are reasonable and requires other government agencies to conduct studies on interchange, debt cancellation agreements and credit insurance products and present reports to Congress on these topics. Although we are already compliant with some provisions, other provisions, such as those addressing limitations on interest rate increases, over limit fees and payment allocation will require us to make changes to our business practices. This may require us and our competitors to manage risk differently than has historically been the case. We are compliant with the provisions of the CARD Act that took effect in August 2009. Pricing, underwriting and product changes in response to the new legislation have either been implemented or are under analysis. We are currently in the process of making changes to processes and systems to comply with remaining provisions of the new rules and will be fully compliant by the applicable February and August 2010 effective dates. The full impact of the CARD Act on us at this time is uncertain as it ultimately depends upon Federal Reserve and other government agency interpretation of some provisions as discussed above, successful implementation of our strategies, consumer behavior and the actions of our competitors. Although we currently believe the implementation of these new rules could ultimately have a material impact to us, the impact would be limited to the existing affected loan portfolio as the purchase price on future sales volume paid to HSBC Finance would be adjusted to consider the new requirements. Further changes to this legislation are being considered that would, among other things, accelerate the February and August 2010 effective dates to December 1, 2009. We are currently assessing our ability to accelerate process and systems changes currently underway to meet a December 1, 2009 compliance date should this legislative effort be successful.

Commercial Banking (“CMB”)

Our Commercial Banking segment is comprised of three lines of business. These lines include Commercial Banking (Middle Market Enterprises), Business Banking and Commercial Real Estate. The Commercial Banking segment’s overall business strategy is to retain and expand existing relationships with a focus on international activity while recruiting new relationships with international connectivity or international business needs. The products and services provided by these segments are offered through multiple delivery systems including the branch banking network.

Interest income from loans and fees has helped to offset the negative impact of narrowing liquidity spreads resulting from the declining interest rate environment. Loan impairment charges have increased in the nine months ended September 30, 2009, as compared to the year ago period, due to higher levels of criticized assets and overall deterioration in the credit environment which has led to higher charge-offs across all commercial business lines.

Tightened credit standards and increased paydowns have resulted in a small increase in loans outstanding to middle market customers during the first nine months of 2009 as compared to the year-ago period, while deposits from middle market customers have grown 14 percent over the period. The business banking loan portfolio has seen moderate growth due to tightened credit standards and the competitive environment while business banking customer

deposits grew 15 percent at September 30, 2009 compared to a year-ago, following successful fall and spring marketing campaigns. The commercial real estate business continues to focus on deal quality and portfolio management rather than volume.

Average customer deposit balances across all CMB business lines increased 12 percent during the first nine months of 2009 as compared to the year-ago period and average loans have remained broadly flat during the first nine months of 2009 as compared to the year-ago period.

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

| <u>Three Months Ended September 30</u> | <u>2009</u> | <u>2008</u> | Increase (Decrease) | |
|---|--------------------|--------------------|--------------------------------|-----------------|
| | | | <u>Amount</u> | <u>%</u> |
| (dollars are in millions) | | | | |
| Net interest income | \$ 195 | | \$ (5.6) | |
| | 184 | | (11) | |
| Other operating income | <u>92</u> | <u>94</u> | <u>(2)</u> | <u>(2.1)</u> |
| | | |) |) |
| Total operating income | 276 | 289 | (13) | (4.5) |
| Loan impairment charges | <u>51</u> | <u>71</u> | <u>(20)</u> | <u>(28.2)</u> |
| | | |) |) |
| Operating expenses | <u>225</u> | 218 | <u>7</u> | <u>3.2</u> |
| Profit before tax | <u>\$ 159</u> | <u>\$ 155</u> | <u>\$ 4</u> | <u>2.6</u> |
| | 66 | 63 | 3 | |

| <u>Nine Months Ended September 30</u> | <u>2009</u> | <u>2008</u> | Increase (Decrease) | |
|--|--------------------|--------------------|--------------------------------|-----------------|
| | | | <u>Amount</u> | <u>%</u> |
| (dollars are in millions) | | | | |
| Net interest income | \$ 575 | | \$ (6.1) | |
| | 540 | | (35) | |
| Other operating income | <u>255</u> | <u>236</u> | <u>19</u> | <u>8.1</u> |
| Total operating income | 795 | 811 | (16) | (2.0) |
| Loan impairment charges | <u>222</u> | <u>178</u> | <u>44</u> | <u>24.7</u> |
| | 573 | 633 | (60) | (9.5) |
| Operating expenses | <u>471</u> | <u>446</u> | <u>25</u> | <u>5.6</u> |
| Profit before tax | <u>\$ 102</u> | <u>\$ 187</u> | <u>\$ (85)</u> | |
| | | |) |) |

Net interest income decreased in the three and nine months ended September 30, 2009 primarily due to narrower spreads on deposits partially offset growth in deposit balances and improved loan spreads from repricing.

Other operating income decreased marginally in the three months ended September 30, 2009 due to fewer syndications and lower gains on sale of real estate loans, while higher income from low income housing investments resulted in an increase in the first nine months of the year.

Loan impairment charges decreased in the three months ended September 30, 2009 due to a reduction in future loss estimates and fewer customer downgrades. Loan impairment charges however, have increased in the first nine months of the year due to worsening economic conditions, which has resulted in higher levels of criticized assets as a result of customer downgrades, leading to higher net charge-offs across all commercial business lines.

Operating expenses increased during both periods due primarily to higher FDIC insurance premiums, including the special assessment recorded in the second quarter of 2009, partially offset by reduced staff costs and efficiency savings, including lower marketing spend.

Global Banking and Markets

The Global Banking and Markets segment results continued to be affected by reduced market liquidity and volatility in spreads in the corporate credit and residential mortgage lending markets, however the impact to other operating income has declined significantly as compared with the year-ago periods and in the third quarter have actually begun to reverse for certain items. This impacted trading revenue in credit derivatives and subprime mortgage loans in particular, and has led to substantial counterparty credit reserves for monoline exposure and significant valuation losses being taken in both the Trading and Available-for-sale securities portfolios, particularly in 2008. Additionally, the nine month period ended September 30, 2009 reflected higher revenue from balance sheet management activities, primarily the result of realized gains from securities sales in the available for sale portfolio and higher intersegment income.

On October 11, 2008, the International Accounting Standards Board (“IASB”) issued an amendment to IAS 39 which permits entities to transfer financial assets from the Trading classification into the Available-for-sale or Loans and Receivables classifications if the entity has the intention and ability to hold the assets for the foreseeable future or until maturity. Temporary changes in the market value of re-classified assets will no longer impact current period earnings. Instead, these assets will only be marked-to-market (through other comprehensive income) if classified as Available-for-sale Securities and will be subject to on-going impairment tests.

Following careful analysis of the implications and with consideration given to industry and peer practices, we elected to re-classify \$1.8 billion in leveraged loans and high yield notes and \$892 million in securities held for balance sheet management purposes from Trading Assets to Loans and Available-for-sale Investment Securities, effective July 1, 2008. In November 2008, \$967 million in additional securities were also transferred from Trading Assets to Available-for-sale Investment Securities. If these IFRS reclassifications had not been made, our profit before tax would have been \$378 million and \$616 million higher during the three and nine months ended September 30, 2009, respectively.

The following table summarizes IFRSs Basis results for the Global Banking and Markets segment.

| <u>Three Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> | <u>Increase (Decrease)</u> | |
|---|-------------|-------------|--------------------------------|---------------|
| | | | <u>Amount</u> | <u>%</u> |
| (dollars are in millions) | | | | |
| Net interest income | \$ 334 | | \$ (39.8) | |
| | 201 | | (133) | |
| Other operating income (loss) | <u>91</u> | <u>(72)</u> | <u>163</u> | <u>100+</u> |
| | |) | | |
| Total operating income (loss) | 292 | 262 | 30 | 11.5 |
| Loan impairment charges | <u>163</u> | <u>30</u> | <u>133</u> | <u>100+</u> |
| | 129 | 232 | (103) | (44.4) |
| Operating expenses | <u>180</u> | <u>201</u> | <u>(21)</u> | <u>(10.4)</u> |
| | |) | |) |
| Profit (loss) before tax | \$ | \$ | \$ | <u>(100)</u> |
| | | | |)+ |
| | <u>(51)</u> | <u>31</u> | <u>(82)</u> | |
| |) |) |) | |

| <u>Nine Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> | <u>Increase (Decrease)</u> | |
|--|--------------|--------------|--------------------------------|-------------|
| | | | <u>Amount</u> | <u>%</u> |
| (dollars are in millions) | | | | |
| Net interest income | \$ 650 | | \$ | .8 |
| | 655 | | 5 | |
| Other operating income (loss) | <u>600</u> | <u>(862)</u> | <u>1,462</u> | <u>100+</u> |
| | |) | | |
| Total operating income (loss) | 1,255 | (212) | 1,467 | 100+ |
| Loan impairment charges | <u>589</u> | <u>87</u> | <u>502</u> | <u>100+</u> |
| | 666 | (299) | 965 | 100+ |
| Operating expenses | <u>615</u> | <u>607</u> | <u>8</u> | <u>1.3</u> |
| Profit (loss) before tax | \$ | \$ | \$ | <u>100+</u> |
| | <u>51</u> | <u>(906)</u> | <u>957</u> | |
| |) |) |) | |

Decreased net interest income during the three months ended September 30, 2009 was primarily due to lower yields on the available for sale securities portfolio as a result of the sales earlier in the year, partially offset by wider credit spreads in our commercial loan portfolio. Net interest income during the nine month period ended September 30, 2009 was in line with the year ago period as wider credit spreads on our commercial loan portfolio were substantially offset by reduced income from our available for sale securities portfolio.

Other operating income (loss) improved in the three month period ended September 30, 2009 as the prior year period reflects a \$215 million charge recorded in September 2008 relating to a single asset-backed security and the preferred equity securities of FNMA. Other operating income improved during the nine month period ended September 30, 2009 due to higher realized gains on available for sale securities, higher intersegment income from PFS as discussed more fully below and higher transaction fees in Corporate Banking. Other operating income overall continued to be affected by adverse market conditions, particularly in the nine month period, but to a lesser extent than in the prior year periods. Additionally, revenues in the first nine months of 2009 were lower than the year-ago period due to the reclassification of assets from trading to available-for-sale assets and to loans and receivables under the IAS 39 amendment as previously discussed.

Other operating income (loss) reflects gains on structured credit products of \$35 million and losses of \$286 million during the three and nine months ended September 30, 2009, respectively, as compared to losses of \$105 million and \$1,179 million in the year-ago periods, as the widening of credit spreads slowed resulting in lower losses from hedging activity and counterparty exposures. Exposure to monolines continued as deterioration in creditworthiness persisted, although the pace of such deterioration slowed significantly, resulting in gains of \$54 million and losses of \$104 million during the three and nine months ended September 30, 2009, respectively, as compared to losses of \$155 million and \$957 million in the year-ago periods. Correlation trading resulted in gains of \$78 million and losses of \$83 million during the three and nine months ended September 30, 2009, as compared to gains of \$23 million and losses of \$185 million in the year-ago periods.

Valuation losses of \$28 million and \$182 million during the three and nine months ended September 30, 2009, respectively, were also recorded against the fair values of sub-prime residential mortgage loans held for sale as compared to valuation losses of \$87 million and \$331 million in the year-ago periods. There were fair value adjustments of \$1 million and \$2 million on the leveraged loan portfolio in the three and nine months ended September 30, 2009, respectively which reflects the classification of substantially all leveraged loans and notes as loans and receivables compared to losses of \$4 million and \$107 million during the three and nine months ended September 30, 2008, respectively, when these assets were subject to fair value accounting. Other operating income also benefited from gains on the sales of securities, primarily during the second quarter of 2009, of \$245 million and from intersegment income from PFS of \$163 million during the nine months ended September 30, 2009, relating to the break funding fee charged for the early termination of funding associated with the sale of the residential mortgage loans as compared to a similar benefit of \$14 million and \$45 million during the three and nine months ended September 30, 2008, respectively.

Loan impairment charges increased primarily due to a charge of \$57 million and \$374 million during the three and nine months ended September 30, 2009 on securities determined to be other-than-temporarily impaired as compared to having no other-than-temporary impairment charges in the prior year quarter and year-to date periods. Loan impairment charges also increased due to several credit downgrades on our exposure to the financial services industry and other downgrades on specific accruing loans.

Operating expenses declined during the three months ended September 30, 2009 compared to the year ago period due to lower salary and other staff costs resulting from a decreased overall number of employees due to our ongoing efficiency initiatives. Operating expenses increased during the nine month period as higher FDIC assessment charges, including the special assessment recorded during the second quarter of 2009 and higher performance related compensation costs due to improved revenues more than offset the lower salary and other staff costs resulting from a decreased overall number of employees.

Private Banking (“PB”)

Resources continue to be dedicated to expanding products and services provided to high net worth customers served by the PB business segment.

The level of client deposits at September 30, 2009 declined 10 percent compared to the prior year as domestic institutional clients began to invest their liquidity in investment products with lower risk. Similarly, total average loans (mostly domestic consumer) at September 30, 2009 were 13 percent lower as compared to the prior year, reflective of lower client demand. Substantial reductions from a challenging economic environment and outflows from domestic custody clients affected market value of client assets under management which declined 10 percent compared to the prior year. Assets under management were \$33.7 billion at September 30, 2009, compared to \$39.8 billion at December 31, 2008 and \$37.3 billion at September 30, 2008.

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

| <u>Three Months Ended September 30,</u> | | | Increase (Decrease) | |
|--|----------------------------------|--------------------|--------------------------------|-----------------|
| | <u>2009</u> | <u>2008</u> | <u>Amount</u> | <u>%</u> |
| | (dollars are in millions) | | | |
| Net interest income | \$ 48 | | \$ (14.6) | |
| | 41 | | (7) | |
| Other operating income (loss) | 23 | 36 | (13) | (36.1) |
| | | |) |) |
| Total operating income | 64 | 84 | (20) | (23.8) |
| Loan impairment charges | 86 | 4 | 82 | 100+ |
| | (22) | 80 | (102) | (100)+ |
| Operating expenses | 58 | 70 | (12) | (17.1) |
| | | |) |) |
| Profit before tax | \$ | \$ | \$ | (100) |
| | | | |)+ |
| | (80) | 10 | (90) | |
| |) | |) | |

| <u>Nine Months Ended September 30,</u> | | | Increase (Decrease) | |
|---|----------------------------------|--------------------|--------------------------------|-----------------|
| | <u>2009</u> | <u>2008</u> | <u>Amount</u> | <u>%</u> |
| | (dollars are in millions) | | | |
| Net interest income | \$ 144 | | \$ (10.4) | |
| | 129 | | (15) | |
| Other operating income (loss) | 85 | 126 | (41) | (32.5) |
| | | |) |) |
| Total operating income | 214 | 270 | (56) | (20.7) |
| Loan impairment charges | 90 | 5 | 85 | 100+ |
| | 124 | 265 | (141) | (53.2) |
| Operating expenses | 180 | 206 | (26) | (12.6) |
| | | |) |) |
| Profit before tax | \$ | \$ | \$ | (100) |

)+
(56) 59 (115)
))

Net interest income was lower during the three and nine months ended September 30, 2009 primarily as a result of narrowing interest rate spreads due to declining market rates and lower outstanding loan and deposit balances.

Other operating income was lower in both periods primarily due to lower performance fees from equity investments, and lower fee income from credit derivatives, managed products, structured products and recurring fund fees and insurance commissions.

Loan impairment charges during the three and nine months ended September 30, 2009 were higher as compared to the year-ago periods due largely to a specific provision relating to a single client relationship recorded in the third quarter of 2009 and higher reserve levels associated with the downgrade of a separate specific domestic client relationship.

Operating expenses decreased as a result of lower staff costs due to lower headcount resulting from efficiency initiatives. Travel and entertainment, marketing and communications costs were also lower, partially offset by higher FDIC assessment fees, including the special assessment recorded during the second quarter of 2009.

Other

The Other segment primarily includes adjustments made at the corporate level for fair value option accounting related to certain debt issued, as well as any adjustments to the fair value on HSBC shares held for stock plans. The results also include earnings on an equity investment in HSBC Private Bank (Suisse) S.A, through the first quarter of 2009. This investment was sold in March 2009 for a gain.

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

| <u>Three Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> | <u>Increase (Decrease) Amount</u> | <u>%</u> |
|---|---------------------------|-------------|---|---------------|
| | (dollars are in millions) | | | |
| Net interest income | \$ | \$ - | \$ | - |
| | (6) | | (6) | |
| Other operating income (loss) | <u>(63)</u> | <u>181</u> | <u>(244)</u> | <u>(100)+</u> |
| |) | |) | |
| Total operating income | <u>(69)</u> | <u>181</u> | <u>(250)</u> | <u>(100)+</u> |
| Loan impairment charges | = | = | = | = |
| | <u>(69)</u> | <u>181</u> | <u>(250)</u> | <u>(100)+</u> |
| Operating expenses | <u>13</u> | = | <u>13</u> | = |
| Profit (loss) before tax | <u>\$</u> | <u>\$</u> | <u>\$</u> | <u>(100)+</u> |
| | <u>(82)</u> | <u>181</u> | <u>(263)</u> | |

))

| <u>Nine Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> | <u>Increase (Decrease) Amount</u> | <u>%</u> |
|--|---------------------------|-------------|---|----------|
| | (dollars are in millions) | | | |
| Net interest income (loss) | \$ | \$ (3) | \$ | (100.0) |
| | (6) | | (3) | |
| Other operating income (loss) | (406) | 261 | (667) | (100)+ |
| |) | |) | |
| Total operating income | (412) | 258 | (670) | (100)+ |
| Loan impairment charges | = | = | = | = |
| | (412) | 258 | (670) | (100)+ |
| Operating expenses | 65 | = | 65 | = |
| Profit (loss) before tax | \$ | \$ | \$ | (100)+ |
| | (477) | 258 | (735) | |
| |) | |) | |

Other operating income was negatively impacted in the three and nine months ended September 30, 2009 by an increase in the fair value of certain of our own debt instruments outstanding to which fair value option accounting is applied due to narrowing credit spreads. Additionally, the year-to-date period, was impacted by an impairment to a building held for use. Partially offsetting this, we recorded an \$85 million gain relating to the resolution of a lawsuit in March 2009, whose proceeds were used in April to redeem a nominal amount of preferred stock issued to CT Financial Services, Inc. as well as a \$43 million gain on the sale of the equity interest referred to above.

Credit Quality

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

Allowance for Credit Losses

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

estimate.

Probable losses for pools of homogeneous consumer loans are generally estimated using a roll rate migration analysis that estimates the likelihood that a loan will progress through the various stages of delinquency, or buckets, and ultimately charge off. This analysis considers delinquency status, loss experience and severity and takes into account whether loans are in bankruptcy, have been restructured, rewritten, or are subject to forbearance, an external debt management plan, hardship, modification, extension or deferment. The allowance for credit losses on consumer receivables also takes into consideration the loss severity expected based on the underlying collateral, if any, for the loan in the event of default based on historical and recent trends.

Our allowance for credit losses methodology and our accounting policies related to the allowance for credit losses are presented in further detail in Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations in our 2008 Form 10-K under the caption “Critical Accounting Policies and Estimates” and in Note 2, “Summary of Significant Accounting Policies and New Accounting Pronouncements,” of the consolidated financial statements included in our 2008 Form 10-K. Our approach toward credit risk management is summarized in Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations in our 2008 Form 10-K under the caption “Risk Management.” There have been no material revisions to our policies or methodologies during the first nine months of 2009, although we continue to monitor current market conditions and will adjust credit policies as deemed necessary.

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

| | <u>September 30,</u> <u>2009</u> | <u>June 30,</u> <u>2009</u> | <u>December 31,</u> <u>2008</u> |
|------------------|-------------------------------------|--------------------------------|------------------------------------|
| | (dollars are in millions) | | |
| Allowance | | | |
| for | | | |
| credit | | | |
| losses | \$ | \$ | \$ |
| | <u>3,867</u> | <u>3,740</u> | <u>2,397</u> |
| Ratio | | | |
| of | | | |
| Allowance | | | |
| for | | | |
| credit | | | |
| losses | | | |
| to: | | | |
| Loans:(2) | | | |
| Commercial | 2.92% | 2.23% | 1.53% |

| | | | |
|---|--------------------|-------------|-------------|
| Consumer Residential mortgages, excluding HELOCs and home equity HELOCs | 2.73 | 2.42 | 1.15 |
| and home equity mortgages | 4.45 | 3.94 | 3.67 |
| Private label card receivables | 8.19 | 8.22 | 6.86 |
| Credit card receivables | 7.69 | 7.93 | 9.73 |
| Auto finance | 2.23 | 2.30 | 3.25 |
| Other consumer loans | 4.47 | 4.16 | 3.68 |
| Total | <u>5.82</u> | <u>5.75</u> | <u>4.18</u> |

consumer

loans

| | | | |
|-------|-------------|-------------|-------------|
| Total | <u>4.68</u> | <u>4.36</u> | <u>2.96</u> |
| | % | % | % |

Net

charge-offs(1)(2):

Commercial

| | | | |
|--|----------------|---------|---------|
| | 397.06% | 248.85% | 266.05% |
|--|----------------|---------|---------|

Consumer

| | | | |
|-------|---------------|---------------|---------------|
| | <u>90.27</u> | <u>104.96</u> | <u>117.89</u> |
| Total | <u>111.28</u> | <u>118.92</u> | <u>136.04</u> |
| | % | % | % |

Non performing

loans(2):

Commercial

| | | | |
|--|---------------|--------|---------|
| | 73.03% | 94.52% | 146.29% |
|--|---------------|--------|---------|

Consumer

| | | | |
|-------|---------------|---------------|---------------|
| | <u>159.85</u> | <u>168.80</u> | <u>159.67</u> |
| Total | <u>123.86</u> | <u>145.58</u> | <u>156.26</u> |
| | % | % | % |

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

(2) Ratios exclude loans held for sale as these loans are carried at the lower of cost or market.

The allowance for credit losses at September 30, 2009 increased \$127 million, or 3 percent as compared to June 30, 2009, and \$1,470 million, or 61 percent, as compared to December 31, 2008. Reserve levels for all loan categories were impacted by the following:

- Continued weakness in the U.S. economy, including rising unemployment rates; and
- For consumer loans, higher levels of personal bankruptcy filings.

The increase in the allowance for credit losses since June 30, 2009 was driven largely by increased charge-offs and higher loss estimates in our prime residential mortgage and HELOC loan portfolios due to continued deterioration in the housing markets as well as higher reserve requirements in our commercial loan portfolio. These increases were partially offset by lower reserve levels in our private label card and credit card portfolios as dollars of delinquency remained stable and our outlook for future losses on these portfolios improved as the impact of higher unemployment levels on losses has not been as severe as previously anticipated, as well as lower outstanding loan balances.

Loan loss allowances for commercial loans were higher at September 30, 2009 due to higher loss estimates associated with higher criticized loan balances caused by further downgrades in financial institution and certain other counterparties, as well as real estate and middle market customers. The downgrades resulted from continued

deterioration of economic conditions and changes in financial conditions of specific customers within these portfolios. As previously mentioned, downgrades in our commercial real estate portfolio to substandard and doubtful are continuing, particularly for condominium loans and land loans, as well as in hotel and office construction in all markets, especially in the large metropolitan markets where construction projects have been delayed. Condominium projects in Florida and California have been negatively impacted by sharply declining prices and reduced availability for condominium mortgages. As such, many buyers are either walking away from purchase contracts and deposits, or cannot arrange mortgages or advance additional equity required to close purchases. Although our middle market portfolio has deteriorated in most industry segments and geographies consistent with the overall deterioration in the U.S. economy, customers in those areas of the economy that have expressed above average weakness, such as apparel, auto related suppliers and construction related businesses have been particularly affected. Also contributing to the increase since June 30, 2009 was a specific provision relating to a single private banking relationship.

The increase in the allowance for credit losses since December 31, 2008 reflects higher allowances on our residential mortgage and commercial loan portfolios as discussed above as well as a significantly higher allowance on credit cards due to the purchase of the GM and UP Portfolio in January 2009.

The allowance for credit losses as a percentage of total loans increased to 4.68 percent at September 30, 2009 as compared to 4.36 percent at June 30, 2009 and 2.96 percent at December 31, 2008. The increase in this percentage since June 30, 2009 was driven largely by a higher allowance in our residential mortgage loan and commercial loan portfolios as well as lower outstanding balances in these portfolios as discussed above. The increase in our allowance as a percentage of total loans since December 31, 2008 reflects a higher allowance on our residential mortgage loan and commercial loan portfolios and lower outstanding balances in these portfolios as discussed above, partially offset by a lower credit card ratio reflecting the impact of our prime GM and UP Portfolios on credit card mix. The allowance for credit losses as a percentage of total loans on our private label receivable portfolio also increased compared to December 31, 2008 due in part to higher charge-off levels as a result of portfolio seasoning, continued deterioration in the U.S. economy including rising unemployment levels and lower receivable levels, including the actions previously taken to tighten underwriting and reduce the risk profile of the portfolio and lower customer spending. Compared to the prior quarter, the allowance as a percentage of total loans for private label cards decreased as modest increases in delinquency were more than offset by an improved outlook on future loss estimates as previously discussed.

The allowance for credit losses as a percentage of net charge-offs (quarter-to-date, annualized) declined to 111.28 percent at September 30, 2009 as compared to 118.92 percent at June 30, 2009 and 136.04 percent at December 30, 2008, as the increase in the net charge-offs outpaced the increase in the allowance for credit losses due largely to credit card receivables and private label receivables.

Changes in the allowance for credit losses by general loan categories for the three and nine months ended September 30, 2009 and 2008 are summarized in the following table:

| <u>Commercial</u> | <u>Residential</u> | <u>HELOCs</u> | <u>Private</u> | <u>Credit</u> | <u>Auto</u> | <u>Other</u> | <u>Total</u> |
|-------------------|--------------------|---------------|--------------------|--------------------|----------------|-----------------|--------------|
| <u>Mortgage,</u> | <u>and</u> | | <u>Label</u> | <u>Card</u> | <u>Finance</u> | <u>Consumer</u> | |
| <u>excluding</u> | <u>Home</u> | | <u>Card</u> | <u>Receivables</u> | | | |
| | <u>Equity</u> | | <u>Receivables</u> | | | | |
| <u>HELOCs</u> | <u>Mortgages</u> | | | | | | |
| <u>and</u> | | | | | | | |
| <u>Home</u> | | | | | | | |
| <u>Equity</u> | | | | | | | |

(In millions)

Three months ended September 30, 2009:

| | | | | | | | | |
|---|----------|--------|--------|-----------|-----------|----------|----------|-----------|
| | \$ | | | \$ | \$ | | | \$ |
| Balances at beginning of period | 759 | \$ 357 | \$ 176 | 1,238 | 1,092 | \$ 51 | \$ 67 | 3,740 |
| Charge offs | 63 | 55 | 61 | 354 | 363 | 30 | 28 | 954 |
| Recoveries | <u>3</u> | = | = | <u>41</u> | <u>20</u> | <u>6</u> | <u>8</u> | <u>78</u> |
| Net charge offs | 60 | 55 | 61 | 313 | 343 | 24 | 20 | 876 |
| Provision charged to income | 246 | 92 | 79 | 272 | 275 | 20 | 22 | 1,006 |
| Allowance on loans transferred to held for sale | - | - | - | - | - | (4) | - | (4) |
| Other | = | = | = | = | <u>1</u> | = | = | <u>1</u> |
| | \$ | | | \$ | \$ | | | \$ |
| Balance at end of period | 945 | \$ 394 | \$ 194 | 1,197 | 1,025 | \$ 43 | \$ 69 | 3,867 |

Three months ended September 30, 2008:

| | | | | | | | | |
|---|------------|-----------|-----------|------------|-----------|----------|-----------|------------|
| | \$ | | | | | | | \$ |
| Balance at beginning of period | 391 | \$ 88 | \$ 148 | \$ 954 | \$ 154 | \$ 5 | \$ 56 | 1,796 |
| Charge offs | 59 | 37 | 26 | 288 | 39 | 3 | 27 | 479 |
| Recoveries | <u>7</u> | = | = | <u>44</u> | <u>6</u> | = | <u>6</u> | <u>63</u> |
| Net charge offs | 52 | 37 | 26 | 244 | 33 | 3 | 21 | 416 |
| Allowance on loans transferred to held for sale | - | - | - | 21 | - | - | - | 21 |
| Provision charged to income | <u>124</u> | <u>71</u> | <u>33</u> | <u>345</u> | <u>58</u> | <u>2</u> | <u>25</u> | <u>658</u> |
| | \$ | | | \$ | | | | \$ |
| Balance at end of period | 463 | \$ 122 | \$ 155 | 1,076 | \$ 179 | \$ 4 | \$ 60 | 2,059 |

Nine months ended September 30, 2009:

| | | | | | | | | |
|--|-----------|-----------|-----------|------------|-----------|-----------|-----------|------------|
| | \$ | | | \$ | | | | \$ |
| Balances at beginning of period | 572 | \$ 207 | \$ 167 | 1,171 | \$ 208 | \$ 5 | \$ 67 | 2,397 |
| Charge offs | 206 | 175 | 151 | 1,079 | 678 | 61 | 83 | 2,433 |
| Recoveries | <u>19</u> | <u>11</u> | <u>12</u> | <u>124</u> | <u>36</u> | <u>13</u> | <u>15</u> | <u>230</u> |
| Net charge offs | 187 | 164 | 139 | 955 | 642 | 48 | 68 | 2,203 |
| Provision charged to income | 560 | 351 | 166 | 981 | 1,034 | 85 | 70 | 3,247 |
| Allowance on loans transferred to held for sale | - | - | - | - | - | (12) | - | (12) |
| Allowance related to bulk loan purchases from HSBC Finance | - | - | - | - | 424 | 13 | - | 437 |
| Other | = | = | = | = | <u>1</u> | = | = | <u>1</u> |
| | \$ | | | \$ | \$ | | | \$ |
| Balance at end of period | 945 | \$ 394 | \$ 194 | 1,197 | 1,025 | \$ 43 | \$ 69 | 3,867 |

Nine months ended September 30, 2008:

| | | | | | | | | |
|---|------------|------------|------------|------------|------------|----------|-----------|--------------|
| | \$ | | | | | | | \$ |
| Balance at beginning of period | 300 | \$ 53 | \$ 35 | \$ 844 | \$ 119 | \$ 8 | \$ 55 | 1,414 |
| Charge offs | 127 | 96 | 61 | 839 | 109 | 8 | 84 | 1,324 |
| Recoveries | <u>25</u> | <u>1</u> | = | <u>142</u> | <u>16</u> | <u>2</u> | <u>21</u> | <u>207</u> |
| Net charge offs | 102 | 95 | 61 | 697 | 93 | 6 | 63 | 1,117 |
| Allowance on loans transferred to held for sale | - | - | - | - | - | - | - | - |
| Provision charged to income | <u>265</u> | <u>164</u> | <u>181</u> | <u>929</u> | <u>153</u> | <u>2</u> | <u>68</u> | <u>1,762</u> |

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| | | | | | | | | |
|--------------------------|-----|--------|--------|---------|--------|------|-------|-------|
| | \$ | | | | | | | \$ |
| Balance at end of period | 463 | \$ 122 | \$ 155 | \$ 1076 | \$ 179 | \$ 4 | \$ 60 | 2,059 |

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

| | <u>September 30, 2009</u> | | <u>June 30, 2009</u> | | <u>December 31, 2008</u> | |
|----------------|---------------------------|-----------------|----------------------|-----------------|--------------------------|-----------------|
| | % of | | % of | | % of | |
| | Loans to | | Loans to | | Loans to | |
| | Total | | Total | | Total | |
| | <u>Amount</u> | <u>Loans(1)</u> | <u>Amount</u> | <u>Loans(1)</u> | <u>Amount</u> | <u>Loans(1)</u> |
| | (dollars are in millions) | | | | | |
| | \$ | | \$ | | \$ | |
| Commercial (2) | 945 | 39.21% | 759 | 39.59% | 572 | 46.14% |
| Consumer: | | | | | | |
| Residential | | | | | | |
| mortgages, | | | | | | |
| excluding | | | | | | |
| HELOCs | | | | | | |
| and | | | | | | |
| home | | | | | | |
| equity | | | | | | |
| mortgages | | | | | | |
| HELOCs | 394 | 17.47 | 357 | 17.18 | 207 | 22.13 |
| and | | | | | | |
| home | | | | | | |
| equity | | | | | | |
| mortgages | | | | | | |
| Private | 194 | 5.29 | 176 | 5.20 | 167 | 5.61 |
| label | 1,197 | 17.70 | 1,238 | 17.54 | 1,171 | 21.05 |

| | | | | | | |
|-------------|--------------|---------------|--------------|---------------|--------------|---------------|
| card | | | | | | |
| receivables | | | | | | |
| Credit | | | | | | |
| card | | | | | | |
| receivables | 1,025 | 16.14 | 1,092 | 16.03 | 208 | 2.63 |
| Auto | | | | | | |
| finance | 43 | 2.32 | 51 | 2.58 | 5 | .19 |
| Other | | | | | | |
| consumer | 69 | 1.87 | <u>67</u> | <u>1.88</u> | <u>67</u> | <u>2.25</u> |
| Total | | | | | | |
| consumer | 2,922 | 60.79 | <u>2,981</u> | <u>60.41</u> | <u>1,825</u> | <u>53.86</u> |
| | \$ | | \$ | | \$ | |
| Total | 3,867 | 100.00 | <u>3,740</u> | <u>100.00</u> | <u>2,397</u> | <u>100.00</u> |
| | | % | | % | | % |

(1) Excluding loans held for sale.

(2) Components of the commercial allowance for credit losses, including exposure relating to off-balance sheet credit risk, and the movements in comparison with prior years, are summarized in the following table:

September 30, June 30, December 31,

| | 2009 | 2009 | 2008 |
|----------------------------------|----------------------|-------------|-------------|
| | (in millions) | | |
| On-balance sheet allowance: | | | |
| Specific | \$ 255 | \$ 86 | \$ 43 |
| Collective | 630 | 608 | 476 |
| Transfer risk | - | - | 5 |
| Unallocated | 60 | 65 | 48 |
| Total on-balance sheet allowance | 945 | 759 | 572 |
| Off-balance sheet allowance | 167 | 166 | 168 |
| Total commercial allowances | \$ 1,112 | \$ 925 | \$ 740 |

Reserves for Off-Balance Sheet Credit Risk

We also maintain a separate reserve for credit risk associated with certain off-balance sheet exposures, including letters of credit, unused commitments to extend credit and financial guarantees. This reserve, included in other liabilities, was \$167 million, \$166 million and \$180 million at September 30, 2009, June 30, 2009 and December 31, 2008, respectively. The related provision is recorded as a miscellaneous expense and is a component of operating expenses. Off-balance sheet exposures are summarized in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our 2008 Form 10-K under the caption "Off-Balance Sheet Arrangements and Contractual Obligations."

Delinquency

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

| | September 30, June 30, December 31, | | |
|--|--|--------------------|--------------------|
| | <u>2009</u> | <u>2009</u> | <u>2008</u> |
| Dollars of Delinquency: | | | |
| Commercial | \$ 938 | \$ 709 | \$ 385 |
| Consumer: | | | |
| Residential mortgage, excluding HELOCs and home equity mortgages | 1,445 | 1,335 | 1,189 |
| HELOCs and home equity mortgages | <u>185</u> | <u>194</u> | <u>161</u> |
| Total residential mortgages(1) | 1,630 | 1,529 | 1,350 |
| Private label card receivables | 639 | 634 | 663 |
| Credit card receivables | 591 | 583 | 118 |
| Auto finance | 47 | 37 | 3 |
| Other consumer | 18 | 19 | 27 |
| Total consumer | <u>2,925</u> | <u>2,802</u> | <u>2,161</u> |
| Total | <u>\$ 3,863</u> | <u>\$ 3,511</u> | <u>\$ 2,546</u> |
| Delinquency Ratio: | | | |
| Commercial | 2.80% | 2.03% | 1.01% |
| Consumer: | | | |
| Residential mortgage, excluding HELOCs and home equity mortgages | 9.20 | 8.14 | 5.54 |
| HELOCs and home equity mortgages | <u>4.24</u> | <u>4.35</u> | <u>3.54</u> |
| Total residential mortgages(1) | 8.12 | 7.33 | 5.19 |
| Private label card receivables | 4.37 | 4.21 | 3.88 |
| Credit card receivables | 4.43 | 4.23 | 5.52 |
| Auto finance | 2.06 | 1.48 | 1.95 |
| Other consumer | <u>1.14</u> | <u>1.15</u> | <u>1.45</u> |
| Total consumer | <u>5.64</u> | <u>5.20</u> | <u>4.57</u> |
| Total | <u>4.53%</u> | <u>3.95%</u> | <u>2.98%</u> |

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

| | September 30, June 30, December 31, | | |
|--------------------------------|--|--------------------|--------------------|
| | <u>2009</u> | <u>2009</u> | <u>2008</u> |
| Dollars of Delinquency: | | | |
| Interest-only loans | \$ 388 | \$ 368 | \$ 302 |
| ARM loans | 782 | 734 | 657 |
| Delinquency Ratio: | | | |
| Interest-only loans | 13.79% | 11.87% | 7.11% |
| ARM loans | 10.03 | 9.47 | 6.06 |

Our total delinquency ratio increased 58 basis points compared to the prior quarter. The overall increase in delinquency was impacted by the following:

- Continued weakness in the U.S. economy; and
- Continued high unemployment rates during the quarter

In addition to the above, our residential mortgage portfolio, which includes our subprime mortgage whole loans held for sale for purposes of delinquency reporting, has continued to experience higher delinquency as a result of continued weakening in the housing industry. Also, lower loan balances for residential mortgage loans, private label cards, credit card and auto finance loans and seasonality in the credit card portfolio compared to the prior quarter also contributed to the higher delinquency ratios. Increased delinquency in the auto finance loans purchased from HSBC Finance reflects the previously current loans beginning to season.

During the third quarter of 2009, we experienced an increase in our two-months-and-over contractual delinquency ratio compared to the prior quarter relating to our private label credit card and credit card portfolios, due largely to lower receivable levels, including the actions previously taken to tighten underwriting and reduce the risk profile of the portfolio as well as the impact of continued economic pressures including rising unemployment levels and lower customer spending. This was partially offset by higher levels of personal bankruptcy filings in the first half of 2009 which resulted in accounts migrating to charge-off more quickly. Dollars of delinquency in these portfolios however, have remained relatively flat.

Our commercial portfolio experienced higher delinquency ratios due to continued deterioration of economic conditions, as previously discussed.

Compared to December 31, 2008, our delinquency ratio increased 155 basis points at September 30, 2009, largely due to higher residential mortgage, private label card and credit card delinquencies due to the factors described above. A significant factor contributing to the increased dollars of delinquency associated with our credit card portfolios is the impact of the GM and UP Portfolios purchased in January 2009.

Net Charge-offs of Loans

The following table summarizes net charge-off dollars as well as the net charge-off of loans for the quarter, annualized, as a percent of average loans, excluding loans held for sale, (“net charge-off ratio”):

| | September 30, June 30, September 30, | | |
|--|---|--------------------|--------------------|
| | <u>2009</u> | <u>2009</u> | <u>2008</u> |
| | (dollars are in millions) | | |
| Net Charge-off Dollars: | | | |
| Commercial | \$ 60 | \$ 76 | \$ 52 |
| Consumer: | | | |
| Residential mortgage, excluding HELOCs and home equity mortgages | 55 | 50 | 37 |
| HELOCs and home equity mortgages | <u>61</u> | <u>50</u> | <u>26</u> |
| Total residential mortgage | 116 | 100 | 63 |
| Private label card receivables | 313 | 328 | 244 |
| Credit card receivables | 343 | 238 | 33 |
| Auto finance | 24 | 20 | 3 |
| Other consumer | <u>20</u> | <u>22</u> | <u>21</u> |
| Total consumer | <u>816</u> | <u>708</u> | <u>364</u> |
| Total | <u>\$ 876</u> | <u>\$ 784</u> | <u>\$ 416</u> |
| Net Charge-off Ratio: | | | |
| Commercial | .72% | .87% | .54% |
| Consumer: | | | |
| Residential mortgage, excluding HELOCs and home equity mortgages | 1.49 | 1.34 | .63 |
| HELOCs and home equity mortgages | <u>5.47</u> | <u>4.44</u> | <u>2.25</u> |
| Total residential mortgage | 2.42 | 2.06 | .90 |
| Private label card receivables | 8.13 | 8.31 | 5.96 |
| Credit card receivables | 10.33 | 7.05 | 6.69 |
| Auto finance | 4.00 | 3.05 | 5.80 |
| Other consumer | <u>5.99</u> | <u>5.33</u> | <u>4.31</u> |
| Total consumer | <u>6.32</u> | <u>5.34</u> | <u>3.01</u> |
| Total | <u>4.13%</u> | <u>3.56%</u> | <u>1.91%</u> |

Our net charge-off ratio as a percentage of average loans increased 57 basis points compared to the prior quarter primarily due to higher credit card, auto finance and residential mortgage charge-offs. Higher net charge-off levels are a result of the following:

- Higher delinquency levels migrating to charge-off due to:
 - Continued weakness in the U.S economy and housing markets;

- Continued high unemployment rates; and
- Portfolio seasoning; and
- Higher loss severities for secured loans.

Charge-off dollars and ratios increased in the residential mortgage portfolio reflecting continued weakness in the housing and mortgage industry, including marked decreases in home values in certain markets as well as lower average loans outstanding. Charge-off dollars and ratios for our private label card portfolio improved slightly as credit quality remained relatively stable.

Charge-off levels in our credit card portfolio were negatively impacted by the GM and UP Portfolio purchased from HSBC Finance, a portion of which were subject to the application of accounting principles that require that purchased loans with evidence of credit deterioration since origination be recorded at an amount based on the net cash flows expected to be collected which reduced the overall level of credit card charge-off reported in the first half of 2009. The portion of the portfolio not subject to this accounting is now seasoning resulting in increased charge-offs during the third quarter.

Our auto finance net charge-off ratio increased as the purchase of \$3.0 billion of non-delinquent auto finance receivables purchased from HSBC Finance in January 2009 are now beginning to season and migrate to charge-off.

Our net charge-off ratio increased 57 basis points compared to the prior quarter primarily due to higher charge-offs in our residential mortgage, private label card and credit card receivables as discussed above. Commercial charge-off dollars and ratios increased due to a higher level of losses in the small business portfolio and an increase in losses in the middle market and commercial real estate portfolios.

Nonperforming Assets

Nonperforming assets are summarized in the following table.

| | <u>2009</u> | <u>2009</u> | <u>2008</u> |
|---|--------------|-------------|-------------|
| September 30, June 30, December 31, | | | |
| Nonaccrual loans: | | | |
| Commercial: | | | |
| Construction and other real estate | \$ 375 | \$ 288 | \$ 74 |
| Other commercial | <u>576</u> | <u>301</u> | <u>167</u> |
| Total commercial | 951 | 589 | 241 |
| Consumer: | | | |
| Residential mortgages, excluding HELOCs and home equity mortgages | 787 | 693 | 444 |
| HELOCs and home equity mortgages | <u>101</u> | <u>125</u> | <u>122</u> |
| Total residential mortgages | 888 | 818 | 566 |
| Credit card receivables | 3 | 3 | 2 |
| Auto finance | <u>47</u> | <u>37</u> | <u>3</u> |
| Total consumer loans | 938 | 858 | 571 |
| Nonaccrual loans held for sale | <u>453</u> | <u>433</u> | <u>441</u> |
| Total nonaccruing loans | 2,342 | 1,880 | 1,253 |

| | | | |
|---|------------------------|-----------------|-----------------|
| Accruing loans contractually past due 90 days or more: | | | |
| Total commercial | 343 | 214 | 150 |
| Consumer: | | | |
| Residential mortgages, excluding HELOCs and home equity mortgages | - | - | - |
| HELOCs and home equity mortgages | = | = | = |
| Total residential mortgages | - | - | - |
| Private label card receivables | 449 | 456 | 462 |
| Credit card receivables | 411 | 423 | 82 |
| Auto finance | 1 | 1 | 1 |
| Other consumer | 29 | 28 | 27 |
| Total consumer loans | 890 | 908 | 572 |
| Accruing loans contractually past due 90 days or more held for sale | = | = | = |
| Total accruing loans contractually past due 90 days or more | <u>1,233</u> | <u>1,122</u> | <u>722</u> |
| Total nonperforming loans | 3,575 | 3,002 | 1,975 |
| Other real estate owned | 90 | 91 | 80 |
| Total nonperforming assets | <u>\$ 3,665</u> | <u>\$ 3,093</u> | <u>\$ 2,055</u> |
| Allowance for credit losses as a percent of nonperforming loans(1) | | | |
| Commercial | 73.03% | 94.52% | 146.29% |
| Consumer | 159.85 | 168.80 | 159.67 |

- (1) Ratio excludes nonperforming loans associated with loan portfolios which are considered held for sale as these loans are carried at the lower of cost or market.

Increases in nonperforming loans at September 30, 2009 as compared to the prior quarter are primarily related to commercial loans, residential mortgages, and credit card receivables 90 days or more past due and still accruing. Deterioration in the U.S. economy, including rising unemployment rates, contributed to the overall increase in nonperforming loans. Commercial non-accrual loans increased as compared to both the prior quarter and prior year quarter largely due to continued deterioration of economic conditions and changes in the financial condition of specific customers. Residential mortgage nonperforming loans increased largely due to deterioration in the housing markets. Increases in accruing loans past due 90 days or more during the quarter also reflect seasonality and, as compared to the prior year, a significantly higher portfolio of credit card receivables. Our policies and practices for problem loan management and placing loans on nonaccrual status are summarized in Note 2, "Summary of Significant Accounting Policies and New Accounting Pronouncements," in our 2008 Form 10-K.

Interest that has been accrued but unpaid on loans placed on nonaccrual status generally is reversed and reduces current income at the time loans are so categorized. Interest income on these loans may be recognized to the extent of cash payments received. In those instances where there is doubt as to collectability of principal, any cash interest payments received are applied as reductions of principal. Loans are not reclassified as accruing until interest and principal payments are brought current and future payments are reasonably assured.

Impaired Commercial Loans

A commercial loan is considered to be impaired when it is deemed probable that all principal and interest amounts due, according to the contractual terms of the loan agreement, will not be collected. Probable losses from impaired loans are quantified and recorded as a component of the overall allowance for credit losses. Generally, impaired commercial loans include loans in nonaccrual status, loans that have been assigned a specific allowance for credit losses, loans that have been partially or wholly charged off and loans designated as troubled debt restructurings. Impaired commercial loan statistics are summarized in the following table:

September 30, June 30, December 31, September 30,

| | <u>2009</u> | <u>2009</u> | <u>2008</u> | <u>2008</u> |
|--------------------------------|---------------------------|-------------|-------------|-------------|
| | (dollars are in millions) | | | |
| Impaired commercial loans: | | | | |
| Balance at end of period | \$ 951 | \$ 589 | \$ 241 | \$ 226 |
| Amount with impairment reserve | 743 | 304 | 150 | 145 |
| Impairment reserve | 216 | 65 | 43 | 44 |

Criticized Assets

Criticized asset classifications are based on the risk rating standards of our primary regulator. Problem loans are assigned various criticized facility grades under our allowance for credit losses methodology. The following facility grades are deemed to be criticized. Criticized assets are summarized in the following table.

| | <u>Increases (Decreases) from</u> | | | | | | |
|------------------|-----------------------------------|-----------------|---------------|---------------------|---------------|----------------------|--------------|
| | <u>September 30,</u> | <u>June 30,</u> | | <u>December 31,</u> | | <u>September 30,</u> | |
| | <u>2009</u> | <u>2009</u> | <u>2008</u> | <u>2008</u> | <u>2008</u> | <u>2008</u> | |
| | <u>Amount</u> | <u>%</u> | <u>Amount</u> | <u>%</u> | <u>Amount</u> | <u>%</u> | |
| Special mention: | | | | | | | |
| Commercial loans | \$ 3,576 | \$ (281) | (7.3)% | \$ (490) | (12.1)% | \$ 183 | 5.4% |
| Substandard: | | | | | | | |
| Commercial loans | 3,686 | 195 | 5.6 | 1,812 | 96.7 | 2,357 | 100+ |
| Consumer loans | <u>1,920</u> | <u>64</u> | <u>3.4</u> | <u>689</u> | <u>56.0</u> | <u>861</u> | <u>81.3</u> |
| | 5,606 | 259 | 4.8 | 2,501 | 80.5 | 3,218 | 100+ |
| Doubtful: | | | | | | | |
| Commercial loans | <u>458</u> | <u>326</u> | <u>100+</u> | <u>398</u> | <u>100+</u> | <u>393</u> | <u>100+</u> |
| Total | \$ 9,640 | \$ 304 | 3.3% | \$ 2,409 | 33.3% | \$ 3,794 | 64.9% |

The increase in criticized commercial loans resulted mainly from further customer credit downgrades in financial institution counterparties as well as real estate and middle market customers. As previously mentioned, downgrades in our commercial real estate portfolio are continuing, particularly for condominium and land loans, as well as hotel and office construction where many construction projects have been delayed. Although our middle market portfolio has deteriorated in most industry segments and geographies, consistent with the overall deterioration in the U.S. economy, customers in those areas of the economy that have experienced above average weakness such as apparel, auto related suppliers and construction related businesses have been particularly affected. Higher substandard consumer loans since December 31, 2008 were largely driven by our acquisition of the GM and UP Portfolios.

Geographic Concentrations

Regional exposure at September 30, 2009 for certain loan portfolios is summarized in the following table.

| | Commercial | Residential | Credit |
|-----------------------------|----------------------------|--------------------|--------------------|
| | Construction | Mortgage | Card |
| | and | Loans | Receivables |
| | Other Real | | |
| | <u>Estate Loans</u> | | |
| New York State | 45.95% | 37.57% | 10.35% |
| North Central United States | 4.00 | 9.02 | 27.64 |
| North Eastern United States | 11.07 | 10.01 | 14.41 |
| Southern United States | 20.90 | 18.72 | 26.32 |
| Western United States | 17.41 | 24.66 | 20.95 |
| Other | <u>.67</u> | <u>.02</u> | <u>.33</u> |
| Total | <u>100.00%</u> | <u>100.00%</u> | <u>100.00%</u> |

Liquidity and Capital Resources

Effective liquidity management is defined as making sure we can meet customer loan requests, customer deposit maturities/withdrawals and other cash commitments efficiently under both normal operating conditions and under unpredictable circumstances of industry or market stress. To achieve this objective, we have guidelines that require sufficient liquidity to cover potential funding requirements and to avoid over-dependence on volatile, less reliable funding markets. Guidelines are set for the consolidated balance sheets of HSBC USA Inc. to ensure that it is a source of strength for our regulated, deposit-taking banking subsidiary, as well to address the more limited sources of liquidity available to us. Similar guidelines are set for the balance sheet of HSBC Bank USA to ensure that it can meet its liquidity needs in various stress scenarios. Cash flow analysis, including stress testing scenarios, forms the basis for liquidity management and contingency funding plans.

During 2008 and continuing into early 2009, financial markets were extremely volatile. New issue term debt markets were extremely challenging with issues attracting substantially higher rates of interest than had historically been experienced and credit spreads for all issuers continued to trade at historically wide levels. Liquidity for asset backed securities remained tight as spreads remained high, negatively impacting the ability to securitize credit card receivables. The Federal Reserve Board introduced the Term Asset Backed Securities Loan Facility Program (“TALF”) in late 2008 to improve liquidity in asset backed securities. While the on-going financial market disruptions continued to impact credit spreads and liquidity during the first nine months of 2009, we have continued to see improvements in liquidity beginning in the second quarter and continuing into the third quarter of 2009 and credit spreads have continued to narrow due to increased market confidence stemming largely from the various government actions taken to restore faith in the capital markets. Financial institutions are now able to issue longer term debt without government guarantees, and the FDIC has been able to allow the Debt Guarantee Program to expire. Similarly, many non-TALF

eligible asset backed securitizations have been issued at favorable rates in the second and third quarters of 2009.

During 2008 and continuing into 2009, we witnessed the systemic reduction in available liquidity in the market and took steps to reduce our reliance on debt capital markets and to increase deposits. After adjusting for the \$6.1 billion of debt acquired with the credit card transfers, we reduced our long-term debt by \$6.8 billion during the nine months ended September 30, 2009. In the latter part of 2008, we had grown deposits in anticipation of the asset transfers and December 31, 2008 balances also benefitted from clients choosing to place their surplus liquidity into banks. Subsequent to December 31, 2008 we managed our overall balance sheet downward by reducing low margin investments and deposits, and continuing to manage the overall balance sheet risk.

Interest bearing deposits with banks totaled \$18.5 billion and \$15.9 billion at September 30, 2009 and December 31, 2008, respectively. Balances increased during the nine months ended September 30, 2009 as excess liquidity was placed in these accounts.

Federal funds sold and securities purchased under agreements to resell totaled \$4.5 billion and \$10.8 billion at September 30, 2009 and December 31, 2008, respectively. Balances decreased during the nine months ended September 30, 2009 as we redeployed surplus liquidity out of repurchase agreements into purchases of short term treasury bills.

Short-term borrowings totaled \$8.3 billion and \$10.5 billion at September 30, 2009 and December 31, 2008, respectively. See “Balance Sheet Review” in this MD&A for further analysis and discussion on short-term borrowing trends.

Deposits decreased to \$115.5 billion at September 30, 2009 from \$119.0 billion at December 31, 2008. See “Balance Sheet Review” in this MD&A for further analysis and discussion on deposit trends.

Long-term debt decreased to \$21.4 billion at September 30, 2009 from \$22.1 billion at December 31, 2008 as the assumption of debt from HSBC Finance relating to the credit card receivable purchases and additional issuances during the first nine months of 2009 were more than offset by maturities. The following table summarizes issuances and retirements of long-term debt during the nine months ended September 30, 2009 and 2008:

| <u>Nine Months Ended September 30,</u> | <u>2009</u> | <u>2008</u> |
|---|----------------------|--------------------|
| | (in millions) | |
| Long-term debt issued | \$ 3,022 | \$ 3,463 |
| Long-term debt retired | (9,396) | (9,493) |
| Net long-term debt retired | \$ (6,374) | \$ (6,030) |

Issuances of long-term debt during the nine months ended September 30, 2009 included:

- \$1.7 billion of medium term notes, of which \$293 million was issued by HSBC Bank USA,
- \$1.0 billion of senior notes which was issued to HSBC North America,
- \$250 million of two-year Senior Floating Rate Notes, and
- \$55 million of subordinated debt issued by a subsidiary of HSBC Bank USA.

None of the debt issued in 2009 was guaranteed by the FDIC.

As discussed above, as part of the purchase of the UP and GM Portfolio from HSBC Finance in January 2009, we assumed \$6.1 billion of indebtedness accounted for as secured financings. At September 30, 2009, \$2.5 billion was outstanding.

Under our shelf registration statement on file with the Securities and Exchange Commission, we may issue debt securities or preferred stock. The shelf has no dollar limit, but the ability to issue debt is limited by the issuance authority granted by the Board of Directors. We are currently authorized to issue up to \$12.0 billion, of which \$3.9 billion is available. HSBC Bank USA also has a \$40.0 billion Global Bank Note Program of which \$20.1 billion is available.

As a member of the New York Federal Home Loan Bank (“FHLB”), we have a secured borrowing facility which is collateralized by residential mortgage loans and investment securities. At September 30, 2009 and December 31, 2008, long-term debt included \$1.0 billion and \$2.0 billion, respectively, under this facility. The facility also allows access to further borrowings of up to \$2.6 billion based upon the amount pledged as collateral with the FHLB.

At September 30, 2009 and December 31, 2008 we had a \$2.5 billion unused line of credit with HSBC Bank, plc, a U.K. based HSBC subsidiary to support issuances of commercial paper.

Preferred Equity In April 2009, the preferred stock issued to CT Financial Services Inc. in 1997 was redeemed. See Note 20, “Preferred Stock,” in the consolidated financial statements included in our 2008 Form 10-K for information regarding all outstanding preferred share issues.

Common Equity During the nine months ended September 30, 2009, HNAI made 3 capital contributions to us totaling \$2.2 billion in exchange for 3 shares of our common stock. Subsequently, we contributed \$2.7 billion to HSBC Bank USA in exchange for 3 shares of HSBC Bank USA’s common stock. These capital contributions were to support ongoing operations, including the credit card receivables purchased from HSBC Finance and to maintain capital at levels we believe are prudent in current market conditions.

Selected Capital Ratios Capital amounts and ratios are calculated in accordance with current banking regulations. In managing capital, we develop targets for Tier 1 capital to risk weighted assets and Tier 1 capital to average assets. Our targets may change from time to time to accommodate changes in the operating environment or other considerations such as those listed above. Selected capital ratios are summarized in the following table:

| | September 30, December 31, | |
|--|-----------------------------------|--------------------|
| | <u>2009</u> | <u>2008</u> |
| Tier 1 capital to risk weighted assets | 9.25% | 7.60% |
| Tier 1 capital to average assets | 7.65 | 5.96 |
| Total equity to total assets | 8.66 | 6.85 |

We maintain rolling 12 month capital forecasts on a consolidated basis, and for our banking subsidiary. Target capital ratios approved by the Board of Directors are set above levels established by regulators as “well capitalized”, and are partly based on a review of peer banks. Dividends are generally paid to our parent company, HNAI, when available capital exceeds target levels. To the extent that our forecasts indicate that capital will not exceed target levels, we will generally seek a capital infusion from our parent, in accordance with HSBC capital management policy. HUSI’s target

capital ratios and capital forecasting are integrated into the capital management process of HSBC.

HSBC USA Inc. and HSBC Bank USA are required to meet minimum capital requirements by their principal regulators. Risk-based capital amounts and ratios are presented in Note 16, "Regulatory Capital," in the accompanying consolidated financial statements.

As part of the regulatory approvals with respect to the aforementioned receivable purchases completed in January 2009, we and our ultimate parent, HSBC, committed that HSBC Bank USA will maintain a Tier 1 risk-based capital ratio of at least 7.62 percent, a total capital ratio of at least 11.55 percent and a Tier 1 leverage ratio of at least 6.45 percent for one year following the date of transfer. In addition, we and HSBC made certain additional capital commitments to ensure that HSBC Bank USA holds sufficient capital with respect to the purchased receivables that are or become "low-quality assets," as defined by the Federal Reserve Act. In May 2009, we received further clarification from the Federal Reserve regarding HSBC Bank USA's regulatory reporting requirements with respect to these capital commitments in that the additional capital requirements, (which require a risk-based capital charge of 100 percent for each "low-quality asset" transferred or arising in the purchased portfolios rather than the eight percent capital charge applied to similar assets that are not part of the transferred portfolios), should be applied both for purposes of satisfying the terms of the commitments and for purposes of measuring and reporting HSBC Bank USA's risk-based capital and related ratios. This treatment applies as long as the low-quality assets are owned by an insured bank. During the third quarter of 2009, HSBC Bank USA sold low-quality auto finance loans with a net book value of approximately \$165 million to a non-bank subsidiary of HSBC USA Inc. to reduce this capital requirement. Capital ratios and amounts reported above at September 30, 2009 reflect this revised regulatory reporting. At September 30, 2009, we have exceeded our committed ratios and would have done so without the benefit associated with these low-quality asset sales. In addition to the target capital ratios, we have established an Internal Capital Adequacy Assessment Process ("ICAAP"). Under ICAAP, capital adequacy is evaluated through the examination of regulatory capital ratios (measured under current and Basel II rules), economic capital and stress testing. The results of the ICAAP are forwarded to HSBC and, to the extent that this evaluation identifies potential capital needs, incorporated into the HSBC capital management process. HSBC has indicated that they are fully committed and have the capacity to provide capital as needed to run operations, maintain sufficient regulatory capital ratios, and fund certain tax planning strategies.

We assumed \$6.1 billion of securities backed by credit card receivables in the first quarter of 2009 as part of the credit card receivables purchase from HSBC Finance. For accounting purposes, these transactions were structured as secured financings. Therefore, the receivables and the related debt remain on our balance sheet. At September 30, 2009, private label, other credit card receivables and restricted available for sale investments totaling \$4.0 billion secured \$3.0 billion of outstanding public debt and conduit facilities. At December 31, 2008, private label receivables totaling \$1.6 billion secured \$1.2 billion of outstanding debt. At September 30, 2009, we had conduit credit facilities with commercial and investment banks under which our operations may issue securities backed with up to \$3.3 billion of private label and credit card receivables. The facilities are renewable at the providers' option. Our total conduit capacity increased by \$2.2 billion during the nine months ended September 30, 2009. The increase is primarily the result of the GM and UP credit card receivable purchase and related secured financing conduit facilities completed in the first quarter of 2009. At September 30, 2009, private label and credit card receivables of \$1.6 billion were used to collateralize \$1.2 billion of funding transactions structured as secured financings under these funding programs. For the conduit credit facilities that have renewed in 2009, credit performance requirements have generally been more restrictive and pricing has increased to reflect the perceived quality of the underlying assets although in the second quarter, we began to witness an easing of such terms. Available for sale investments at September 30, 2009 included \$730 million which were restricted for the sole purpose of paying down certain secured financings at the established payment date. There were no restricted available for sale investments at December 31, 2008.

The securities issued in connection with collateralized funding transactions may pay off sooner than originally scheduled if certain events occur. Early payoff of securities may occur if established delinquency or loss levels are exceeded or if certain other events occur. For all other transactions, early payoff of the securities begins if the

annualized portfolio yield drops below a base rate or if certain other events occur. Presently we do not anticipate that any early payoff will take place. If early payoff were to occur, our funding requirements would increase. These additional requirements could be met through issuance of various types of debt or borrowings under existing back-up lines of credit. We believe we would continue to have adequate sources of funds if an early payoff event were to occur. Further, we have significantly reduced our overall dependence on these sources as we shift to more stable sources while reducing our overall cost of funding.

In 2008 and continuing into early 2009, the market for new securities backed by receivables essentially disappeared as spreads rose to historic highs. However, many non-TALF eligible asset backed securitizations have been issued at favorable rates in the second and third quarters of 2009. Factors affecting our ability to structure collateralized funding transactions as secured financings going forward or to do so at cost-effective rates, include the overall credit quality of our securitized loans, the stability of the securitization markets, the securitization market's view of our desirability as an investment and the legal, regulatory, accounting and tax environments governing collateralized funding transactions.

HSBC Bank USA is subject to restrictions that limit the transfer of funds from it to us and our nonbank subsidiaries (including affiliates) in so-called "covered transactions." In general, covered transactions include loans and other extensions of credit, investments and asset purchases, as well as certain other transactions involving the transfer of value from a subsidiary bank to an affiliate or for the benefit of an affiliate. Unless an exemption applies, covered transactions by a subsidiary bank with a single affiliate are limited to 10% of the subsidiary bank's capital and surplus and, with respect to all covered transactions with affiliates in the aggregate, to 20% of the subsidiary bank's capital and surplus. Also, loans and extensions of credit to affiliates generally are required to be secured in specified amounts. A bank's transactions with its nonbank affiliates are also generally required to be on arm's length terms.

2009 Funding Strategy Our current range of estimates for funding needs and sources for 2009 are summarized in the following table.

| | Actual | Estimated | |
|---|---|--------------------|---------------------|
| | January 1, | October 1, | |
| | through | through | Estimated |
| | September 30, December 31, Full Year | | |
| | <u>2009</u> | <u>2009</u> | <u>2009</u> |
| | (in billions) | | |
| Funding needs: | | | |
| Net loan growth (attrition), excluding asset transfers | \$ (7) | \$ - | \$ (7) |
| Net asset transfers | 9 | - | 9 |
| Long-term debt maturities | 7 | 3 | 10 |
| Investment portfolio | 4 | - | 4 |
| Secured financings, including conduit facility maturities | 4 | - | 4 |
| Total funding needs | <u>\$ 17</u> | <u>\$ 3</u> | <u>\$ 20</u> |
| Funding sources: | | | |
| Cash from operations | \$ 3 | \$ - | \$ 3 |
| Core deposit growth | 9 | (1) | 8 |
| Other deposit growth (attrition) | (12) | - | (12) |
| Loan sales | 4 | - | 4 |

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| | | | |
|---|---------------------|--------------------|---------------------|
| Long-term debt issuance | 3 | - | 3 |
| Short-term funding/investments | 5 | 4 | 9 |
| Secured financings, including conduit facility renewals | 1 | - | 1 |
| Other, including capital infusions | 4 | = | 4 |
| Total funding sources | <u>\$ 17</u> | <u>\$ 3</u> | <u>\$ 20</u> |

The above table reflects a long-term funding strategy. Daily balances fluctuate as we accommodate customer needs, while ensuring that we have liquidity in place to support the balance sheet maturity funding profile. Should market conditions worsen, we have contingency plans to generate additional liquidity through the sales of assets or financing transactions. Our prospects for growth are dependent upon access to the global capital markets and our ability to attract and retain deposits. We remain confident in our ability to access the market for long-term debt funding needs in the current market environment. Deposits are expected to grow as we continue to expand our core domestic banking network. We continue to seek well-priced and stable customer deposits as customers move funds to larger, well-capitalized institutions due to a volatile market.

In January 2009, we purchased a \$6.3 billion portfolio of General Motors MasterCard receivables, a \$6.1 billion portfolio of AFL-CIO Union Plus MasterCard/Visa receivables and a \$3.0 billion auto loan portfolio from HSBC Finance. Related funding of \$6.1 billion and equity of \$1.1 billion was also transferred as part of the purchase.

We will continue to sell a majority of new mortgage loan originations to government sponsored enterprises and private investors.

The 2009 Full Year Estimate in the table above reflects current market conditions. The 2009 Full Year Estimate in our 2008 10-K reflected market conditions existing at the time of its publication. For further discussion relating to our sources of liquidity and contingency funding plan, see the caption "Risk Management" in the MD&A of this Form 10-Q.

Off-Balance Sheet Arrangements

As part of our normal operations, we enter into various off-balance sheet arrangements with affiliates and third parties. These arrangements arise principally in connection with our lending and client intermediation activities and involve primarily extensions of credit and guarantees.

As a financial services provider, we routinely extend credit through loan commitments and lines and letters of credit and provide financial guarantees, including derivative transactions that meet the definition of a guarantee. The contractual amounts of these financial instruments represent our maximum possible credit exposure in the event that a counterparty draws down the full commitment amount or we are required to fulfill our maximum obligation under a guarantee.

The following table provides maturity information related to our off-balance sheet arrangements. Many of these commitments and guarantees expire unused or without default. As a result, we believe that the contractual amount is not representative of the actual future credit exposure or funding requirements. Descriptions of these arrangements are found in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our 2008 Form 10-K under the caption "Off-Balance Sheet Arrangements and Contractual Obligations."

Balance at September 30, 2009

- (1) For multi-seller conduits, the amounts presented represent only the specific assets and related funding supported by our liquidity facilities. For single-seller conduits, the amounts presented represent the total assets and funding of the conduit.

| <u>Asset Class</u> | <u>Average</u> | <u>Average Credit Quality(1)</u> | | | | | |
|------------------------------|------------------|----------------------------------|---------------|------------|-----------|------------|---------------|
| | <u>Asset Mix</u> | <u>AAA</u> | <u>AA+/AA</u> | <u>A</u> | <u>A-</u> | <u>BBB</u> | <u>BB/BB-</u> |
| Multi-seller conduits | | | | | | | |
| Debt securities backed by: | | | | | | | |
| Auto loans and leases | 50% | 42% | 17% | 21% | 14% | 6% | -% |
| Trade receivables | 15 | 20 | 26 | 54 | - | - | - |
| Credit card receivables | 21 | 43 | - | 57 | - | - | - |
| Other securities | 11 | - | - | - | - | - | 100 |
| Capital calls | 1 | - | - | 100 | - | - | - |
| Equipment loans | 2 | 100 | - | - | - | - | - |
| Auto dealer floor plan loans | = | = | = | <u>100</u> | = | = | = |
| Total | 100% | 36% | 12% | 31% | 7% | 3% | 11% |
| Single-seller conduits | | | | | | | |
| Debt securities backed by: | | | | | | | |
| Auto loans and leases | 100% | 95% | 5% | -% | -% | -% | -% |
| Loans and trade receivables: | | | | | | | |
| Auto loans and leases | = | = | = | = | = | = | = |
| Total | 100% | 95% | 5% | -% | -% | -% | -% |

- (1) Credit quality is based on Standard and Poor's ratings at September 30, 2009 except for loans and trade receivables held by single-seller conduits, which are based on our internal ratings. For the single-seller conduits, external ratings are not available; however, our internal credit ratings were developed using similar methodologies and rating scales equivalent to the external credit ratings.

We receive fees for providing these liquidity facilities. Credit risk on these obligations is managed by subjecting them to our normal underwriting and risk management processes.

During the first nine months of 2009, U.S. asset backed commercial paper volumes declined as most bank conduit sponsors reduced exposure to certain industry sectors and generally tightened credit availability. Despite the volume reduction, there are signs that most major bank conduits sponsors are extending new financing but at a slower pace. Credit spreads in the multi-seller conduit market have trended lower since the beginning of the year following a pattern that is prevalent across the U.S. credit markets. In the ABCP market, the success of the TALF program has revived the term ABS market and has been the primary catalyst for the lowering of spreads in the ABCP market. The lower supply of ABCP has led to greater investor liquidity for the large bank sponsors that are attracting demand from money fund investors. The improved demand for higher quality ABCP program has led to an improved market sentiment and less volatility in issuance spreads.

The preceding tables do not include information on liquidity facilities that we previously provided to certain Canadian multi-seller ABCP conduits that have been subject to restructuring agreements. As a result of specific difficulties in the Canadian asset backed commercial paper markets, we entered into various agreements during the second half of

2007 modifying obligations with respect to these facilities.

Under one of these agreements, known as the Montreal Accord, a restructuring proposal to convert outstanding commercial paper into longer term securities was approved by ABCP noteholders during the second quarter of 2008 and endorsed by the Canadian justice system during the third quarter of 2008. The restructuring plan was formally executed during the first quarter of 2009. As part of the enhanced collateral pool established for the restructuring, we have provided a \$374 million Margin Funding Facility to new Master Conduit Vehicles, which is currently undrawn. HBUS derivatives transactions with the previous conduit vehicles have been assigned to new Master Conduit Vehicles. Under the restructuring, collateral provided to us to mitigate the derivatives exposures is significantly higher than it was previously.

Also in Canada but separately from the Montreal Accord, as part of an ABCP conduit restructuring executed in the second quarter of 2008, we hold \$281 million of long-term securities and provide a \$94 million Credit Facility. As of September 30, 2009, approximately \$4 million of the Credit Facility was drawn and the \$281 million of securities were still held. As of December 31, 2008, approximately \$77 million of the Credit Facility was drawn and \$246 million of securities were held.

As of September 30, 2009 and December 31, 2008, other than the Margin Funding Facilities referenced above, we no longer have outstanding liquidity facilities to Canadian ABCP conduits subject to the Montreal Accord or other agreements referenced. However, we hold \$10 million of long-term securities that were converted from a liquidity drawing which fell under the Montreal Accord restructuring agreement.

In addition to the facilities provided to ABCP conduits, we also provide a \$50 million liquidity facility (of which \$38 million was outstanding at September 30, 2009) to a third-party sponsored multi-seller structured investment vehicle ("SIV"). This SIV and our involvement with it is more fully described in Note 17, "Special Purpose Entities," of the accompanying consolidated financial statements. At September 30, 2009 and December 31, 2008, this facility was fully funded and is recorded in loans on our balance sheet. The funded amount related to this liquidity facility was considered in the determination of our allowance for loan losses and a specific reserve of \$13 million was established during the third quarter of 2009 against this facility in accordance with our credit policies. As of October 1, 2009, the assets of the existing SIV were transferred to a newly formed SIV in order to foreclose upon the assets within the existing SIV. The transfer occurred as the creditors received their respective share in the new SIV transaction by exchanging the current exposure for notes in the new trust. The notes will accrue interest at a spread over LIBOR to be determined based upon the collections (contingent interest).

We have established and manage a number of constant net asset value ("CNAV") money market funds that invest in shorter-dated highly-rated money market securities to provide investors with a highly liquid and secure investment. These funds price the assets in their portfolio on an amortized cost basis, which enables them to create and liquidate shares at a constant price. The funds, however, are not permitted to price their portfolios at amortized cost if that amount varies by more than 50 basis points from the portfolio's market value. In that case, the fund would be required to price its portfolio at market value and consequently would no longer be able to create or liquidate shares at a constant price. We do not consolidate the CNAV funds as they are not VIEs and we do not hold a majority voting interest.

Fair Value

Fair value measurement accounting principles require a reporting entity to take into consideration its own credit risk in determining the fair value of financial liabilities. The incorporation of our own credit risk accounted for an increase of \$104 million and \$254 million in the fair value of financial liabilities for the three and nine month periods ended September 30, 2009, respectively, as compared with a decrease of \$175 million and \$437 million in the fair value of financial liabilities for the year-ago periods.

Net income volatility arising from changes in either interest rate or credit components of the mark-to-market on debt designated at fair value and related derivatives affects the comparability of reported results between periods. Accordingly, gain on debt designated at fair value and related derivatives for the nine months ended September 30, 2009 should not be considered indicative of the results for any future period.

Control Over Valuation Process and Procedures

A control framework has been established which is designed to ensure that fair values are either determined or validated by a function independent of the risk-taker. To that end, the ultimate responsibility for the determination of fair values rests with Finance. Finance establishes policies and procedures to ensure appropriate valuations. For fair values determined by reference to external quotations on the identical or similar assets or liabilities, an independent price validation process is utilized. For price validation purposes, quotations from at least two independent pricing sources are obtained for each financial instrument, where possible. We consider the following factors in determining fair values:

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

Greater weight is given to quotations of instruments with recent market transactions, pricing quotes from dealers who stand ready to transact, quotations provided by market-makers who originally structured such instruments, and market consensus pricing based on inputs from a large number of participants. Any significant discrepancies among the external quotations are reviewed by management and adjustments to fair values are recorded where appropriate.

For fair values determined by using internal valuation techniques, valuation models and inputs are developed by the business and are reviewed, validated and approved by the Quantitative Risk and Valuation Group (“QRVG”) or other independent valuation control teams within Finance. Any subsequent material changes are reviewed and approved by the Valuation Committee which is comprised of representatives from the business and various control groups. Where available, we also participate in pricing surveys administered by external pricing services to validate our valuation models and the model inputs. The fair values of the majority of financial assets and liabilities are determined using well developed valuation models based on observable market inputs. The fair value measurements of these assets and liabilities require less judgment. However, certain assets and liabilities are valued based on proprietary valuation models that use one or more significant unobservable inputs and judgment is required to determine the appropriate level of adjustments to the fair value to address, among other things, model and input uncertainty. Any material adjustments to the fair values are reported to management.

Fair Value Hierarchy

Fair value measurement accounting principles establish a fair value hierarchy structure that prioritizes the inputs to determine the fair value of an asset or liability (the “Fair Value Framework”). The Fair Value Framework distinguishes between inputs that are based on observed market data and unobservable inputs that reflect market participants’ assumptions. It emphasizes the use of valuation methodologies that maximize observable market inputs. For financial

instruments carried at fair value, the best evidence of fair value is a quoted price in an actively traded market (Level 1). Where the market for a financial instrument is not active, valuation techniques are used. The majority of our valuation techniques use market inputs that are either observable or indirectly derived from and corroborated by observable market data for substantially the full term of the financial instrument (Level 2). Because Level 1 and Level 2 instruments are determined by observable inputs, less judgment is applied in determining their fair values. In the absence of observable market inputs, the financial instrument is valued based on valuation techniques that feature one or more significant unobservable inputs (Level 3). The determination of the level of fair value hierarchy within which the fair value measurement of an asset or a liability is classified often requires judgment and may change over time as market conditions evolve. We consider the following factors in developing the fair value hierarchy:

- whether the asset or liability is transacted in an active market with a quoted market price;
- the level of bid-ask spreads;
- a lack of pricing transparency due to, among other things, complexity of the product and market liquidity;
- whether only a few transactions are observed over a significant period of time;
- whether the pricing quotations vary substantially among independent pricing services;
- whether inputs to the valuation techniques can be derived from or corroborated with market data; and
- whether significant adjustments are made to the observed pricing information or model output to determine the fair value.

Level 1 inputs are unadjusted quoted prices in active markets that the reporting entity has the ability to access for identical assets or liabilities. A financial instrument is classified as a Level 1 measurement if it is listed on an exchange or is an instrument actively traded in the over-the-counter (“OTC”) market where transactions occur with sufficient frequency and volume. We regard financial instruments such as equity securities and derivative contracts listed on the primary exchanges of a country to be actively traded. Non-exchange-traded instruments classified as Level 1 assets include securities issued by the U.S. Treasury or by other foreign governments, to-be-announced (“TBA”) securities and non-callable securities issued by U.S. government sponsored entities.

Level 2 inputs are inputs that are observable either directly or indirectly but do not qualify as Level 1 inputs. We classify mortgage pass-through securities, agency and certain non-agency mortgage collateralized obligations, certain derivative contracts, asset-backed securities, corporate debt, preferred securities and leveraged loans as Level 2 measurements. Where possible, at least two quotations from independent sources are obtained based on transactions involving comparable assets and liabilities to validate the fair value of these instruments. Where significant differences arise among the independent pricing quotes and the internally determined fair value, we investigate and reconcile the differences. If the investigation results in a significant adjustment to the fair value, the instrument will be classified as Level 3 within the fair value hierarchy. In general, we have observed that there is a correlation between the credit standing and the market liquidity of a non-derivative instrument. Most of the Level 2 asset-backed and mortgage-backed securities have credit ratings of AAA for which the market has maintained a certain degree of liquidity.

Level 2 derivative instruments are generally valued based on discounted future cash flows or an option pricing model adjusted for counterparty credit risk and market liquidity. The fair value of certain structured derivative products is determined using valuation techniques based on inputs derived from observable benchmark index tranches traded in the OTC market. Appropriate control processes and procedures have been applied to ensure that the derived inputs are applied to value only those instruments that share similar risks to the relevant benchmark indices and therefore demonstrate a similar response to market factors. In addition, a validation process has been established, which

includes participation in peer group consensus pricing surveys, to ensure that valuation inputs incorporate market participants' risk expectations and risk premium.

Level 3 inputs are unobservable estimates that management expects market participants would use to determine the fair value of the asset or liability. That is, Level 3 inputs incorporate market participants' assumptions about risk and the risk premium required by market participants in order to bear that risk. We develop Level 3 inputs based on the best information available in the circumstances. As of September 30, 2009 and December 31, 2008, our Level 3 instruments included the following: collateralized debt obligations ("CDOs") and collateralized loan obligations ("CLOs") for which there is a lack of pricing transparency due to market illiquidity, certain structured credit and structured equity derivatives where significant inputs (e.g., volatility or default correlations) are not observable, credit default swaps with certain monoline insurers where the deterioration in the creditworthiness of the counterparty has resulted in significant adjustments to fair value, U.S. subprime mortgage whole loans and subprime related asset-backed securities, mortgage servicing rights, and derivatives referenced to illiquid assets of less desirable credit quality.

Level 3 Measurements

The following table provides information about Level 3 assets/liabilities in relation to total assets/liabilities measured at fair value as of September 30, 2009 and December 31, 2008.

| | <u>September 30, 2009</u> <u>December 31, 2008</u> | |
|--|--|-----------|
| | (dollars are in millions) | |
| Level 3 assets(1),(2) | \$ 9,380 | \$ 12,081 |
| Total assets measured at fair value(3) | 123,110 | 192,222 |
| Level 3 liabilities | 3,325 | 2,845 |
| Total liabilities measured at fair value(1) | 87,959 | 158,710 |
| Level 3 assets as a percent of total assets measured at fair value | 7.6% | 6.3% |
| Level 3 liabilities as a percent of total liabilities measured at fair value | 3.8% | 1.8% |

- (1) Presented without netting which allow the offsetting of amounts relating to certain contracts if certain conditions are met.
- (2) Includes \$7.7 billion of recurring Level 3 assets and \$1.7 billion of non-recurring Level 3 assets at September 30, 2009 and \$10.7 billion of recurring Level 3 assets and \$1.4 billion of non-recurring Level 3 assets at December 31, 2008.
- (3) Includes \$121.3 billion of assets measured on a recurring basis and \$1.8 billion of assets measured on a non-recurring basis at September 30, 2009 and \$189.8 billion of non-recurring Level 3 assets and \$2.5 billion of non-recurring Level 3 assets at December 31, 2008.

Material Changes in Fair Value for Level 3 Assets and Liabilities

Derivative Assets and Counterparty Credit Risk We have entered into credit default swaps with monoline insurers to hedge our credit exposure in certain asset-backed securities and synthetic CDOs. Beginning in 2007 and continuing into early 2009, the creditworthiness of the monoline insurers has deteriorated significantly. However, in the third quarter of 2009, the deterioration previously experienced began to reverse. As a result, we made a \$104 million negative credit risk adjustment (as compared to a \$957 million negative credit risk adjustment) to the fair value of our credit default swap contracts, which is reflected in trading revenue (loss) for the nine months ended September 30, 2009 and 2008, respectively. We have recorded a cumulative credit adjustment reserve of \$638 million against our monoline exposure as of September 30, 2009.

Loans As of September 30, 2009 and December 31, 2008, we have classified \$931 million and \$1,278 million, respectively, of mortgage whole loans held for sale as a non-recurring Level 3 financial asset. These mortgage loans are accounted for on a lower of cost or fair value basis. Based on our assessment, we recorded a loss of \$28 million and \$182 million for such mortgage loans during the three and nine months ended September 30, 2009 as compared to \$87 million and \$331 million in the year-ago periods. The changes in fair value are recorded as other revenues in the consolidated statement of income (loss).

Material Additions to and Transfers Into (Out of) Level 3 Measurements

During the nine months ended September 30, 2009, we transferred \$613 million of mortgage and other asset-backed securities and \$345 million of corporate bonds from Level 2 to Level 3 as the availability of observable inputs continued to decline. In addition, we transferred \$13 million of credit derivatives from Level 2 to Level 3. See Note 19, "Fair Value Measurements," in the accompanying consolidated financial statements for information on additions to and transfers into (out of) Level 3 measurements during the nine months ended September 30, 2008 as well as for further details including the classification hierarchy associated with assets and liabilities measured at fair value.

During the third quarter and first nine months of 2009, we transferred \$65 million and \$353 million, respectively of auto finance loans to held for sale. As of September 30, 2009 these auto finance loans held for sale are classified as non-recurring Level 3 financial assets, and are accounted for on a lower of cost or fair value basis.

Credit Quality of Assets Underlying Asset-backed Securities

The following tables summarize the types and credit quality of the assets underlying our asset-backed securities as well as certain collateralized debt obligations and collateralized loan obligations held as of September 30, 2009:

Asset-backed securities backed by consumer finance collateral:

| <u>Credit quality of collateral:</u> | <u>Year of issuance:</u> | <u>Total</u> | <u>Prime</u> | | <u>Alt-A</u> | | <u>Sub-prime</u> | |
|--------------------------------------|--------------------------|--------------|----------------------|-------------------|----------------------|-------------------|----------------------|-------------------|
| | | | <u>Prior to 2006</u> | <u>After 2006</u> | <u>Prior to 2006</u> | <u>After 2006</u> | <u>Prior to 2006</u> | <u>After 2006</u> |
| (in millions) | | | | | | | | |
| Rating of securities: | Collateral type: | | | | | | | |
| AAA | Home equity loans | \$ 214 | \$ - | \$ - | \$ 1 | \$ 211 | \$ 2 | \$ - |
| | Auto loans | 27 | - | - | 27 | - | - | - |

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| | | | | | | | | |
|---------|-----------------------|------------|-----------|-------|-----------|------------|-----------|----------|
| | Student loans | 38 | - | - | 38 | - | - | - |
| | Residential mortgages | 1,019 | 4 | 35 | 671 | 7 | 302 | - |
| | Commercial mortgages | 950 | - | - | 84 | 866 | - | - |
| | Not specified | <u>24</u> | = | = | <u>24</u> | = | = | = |
| | Total AAA | 2,272 | 4 | 35 | 845 | 1,084 | 304 | - |
| AA | Home equity loans | 8 | - | - | - | - | 8 | - |
| | Residential mortgages | <u>50</u> | = | = | <u>50</u> | = | = | = |
| | Total AA | 58 | - | - | 50 | - | 8 | - |
| A | Home equity loans | 2 | - | - | 2 | - | - | - |
| | Commercial mortgages | 6 | - | - | - | 6 | - | - |
| | Residential mortgages | <u>99</u> | <u>16</u> | = | <u>7</u> | <u>71</u> | = | <u>5</u> |
| | Total A | 107 | 16 | - | 9 | 77 | - | 5 |
| BBB | Home equity loans | 161 | - | - | 5 | 155 | 1 | - |
| | Residential mortgages | 68 | - | - | 29 | 39 | - | - |
| | Not specified | = | = | = | = | = | = | = |
| | Total BBB | 229 | - | - | 34 | 194 | 1 | - |
| BB | Residential mortgages | 32 | - | - | 16 | 16 | - | - |
| | Not specified | = | = | = | = | = | = | = |
| | Total BB | 32 | - | - | 16 | 16 | - | - |
| B | Auto loans | 42 | - | - | 42 | - | - | - |
| | Residential mortgages | <u>36</u> | = | = | <u>18</u> | <u>18</u> | = | = |
| | Total B | 78 | - | - | 60 | 18 | - | - |
| CCC | Home equity loans | 14 | - | - | - | 14 | - | - |
| | Residential mortgages | <u>395</u> | = | = | <u>37</u> | <u>358</u> | = | = |
| | Total CCC | 409 | - | - | 37 | 372 | - | - |
| CC | Residential mortgages | 15 | - | - | - | 15 | - | - |
| | Home equity loans | <u>28</u> | = | = | = | = | <u>28</u> | = |
| | Total CC | 43 | - | - | - | 15 | 28 | - |
| C | Residential mortgages | <u>26</u> | = | = | <u>26</u> | = | = | = |
| Unrated | Residential mortgages | <u>7</u> | = | = | <u>4</u> | = | = | <u>3</u> |
| | | \$ | \$ 20 | \$ 35 | \$ | \$ | \$ 341 | \$ 8 |
| | | 3,261 | | | 1,081 | 1,776 | | |

Collateralized debt obligations (CDO) and collateralized loan obligations (CLO):

| <u>Credit quality of collateral:</u> | | <u>A</u> | <u>BBB</u> | <u>BB/B</u> | <u>CCC</u> | <u>Unrated</u> |
|--------------------------------------|-------------------------------|---------------|-------------|-------------|------------|----------------|
| | | <u>or</u> | | | | |
| | | <u>Higher</u> | | | | |
| Rating of securities: | Collateral type: | | | | | |
| AAA | Corporate loans | \$ 359 | \$ - | \$ - | \$ 359 | \$ - |
| | Commercial mortgages | 212 | - | - | 148 | 64 |
| | Trust preferred | 197 | - | 197 | - | - |
| | Aircraft leasing | 42 | - | - | - | 42 |
| | Others | = | = | = | = | = |
| | | <u>810</u> | <u>\$ -</u> | <u>\$</u> | <u>\$</u> | <u>\$</u> |
| | | | | <u>197</u> | <u>507</u> | <u>64</u> |
| | | | | | <u>42</u> | |
| | Total asset-backed securities | \$ 4,071 | | | | |

Effect of Changes in Significant Unobservable Inputs

The fair value of certain financial instruments is measured using valuation techniques that incorporate pricing assumptions not supported by, derived from or corroborated by observable market data. The resultant fair value measurements are dependent on unobservable input parameters which can be selected from a range of estimates and may be interdependent. Changes in one or more of the significant unobservable input parameters may change the fair value measurements of these financial instruments. For the purpose of preparing the financial statements, the final valuation inputs selected are based on management's best judgment that reflect the assumptions market participants would use in pricing similar assets or liabilities.

The unobservable input parameters selected are subject to the internal valuation control processes and procedures. When we perform a test of all the significant input parameters to the extreme values within the range at the same time, it could result in an increase of the overall fair value measurement of approximately \$434 million or a decrease of the overall fair value measurement of approximately \$355 million as of September 30, 2009. The effect of changes in significant unobservable input parameters are primarily driven by mortgage whole loans held for sale or securitization, certain asset-backed securities including CDOs, and the uncertainty in determining the fair value of credit derivatives executed against monoline insurers.

Risk Management

Overview Some degree of risk is inherent in virtually all of our activities. For the principal activities undertaken, the following are considered to be the most important types of risks:

- *Credit risk* is the potential that a borrower or counterparty will default on a credit obligation, as well as the impact on the value of credit instruments due to changes in the probability of borrower default.
- *Liquidity risk* is the potential that an institution will be unable to meet its obligations as they become due or fund its customers because of inadequate cash flow or the inability to liquidate assets or obtain funding itself.

- *Market risk* is the potential for losses in daily mark to market positions (mostly trading) due to adverse movements in money, foreign exchange, equity or other markets and includes both interest rate risk and trading risk.
- *Operational risk* technically includes legal and compliance risk.
- *Fiduciary risk* is the risk associated with offering services honestly and properly to clients in a fiduciary capacity in accordance with Regulation 12 CFR 9, Fiduciary Activity of National Banks.
- *Reputational risk* involves the safeguarding of our reputation and can arise from social, ethical or environmental issues, or as a consequence for operations risk events.

In the first quarter of 2009, significant steps were undertaken to further strengthen our risk management organization, including the appointment of an HSBC North America Holdings Inc. Chief Risk Officer and the creation of a distinct, cross-disciplinary risk organization and integrated risk function. Otherwise, there were no significant changes to the policies or approach for managing various types of risk as disclosed in our 2008 Form 10-K, although we continue to monitor current market conditions and will adjust risk management policies and procedures as deemed necessary. See “Risk Management” in Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations in our 2008 Form 10-K for a more complete discussion of the objectives of our risk management system as well as our risk management policies and practices. Our risk management process involves the use of various simulation models. We believe that the assumptions used in these models are reasonable, but actual events may unfold differently than what is assumed in the models. Consequently, model results may be considered reasonable estimates, with the understanding that actual results may vary significantly from model projections.

Credit Risk Management Credit risk is the potential that a borrower or counterparty will default on a credit obligation, as well as the impact on the value of credit instruments due to changes in the probability of borrower default.

Credit risk is inherent in various on- and off-balance sheet instruments and arrangements, such as:

- in loan portfolios;
- in investment portfolios;
- in unfunded commitments such as letters of credit and lines of credit that customers can draw upon; and
- in treasury instruments, such as interest rate swaps which, if more valuable today than when originally contracted, may represent an exposure to the counterparty to the contract.

While credit risk exists widely in our operations, diversification among various commercial and consumer portfolios helps to lessen risk exposure. Day to day management of credit risk is administered by the Co-Chief Credit Officers who report to the HSBC North America Holdings Inc. Chief Risk Officer. Further discussion of credit risk can be found under the “Credit Quality” caption in this Form 10-Q.

Credit risk associated with derivatives is measured as the net replacement cost in the event the counterparties with contracts in a gain position to us fail to perform under the terms of those contracts. In managing derivative credit risk, both the current exposure, which is the replacement cost of contracts on the measurement date, as well as an estimate of the potential change in value of contracts over their remaining lives are considered. Counterparties to our derivative activities include financial institutions, foreign and domestic government agencies, corporations, funds (mutual funds, hedge funds, etc.), insurance companies and private clients as well as other HSBC entities. These counterparties are subject to regular credit review by the credit risk management department. To minimize credit risk, we enter into legally enforceable master netting agreements which reduce risk by permitting the closeout and netting of transactions

with the same counterparty upon occurrence of certain events. In addition, we reduce credit risk by obtaining collateral from counterparties. The determination of the need for and the levels of collateral will vary based on an assessment of the credit risk of the counterparty.

The total risk in a derivative contract is a function of a number of variables, such as:

- volatility of interest rates, currencies, equity or corporate reference entity used as the basis for determining contract payments;
- current market events or trends;
- country risk;
- maturity and liquidity of contracts;
- credit worthiness of the counterparties in the transaction;
- the existence of a master netting agreement among the counterparties; and
- existence and value of collateral received from counterparties to secure exposures.

The table below presents total credit risk exposure measured using rules contained in the risk-based capital guidelines published by U.S. banking regulatory agencies. Risk-based capital guidelines recognize that bilateral netting agreements reduce credit risk and, therefore, allow for reductions of risk-weighted assets when netting requirements have been met. As a result, risk-weighted amounts for regulatory capital purposes are a portion of the original gross exposures.

The risk exposure calculated in accordance with the risk-based capital guidelines potentially overstates actual credit exposure, because: the risk-based capital guidelines ignore collateral that may have been received from counterparties to secure exposures; and the risk-based capital guidelines compute exposures over the life of derivative contracts. However, many contracts contain provisions that allow us to close out the transaction if the counterparty fails to post required collateral. In addition, many contracts give us the right to break the transactions earlier than the final maturity date. As a result, these contracts have potential future exposures that are often much smaller than the future exposures derived from the risk-based capital guidelines.

| | September 30, December 31, | |
|--|-----------------------------------|--------------------|
| | <u>2009</u> | <u>2008</u> |
| | (in millions) | |
| Risk associated with derivative contracts: | | |
| | \$ | \$ |
| Total credit risk exposure | 44,960 | 102,342 |
| Less: collateral held against exposure | <u>5,127</u> | <u>8,228</u> |
| | \$ | |
| Net credit risk exposure | 39,833 | \$ 94,114 |

Liquidity Risk Management There have been no material changes to our approach towards liquidity risk management during the first nine months of 2009. See “Risk Management” in Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations in our 2008 Form 10-K for a more complete discussion of our approach

to liquidity risk.

We have been continuously monitoring the impact of recent market events on our liquidity positions. In general terms, the strains due to the credit crisis have been concentrated in the wholesale market as opposed to the retail market (the latter being the market from which we source core demand and time deposit accounts). Financial institutions with less reliance on the wholesale markets were in many respects less affected by the recent conditions. Our limited dependence upon the wholesale markets for funding has been a significant competitive advantage through the recent period of financial market turmoil.

Our liquidity management approach includes increasing deposits, potential sales (e.g. residential mortgage loans), and securitizations/conduits (e.g. credit cards) in liquidity contingency plans. Given our overall liquidity position, in the first nine months of 2009, we have managed down low margin commercial and institutional deposits in order to maximize profitability.

Our ability to regularly attract wholesale funds at a competitive cost is enhanced by strong ratings from the major credit ratings agencies. At September 30, 2009, we and HSBC Bank USA maintained the following long and short-term debt ratings:

| | <u>Moody's S&P Fitch DBRS(1)</u> | | | |
|-----------------------|---|-------------|------------|------------|
| HSBC USA Inc.: | | | | |
| Short-term borrowings | P-1 | A-1+ | F1+ | R-1 |
| Long-term debt | A1 | AA- | AA | AA |
| HSBC Bank USA: | | | | |
| Short-term borrowings | P-1 | A-1+ | F1+ | R-1 |
| Long-term debt | Aa3 | AA | AA | AA |

(1) Dominion Bond Rating Service.

In March 2009, Moody's Investors Services ("Moody's") downgraded the long-term debt ratings of both HUSI and HSBC Bank USA by one level to A1 and Aa3, respectively and reaffirmed the short-term ratings for each entity at Prime-1. Moody's also changed their outlook for both entities from "stable" to "negative." In April 2009, DBRS re-affirmed the long and short-term debt ratings of HUSI and HSBC Bank USA at AA and R-1, respectively, with a "negative" outlook. In August 2009, Standard and Poor's re-affirmed the long-term and short-term debt ratings of both HUSI and HSBC Bank USA at AA-/A-1+ (HUSI) and AA/A-1+ (HSBC Bank USA).

Interest Rate Risk Management Various techniques are utilized to quantify and monitor risks associated with the repricing characteristics of our assets, liabilities and derivative contracts. Our approach to managing interest rate risk is summarized in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations in our 2008 Form 10-K under the caption "Risk Management." There have been no material changes to our approach towards interest rate risk management during the first nine months of 2009.

Present Value of a Basis Point ("PVBP") is the change in value of the balance sheet for a one basis point upward movement in all interest rates. The following table reflects the PVBP position at September 30, 2009 and December 31, 2008.

September 30, December 31,

| | <u>2009</u> | <u>2008</u> |
|-----------------------------------|---------------|-------------|
| | (in millions) | |
| Institutional PVBP movement limit | \$ 6.5 | \$ 6.5 |
| PVBP position at period end | 0.9 | 4.3 |

Economic value of equity is the change in value of the assets and liabilities (excluding capital and goodwill) for either a 200 basis point immediate rate increase or decrease. The following table reflects the economic value of equity position at September 30, 2009 and December 31, 2008.

September 30, December 31,

| | <u>2009</u> | <u>2008</u> |
|---|--------------------------|-------------|
| | (values as a percentage) | |
| | +/-20 | +/-20 |
| Institutional economic value of equity limit | | |
| Projected change in value (reflects projected rate movements on January 1, 2009): | | |
| Change resulting from an immediate 200 basis point increase in interest rates | (3) | (2) |
| Change resulting from an immediate 200 basis point decrease in interest rates | (5) | (18) |

The loss in value for a 200 basis point increase or decrease in rates is a result of the negative convexity of the residential whole loan and mortgage backed securities portfolios. If rates decrease, the projected prepayments related to these portfolios will accelerate, causing less appreciation than a comparable term, non-convex instrument. If rates increase, projected prepayments will slow, which will cause the average lives of these positions to extend and result in a greater loss in market value.

Dynamic simulation modeling techniques are utilized to monitor a number of interest rate scenarios for their impact on net interest income. These techniques include both rate shock scenarios, which assume immediate market rate movements by as much as 200 basis points, as well as scenarios in which rates rise or fall by as much as 200 basis points over a twelve month period. The following table reflects the impact on net interest income of the scenarios utilized by these modeling techniques.

| | <u>September 30, 2009</u> | | <u>December 31, 2008</u> | |
|---|---------------------------|----------|--------------------------|----------|
| | <u>Amount</u> | <u>%</u> | <u>Amount</u> | <u>%</u> |
| | (dollars are in millions) | | | |
| Projected change in net interest income (reflects projected rate movements on January 1, 2009): | | | | |
| Institutional base earnings movement limit | | (10) | | (10) |
| Change resulting from a gradual 100 basis point increase in the yield curve | \$ (41) | (1) | \$ (56) | (1) |

| | | | | |
|---|-------|-----|-------|-----|
| Change resulting from a gradual 100 basis point decrease in the yield curve | (49) | (1) | (3) | - |
| Change resulting from a gradual 200 basis point increase in the yield curve | (88) | (2) | (146) | (3) |
| Change resulting from a gradual 200 basis point decrease in the yield curve | (115) | (2) | (18) | - |
| Other significant scenarios monitored (reflects projected rate movements on January 1, 2009): | | | | |
| Change resulting from an immediate 100 basis point increase in the yield curve | (54) | (1) | (102) | (2) |
| Change resulting from an immediate 100 basis point decrease in the yield curve | (122) | (2) | (16) | - |
| Change resulting from an immediate 200 basis point increase in the yield curve | (155) | (3) | (322) | (6) |
| Change resulting from an immediate 200 basis point decrease in the yield curve | (242) | (5) | (101) | (2) |

The projections do not take into consideration possible complicating factors such as the effect of changes in interest rates on the credit quality, size and composition of the balance sheet. Therefore, although this provides a reasonable estimate of interest rate sensitivity, actual results will vary from these estimates, possibly by significant amounts.

Capital Risk/Sensitivity of Other Comprehensive Income Large movements of interest rates could directly affect some reported capital balances and ratios. The mark-to-market valuation of available-for-sale securities is credited on a tax effective basis to accumulated other comprehensive income. Although this valuation mark is excluded from Tier 1 and Tier 2 capital ratios, it is included in two important accounting based capital ratios: the tangible common equity to tangible assets and the tangible common equity to risk weighted assets. As of September 30, 2009, we had an available-for-sale securities portfolio of approximately \$29.6 billion with a net negative mark-to-market of \$21 million included in tangible common equity of \$11.1 billion. An increase of 25 basis points in interest rates of all maturities would lower the mark to market by approximately \$214 million to a net loss of \$235 million with the following results on the tangible capital ratios. As of December 31, 2008, we had an available-for-sale securities portfolio of approximately \$25 billion with a net negative mark-to-market of \$651 million included in tangible common equity of \$9.3 billion. An increase of 25 basis points in interest rates of all maturities would lower the mark to market by approximately \$137 million to a net loss of \$788 million with the following results on the tangible capital ratios.

| | <u>September 30, 2009</u> | | <u>December 31, 2008</u> | |
|--|---------------------------|--------------------|--------------------------|--------------------|
| | <u>Actual</u> | <u>Proforma(1)</u> | <u>Actual</u> | <u>Proforma(1)</u> |
| Tangible common equity to tangible assets | 6.42% | 6.36% | 5.06% | 4.96% |
| Tangible common equity to risk weighted assets | 7.90 | 7.81 | 6.58 | 6.45 |

(1) Proforma percentages reflect a 25 basis point increase in interest rates.

Market Risk Management There have been no material changes to our approach towards market risk management during the first nine months of 2009. See “Risk Management” in Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations in our 2008 Form 10-K for a more complete discussion of our approach to market risk.

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. VAR calculations are performed for all material trading activities and as a tool for managing interest rate risk inherent in non-trading activities. We calculate VAR daily for a one-day holding period to a 99 percent confidence level. At a 99 percent confidence level for a two-year observation period, we are setting as our limit the fifth worst loss performance in the last 500 business days.

VAR — Trading Activities Our management of market risk is based on a policy of restricting individual operations to trading within a list of permissible instruments authorized, enforcing rigorous new product approval procedures and restricting trading in the more complex derivative products to offices with appropriate levels of product expertise and robust control systems. Market making and proprietary position-taking is undertaken within Global Banking and Markets.

In addition, at both portfolio and position levels, market risk in trading portfolios is monitored and controlled using a complementary set of techniques, including VAR and various techniques for monitoring interest rate risk as discussed above. These techniques quantify the impact on capital of defined market movements.

Trading portfolios reside primarily within the Markets unit of the Global Banking and Markets business segment, which include warehoused residential mortgage loans purchased with the intent of selling them, and within the mortgage banking subsidiary included within the PFS business segment. Portfolios include foreign exchange, interest rate swaps and credit derivatives, precious metals (i.e., gold, silver, platinum), equities and money market instruments including “repos” and securities. Trading occurs as a result of customer facilitation, proprietary position taking, and economic hedging. In this context, economic hedging may include, for example, forward contracts to sell residential mortgages and derivative contracts which, while economically viable, may not satisfy the hedge accounting requirements.

The trading portfolios have defined limits pertaining to items such as permissible investments, risk exposures, loss review, balance sheet size and product concentrations. “Loss review” refers to the maximum amount of loss that may be incurred before senior management intervention is required.

The following table summarizes trading VAR for the nine months ended September 30, 2009:

| | September 30, | <u>Nine Months Ended</u> | | | December 31, |
|---------------|---------------|---------------------------|----------------|----------------|--------------|
| | <u>2009</u> | <u>September 30, 2009</u> | | | <u>2008</u> |
| | | <u>Minimum</u> | <u>Maximum</u> | <u>Average</u> | |
| | | <u>(in millions)</u> | | | |
| Total trading | \$ 42 | \$ 37 | \$ 120 | \$ 75 | \$ 52 |

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| | | | | | |
|---|----|----|----|----|----|
| Equities | - | - | 2 | 1 | 1 |
| Foreign exchange | 4 | 1 | 10 | 3 | 2 |
| Interest rate directional and credit spread | 33 | 33 | 82 | 51 | 44 |

The following table summarizes the frequency distribution of daily market risk-related revenues for Treasury trading activities during calendar year 2008. Market risk-related Treasury trading revenues include realized and unrealized gains (losses) related to Treasury trading activities, but exclude the related net interest income. Analysis of the gain (loss) data for the nine months ended September 30, 2009 shows that the largest daily gain was \$83 million and the largest daily loss was \$48 million.

| <u>Ranges of Daily Treasury Trading Revenue Earned from Market Risk-Related Activities</u> | Below | \$(10) | \$0 | \$10 | Over |
|--|----------------------|-----------|------------|-------------|-------------|
| | | to | to | to | |
| | <u>\$(10)</u> | <u>to</u> | <u>\$0</u> | <u>\$10</u> | <u>\$20</u> |
| | <u>(in millions)</u> | | | | |

Three months ended September 30, 2009:

Number of trading days market risk-related revenue was within the stated range

11 27 21 4 1

Nine months ended September 30, 2009:

Number of trading days market risk-related revenue was within the stated range

34 62 55 25 9

VAR — Non-trading Activities Interest rate risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost, as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on embedded optionality within certain product areas such as the incidence of mortgage repayments, and from behavioral assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts. The prospective change in future net interest income from non-trading portfolios will be reflected in the current realizable value of these positions, should they be sold or closed prior to maturity. In order to manage this risk optimally, market risk in non-trading portfolios is transferred to Global Markets or to separate books managed under the supervision of the local Asset and Liability Committee (“ALCO”). Once market risk has been consolidated in Global Markets or ALCO-managed books, the net exposure is typically managed through the use of interest rate swaps within agreed limits.

The following table summarizes non-trading VAR for the three months ended September 30, 2009, assuming a 99% confidence level for a two-year observation period and a one-day “holding period”.

| | September 30, | <u>Three Months Ended</u> | | | December 31, |
|---------------|----------------------|---------------------------|----------------|----------------|--------------|
| | <u>2009</u> | <u>Minimum</u> | <u>Maximum</u> | <u>Average</u> | <u>2008</u> |
| | <u>(in millions)</u> | | | | |
| Interest rate | \$ 123 | \$ 76 | \$ 154 | \$ 121 | \$ 92 |

Trading Activities — HSBC Mortgage Corporation (USA) is a mortgage banking subsidiary of HSBC Bank USA. Trading occurs in mortgage banking operations as a result of an economic hedging program intended to offset changes in value of mortgage servicing rights and the salable loan pipeline. Economic hedging may include, for example, forward contracts to sell residential mortgages and derivative instruments used to protect the value of MSR's.

MSR's are assets that represent the present value of net servicing income (servicing fees, ancillary income, escrow and deposit float, net of servicing costs). MSR's are separately recognized upon the sale of the underlying loans or at the time that servicing rights are purchased. MSR's are subject to interest rate risk, in that their value will decline as a result of actual and expected acceleration of prepayment of the underlying loans in a falling interest rate environment.

Interest rate risk is mitigated through an active hedging program that uses trading securities and derivative instruments to offset changes in value of MSR's. Since the hedging program involves trading activity, risk is quantified and managed using a number of risk assessment techniques.

Modeling techniques, primarily rate shock analyses, are used to monitor certain interest rate scenarios for their impact on the economic value of net hedged MSR's, as reflected in the following table.

| | September 30, | December 31, |
|---|----------------------|---------------------|
| | <u>2009</u> | <u>2008</u> |
| | (in millions) | |
| Projected change in net market value of hedged MSR's portfolio (reflects projected rate movements on July 1): | | |
| Value of hedged MSR's portfolio | \$ 394 | \$ 333 |
| Change resulting from an immediate 50 basis point decrease in the yield curve: | | |
| Change limit (no worse than) | (16) | (16) |
| Calculated change in net market value | 5 | (6) |
| Change resulting from an immediate 50 basis point increase in the yield curve: | | |
| Change limit (no worse than) | (8) | (8) |
| Calculated change in net market value | (1) | - |
| Change resulting from an immediate 100 basis point increase in the yield curve: | | |
| Change limit (no worse than) | (12) | (12) |
| Calculated change in net market value | (6) | (10) |

The economic value of the net, hedged MSR's portfolio is monitored on a daily basis for interest rate sensitivity. If the economic value declines by more than established limits for one day or one month, various levels of management review, intervention and/or corrective actions are required.

The following table summarized the frequency distribution of the weekly economic value of the MSR asset during calendar year 2009. This includes the change in the market value of the MSR asset net of changes in the market value of the underlying hedging positions used to hedge the asset. The changes in economic value are adjusted for changes in MSR valuation assumptions that were made during the nine months ended September 30, 2009.

| | |
|--------------|-------------|
| Below | Over |
|--------------|-------------|

| | | | | | |
|---|----------------------|----------------------|--------------------|--------------------|--------------------|
| <u>Ranges of Mortgage Economic Value from Market Risk-Related Activities</u> | <u>\$ (2)</u> | <u>\$ (2)</u> | <u>\$ 0</u> | <u>\$ 2</u> | <u>\$ 4</u> |
| | | to | to | to | |
| | | | <u>\$ 0</u> | <u>\$ 2</u> | <u>\$ 4</u> |
| | | | (in millions) | | |

Number of trading weeks market risk-related revenue was within the stated range **14** **5** **2** **7** **11**

Operational Risk There have been no material changes to our approach towards operational risk management during the first nine months of 2009.

Fiduciary Risk There have been no material changes to our approach towards fiduciary risk management during the first nine months of 2009.

Reputational Risk There have been no material changes to our approach towards reputational risk management during the first nine months of 2009.

CONSOLIDATED AVERAGE BALANCES AND INTEREST RATES

The following table shows the quarter to date average balances of the principal components of assets, liabilities and shareholders' equity together with their respective interest amounts and rates earned or paid, presented on a taxable equivalent basis.

| | <u>Three Months Ended September 30,</u> | | | | | |
|---|--|------------------------|-----------------------|-----------------------|------------------------|-----------------------|
| | <u>2009</u> | | | <u>2008</u> | | |
| | <u>Balance</u> | <u>Interest</u> | <u>Rate(1)</u> | <u>Balance</u> | <u>Interest</u> | <u>Rate(1)</u> |
| | (dollars are in millions) | | | | | |
| Assets | | | | | | |
| Interest bearing deposits with banks | \$ 18,825 | \$ 14 | .28% | \$ 6,168 | \$ 46 | 2.97% |
| Federal funds sold and securities purchased under resale agreements | 4,519 | 7 | .68 | 9,604 | 54 | 2.22 |
| Trading assets | 4,576 | 52 | 4.46 | 8,655 | 139 | 6.40 |
| Securities | 29,313 | 239 | 3.23 | 24,311 | 320 | 5.24 |
| Loans: | | | | | | |
| Commercial | 34,081 | 265 | 3.09 | 40,368 | 510 | 5.03 |
| Consumer: | | | | | | |
| Residential mortgages | 16,175 | 201 | 4.94 | 25,442 | 339 | 5.30 |
| HELOCs and home equity mortgages | 4,422 | 36 | 3.23 | 4,570 | 54 | 4.69 |
| Private label card receivables | 15,286 | 411 | 10.67 | 16,286 | 430 | 10.50 |
| Credit cards | 13,177 | 300 | 9.04 | 1,958 | 41 | 8.37 |
| Auto finance | 2,375 | 109 | 18.25 | 207 | 3 | 5.92 |
| Other consumer | 1,664 | 48 | 11.25 | 2,002 | 46 | 9.10 |
| Total consumer | 53,099 | 1,105 | 8.26 | 50,465 | 913 | 7.19 |
| Total loans | 87,180 | 1,370 | 6.24 | 90,833 | 1,423 | 6.23 |
| Other | 7,216 | 12 | .63 | 9,334 | 54 | 2.29 |
| Total earning assets | 151,629 | \$ 1,694 | 4.43 | 148,905 | \$ 2,036 | 5.44% |
| Allowance for credit losses | (3,897) | | | (1,934) | | |
| Cash and due from banks | 2,595 | | | 3,341 | | |
| Other assets | 22,197 | | | 25,992 | | |

| | | | | | | |
|---|--------------------------|--------|------|--------------------------|--------|-------|
| Total assets | <u>\$ 172,524</u> | | | <u>\$ 176,304</u> | | |
| Liabilities and Shareholders' Equity | | | | | | |
| Deposits in domestic offices: | | | | | | |
| Savings deposits | \$ 48,450 | \$ 121 | .98% | \$ 47,917 | \$ 265 | 2.20% |
| Other time deposits | 18,768 | 92 | 1.94 | 22,912 | 185 | 3.22 |
| Deposits in foreign offices: | | | | | | |
| Foreign banks deposits | 10,763 | 3 | .14 | 12,794 | 47 | 1.47 |
| Other interest bearing deposits | 14,568 | 8 | .23 | 14,250 | 78 | 2.17 |
| Total interest bearing deposits | 92,549 | 224 | .96 | 97,873 | 575 | 2.34 |
| Short-term borrowings | 9,233 | 16 | .71 | 9,574 | 60 | 2.49 |
| Long-term debt | 23,313 | 188 | 3.18 | 24,020 | 225 | 3.71 |
| Total interest bearing liabilities | 125,095 | 428 | 1.36 | 131,467 | 860 | 2.60 |
| Net interest income/Interest rate spread | \$ 1,266 3.07% | | | \$ 1,176 2.84% | | |
| Noninterest bearing deposits | 19,063 | | | 14,899 | | |
| Other liabilities | 13,501 | | | 18,040 | | |
| Total shareholders' equity | 14,865 | | | 11,898 | | |
| Total liabilities and shareholders' equity | <u>\$ 172,524</u> | | | <u>\$ 176,304</u> | | |
| Net interest margin on average earning assets | | | | 3.31% | | 3.14% |
| Net interest margin on average total assets | | | | 2.91% | | 2.66% |

(1) Rates are calculated on unrounded numbers.

Total weighted average rate earned on earning assets is interest and fee earnings divided by daily average amounts of total interest earning assets, including the daily average amount on nonperforming loans. Loan interest for the three months ended September 30, 2009 and 2008 included fees of \$19 million and \$9 million, respectively.

The following table shows the year to date average balances of the principal components of assets, liabilities and shareholders' equity together with their respective interest amounts and rates earned or paid, presented on a taxable equivalent basis.

| | <u>Nine Months Ended September 30,</u> | | | | | |
|---|---|------------------------|-----------------------|-----------------------|------------------------|-----------------------|
| | <u>2009</u> | | | <u>2008</u> | | |
| | <u>Balance</u> | <u>Interest</u> | <u>Rate(1)</u> | <u>Balance</u> | <u>Interest</u> | <u>Rate(1)</u> |
| | (dollars are in millions) | | | | | |
| Assets | | | | | | |
| Interest bearing deposits with banks | \$ 14,037 | \$ 30 | .28% | \$ 5,771 | \$ 132 | 3.06% |
| Federal funds sold and securities purchased under resale agreements | 7,857 | 38 | .65 | 9,432 | 191 | 2.70 |
| Trading assets | 4,709 | 162 | 4.59 | 10,241 | 435 | 5.67 |
| Securities | 26,570 | 749 | 3.77 | 24,888 | 965 | 5.18 |
| Loans: | | | | | | |
| Commercial | 35,934 | 918 | 3.42 | 38,531 | 1,453 | 5.04 |
| Consumer: | | | | | | |
| Residential mortgages | 18,219 | 693 | 5.09 | 28,098 | 1,096 | 5.21 |
| HELOCs and home equity mortgages | 4,499 | 112 | 3.32 | 4,505 | 173 | 5.15 |
| Private label card receivables | 15,901 | 1,236 | 10.39 | 16,419 | 1,277 | 10.39 |

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| | | | | | | |
|---|-------------------|----------|-------|-------------------|----------|-------|
| Credit cards | 13,284 | 969 | 9.75 | 1,873 | 116 | 8.24 |
| Auto finance | 2,531 | 344 | 18.15 | 253 | 11 | 5.79 |
| Other consumer | 1,726 | 106 | 8.19 | 2,044 | 144 | 9.45 |
| Total consumer | 56,160 | 3,460 | 8.24 | 53,192 | 2,817 | 7.07 |
| Total loans | 92,094 | 4,378 | 6.36 | 91,723 | 4,270 | 6.22 |
| Other | 8,490 | 35 | .54 | 9,327 | 198 | 2.84 |
| Total earning assets | 153,757 | \$ 5,392 | 4.69% | 151,382 | \$ 6,191 | 5.46 |
| Allowance for credit losses | (3,542) | | | (1,712) | | |
| Cash and due from banks | 2,565 | | | 3,144 | | |
| Other assets | 24,279 | | | 28,790 | | |
| Total assets | \$ 177,059 | | | \$ 181,604 | | |
| Liabilities and Shareholders' Equity | | | | | | |
| Deposits in domestic offices: | | | | | | |
| Savings deposits | \$ 47,371 | \$ 443 | 1.25% | \$ 45,835 | \$ 784 | 2.28% |
| Other time deposits | 19,648 | 314 | 2.14 | 24,900 | 684 | 3.67 |
| Deposits in foreign offices: | | | | | | |
| Foreign banks deposits | 10,711 | 9 | .12 | 13,794 | 210 | 2.03 |
| Other interest bearing deposits | 15,300 | 38 | .33 | 13,868 | 278 | 2.68 |
| Total interest bearing deposits | 93,030 | 804 | 1.16 | 98,397 | 1,956 | 2.65 |
| Short-term borrowings | 9,728 | 51 | .70 | 11,440 | 227 | 2.65 |
| Long-term debt | 24,548 | 634 | 3.45 | 25,674 | 766 | 3.98 |
| Total interest bearing liabilities | 127,306 | 1,489 | 1.56 | 135,511 | 2,949 | 2.91 |
| Net interest income/Interest rate spread | | \$ 3,903 | 3.13% | | \$ 3,242 | 2.55% |
| Noninterest bearing deposits | 20,065 | | | 14,415 | | |
| Other liabilities | 15,609 | | | 19,983 | | |
| Total shareholders' equity | 14,079 | | | 11,695 | | |
| Total liabilities and shareholders' equity | \$ 177,059 | | | \$ 181,604 | | |
| Net interest margin on average earning assets | | | 3.39% | | | 2.86% |
| Net interest margin on average total assets | | | 2.95% | | | 2.39% |

(1) Rates are calculated on unrounded numbers.

Total weighted average rate earned on earning assets is interest and fee earnings divided by daily average amounts of total interest earning assets, including the daily average amount on nonperforming loans. Loan interest for the nine months ended September 30, 2009 and 2008 included fees of \$64 million and \$25 million, respectively.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

See Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, under the captions "Interest Rate Risk Management" and "Trading Activities" of this Form 10-Q.

Item 4. Controls and Procedures

We maintain a system of internal and disclosure controls and procedures designed to ensure that information required to be disclosed by HSBC USA Inc. in the reports we file or submit under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is recorded, processed, summarized and reported on a timely basis. Our Board of Directors, operating through its audit committee, which is composed entirely of independent outside directors,

provides oversight to our financial reporting process.

We conducted an evaluation, with the participation of the Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report so as to alert them in a timely fashion to material information required to be disclosed in reports we file under the Exchange Act.

There has been no change in our internal control over financial reporting that occurred during the quarter ended September 30, 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

General

We are parties to various legal proceedings resulting from ordinary business activities relating to our current and/or former operations. Due to uncertainties in litigation and other factors, we cannot be certain that we will ultimately prevail in each instance. We believe that our defenses to these actions have merit and any adverse decision should not materially affect our consolidated financial condition. However, losses may be material to our results of operations for any particular future period depending on our income level for that period.

Credit Card Litigation

Since June 2005, HSBC Bank USA, HSBC Finance, HSBC North America and HSBC, as well as other banks and Visa Inc. and MasterCard Incorporated, were named as defendants in four class actions filed in Connecticut and the Eastern District of New York: *Photos Etc. Corp. et al. v. Visa U.S.A., Inc., et al.* (D. Conn. No. 3:05-CV-01007 (WWE)); *National Association of Convenience Stores, et al. v. Visa U.S.A., Inc., et al.* (E.D.N.Y. No. 05-CV 4520 (JG)); *Jethro Holdings, Inc., et al. v. Visa U.S.A., Inc. et al.* (E.D.N.Y. No. 05-CV-4521 (JG)); and *American Booksellers Ass'n v. Visa U.S.A., Inc. et al.* (E.D.N.Y. No. 05-CV-5391 (JG)). Numerous other complaints containing similar allegations (in which no HSBC entity is named) were filed across the country against Visa Inc., MasterCard Incorporated and other banks. These actions principally allege that the imposition of a no-surcharge rule by the associations and/or the establishment of the interchange fee charged for credit card transactions causes the merchant discount fee paid by retailers to be set at supracompetitive levels in violation of the Federal antitrust laws. These suits have been consolidated and transferred to the Eastern District of New York. The consolidated case is: *In re Payment Card Interchange Fee and Merchant Discount Antitrust Litigation*, MDL 1720, E.D.N.Y. A consolidated, amended complaint was filed by the plaintiffs on April 24, 2006 and a second consolidated amended complaint was filed on January 29, 2009. The parties are engaged in discovery and motion practice. At this time, we are unable to quantify the potential impact from this action, if any.

Item 6. Exhibits

Exhibits included in this Report:

Computation of Ratio of Earnings to Fixed Charges and Earnings to Combined Fixed Charges and Preferred Stock Dividends.

- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Signature

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HSBC USA Inc.

(Registrant)

/s/ Gerard Mattia

Gerard Mattia
Senior Executive Vice President and
Chief Financial Officer

Date: November 10, 2009

Exhibit Index

- 12 Computation of Ratio of Earnings to Fixed Charges and Earnings to Combined Fixed Charges and Preferred Stock Dividends.
- 31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

EXHIBIT 12**HSBC USA INC.**

**COMPUTATION OF RATIO OF EARNINGS TO FIXED CHARGES AND TO
COMBINED FIXED CHARGES AND PREFERRED STOCK DIVIDENDS**

Nine Months Ended September 30

2009 2008
(dollars are in

millions)

Ratios excluding interest on deposits:

| | | |
|--|--------------|--------------|
| Net loss | \$ (177) | \$ (588) |
| Income tax expense (benefit) | 56 | (334) |
| Income (loss) before income tax expense (benefit) | (121) | (922) |
| Less: Undistributed equity earnings | 24 | 23 |
| Fixed charges: | | |
| Interest on: | | |
| Borrowed funds | 51 | 227 |
| Long-term debt | 634 | 766 |

| | | |
|--|------------------------|------------------------|
| One third of rents, net of income from subleases | <u>18</u> | <u>18</u> |
| Total fixed charges, excluding interest on deposits | <u>703</u> | <u>1,011</u> |
| Earnings (loss) before taxes and fixed charges, net of undistributed equity earnings | <u>\$ 558</u> | <u>\$ 66</u> |
| Ratio of earnings (loss) to fixed charges | <u>0.79</u> | <u>0.07</u> |
| Total preferred stock dividend factor(1) | <u>\$ 37</u> | <u>\$ 92</u> |
| Fixed charges, including the preferred stock dividend factor | <u>\$ 740</u> | <u>\$ 1,103</u> |
| Ratio of earnings to combined fixed charges and preferred stock dividends | <u>0.75</u> | <u>0.06</u> |
| Ratios including interest on deposits: | | |
| Total fixed charges, excluding interest on deposits | \$ 703 | \$ 1,011 |
| Add: Interest on deposits | <u>804</u> | <u>1,956</u> |
| Total fixed charges, including interest on deposits | <u>\$ 1,507</u> | <u>\$ 2,967</u> |
| Earnings (loss) before taxes and fixed charges, net of undistributed equity earnings | \$ 558 | \$ 66 |
| Add: Interest on deposits | <u>804</u> | <u>1,956</u> |
| Total | <u>\$ 1,362</u> | <u>\$ 2,022</u> |
| Ratio of earnings to fixed charges | <u>0.90</u> | <u>0.68</u> |
| Fixed charges, including the preferred stock dividend factor | \$ 740 | \$ 1,103 |
| Add: Interest on deposits | <u>804</u> | <u>1,956</u> |
| Fixed charges, including the preferred stock dividend factor and interest on deposits | <u>\$ 1,544</u> | <u>\$ 3,059</u> |
| Ratio of earnings to combined fixed charges and preferred stock dividends | <u>0.88</u> | <u>0.66</u> |

(1) Preferred stock dividends grossed up to their pretax equivalents.

EXHIBIT 31.1

Certification of Chief Executive Officer and Chief Financial Officer

pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

Certification of Chief Executive Officer

I, Paul J. Lawrence, President and Chief Executive Officer of HSBC USA Inc., certify that:

- I have reviewed this report on Form 10-Q of HSBC USA Inc.;
- Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
- Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 10, 2009

/s/ PAUL J. LAWRENCE

Paul J. Lawrence

President and Chief Executive Officer

EXHIBIT 31.2

Certification of Chief Financial Officer

I, Gerard Mattia, Senior Executive Vice President and Chief Financial Officer of HSBC USA Inc., certify that:

1. I have reviewed this report on Form 10-Q of HSBC USA Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under

which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is

reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies and material weaknesses in the design or operation of internal controls over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 10, 2009

/s/ GERARD MATTIA

Gerard Mattia

Senior Executive Vice President and

Chief Financial Officer

Exhibit 32.1

Certification of Chief Executive Officer and Chief Financial Officer

pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

**Certification pursuant to 18 U.S.C. Section 1350, as Adopted pursuant to
Section 906 of the Sarbanes-Oxley Act of 2002**

The certification set forth below is being submitted in connection with the HSBC USA Inc. Quarterly Report on Form 10-Q for the period ending September 30, 2008 as filed with the Securities and Exchange Commission on the date hereof (the "Report") for the purpose of complying with Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Section 1350 of Chapter 63 of Title 18 of the United States Code.

I, Paul J. Lawrence, President and Chief Executive Officer of HSBC USA Inc., certify that:

1. the Report fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act; and
2. the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of HSBC USA Inc.

Date: November 10, 2009

/s/ PAUL J. LAWRENCE

Paul J. Lawrence

President and Chief Executive Officer

Exhibit 32.2

Certification Pursuant to 18 U.S.C. Section 1350,

As Adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

The certification set forth below is being submitted in connection with the HSBC USA Inc. Quarterly Report on Form 10-Q for the period ending September 30, 2008 as filed with the Securities and Exchange Commission on the date hereof (the "Report") for the purpose of complying with Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Section 1350 of Chapter 63 of Title 18 of the United States Code.

I, Gerard Mattia, Senior Executive Vice President and Chief Financial Officer of HSBC USA Inc., certify that:

1. the Report fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act; and

2. the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of HSBC USA Inc.

Date: November 10, 2009

/s/ GERARD MATTIA

Gerard Mattia

Senior Executive Vice President and

Chief Financial Officer

This certification accompanies each Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by HSBC USA Inc. for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

Signed originals of these written statements required by Section 906 of the Sarbanes-Oxley Act of 2002 have been provided to HSBC USA Inc. and will be retained by HSBC USA Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HSBC Holdings plc

By:

Name: P A Stafford

Title: Assistant Group

Secretary

Date: 10 November 2009