98

Midland Bank plc

Annual Report and Accounts

HSBC

Contents

FORWARD-LOOKING STATEMENTS

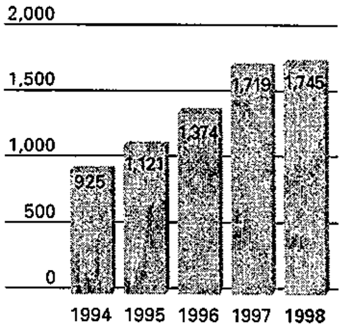
This document contains certain forward-looking statements with respect to the financial condition, results of operations and business of Midland Bank plc (the 'Bank') and its subsidiary and associated undertakings (together 'Midland'). Among other sections, 'Business Description', 'Financial Review' and 'Year 2000 Readiness' contain various forward-looking statements which represent the Bank's expectations or beliefs concerning future events and involve known and unknown risks and uncertainty that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Certain statements, such as those that include the words 'potential', 'value at risk', 'estimation', 'hypothetical', and similar expressions or variations on such expressions may be considered 'forward-looking statements'. Other factors that could cause actual results, performance or events to differ materially from those expressed or implied in this document include, but are not limited to, general economic conditions, changes in competition and fiscal and other government policies adopted in the UK and in other countries in which Midland has significant business activity or investments.

Annual Report and Accounts 1998

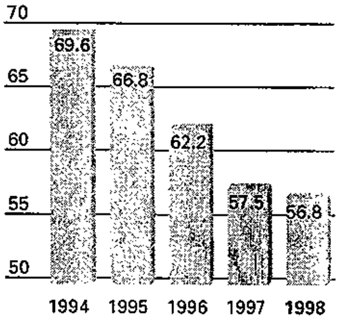
Financial Highlights

	1998	*1997*	*1996*	*1995*	*1994*
For the year (£m)					
Operating profit before provisions	**1,745**	*1,719*	*1,374*	*1,121*	*925*
Profit on ordinary activities before tax	**1,522**	*1,625*	*1,272*	*998*	*905*
Profit attributable	**1,042**	*1,051*	*849*	*610*	*595*
At year-end (£m)					
Shareholders' funds	**4,780**	*4,435*	*3,960*	*3,239*	*2,858*
Capital resources	**7,918**	*7,600*	*7,332*	*6,205*	*5,541*
Customer accounts and deposits by banks	**72,181**	*70,169*	*66,318*	*64,769*	*58,225*
Total assets	**104,846**	*102,076*	*96,221*	*93,627*	*80,375*
Ratios (%)					
Return on average shareholders' funds (equity)	**23.4**	*26.0*	*24.5*	*20.0*	*21.2*
Capital ratios					
— total capital	**11.1**	*11.4*	*11.5*	*10.8*	*11.5*
— tier 1 capital	**6.8**	*6.7*	*6.7*	*6.3*	*6.6*
Cost:income ratio	**56.8**	*57.5*	*62.2*	*66.8*	*69.6*
Per ordinary share (pence)					
Earnings	**125.3**	*126.3*	*101.9*	*73.8*	*73.1*

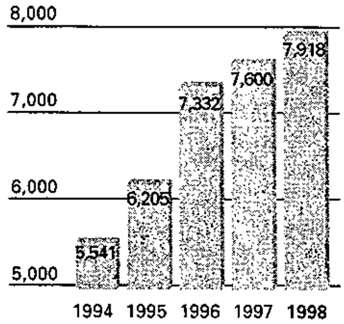
Operating profit before provisions (£m)



Cost:income ratio (%)



Capital resources (£m)



Presentation of Information

This document comprises the 1998 Annual Report and Accounts and the 1998 Annual Report on Form 20-F to the US Securities and Exchange Commission (the 'SEC') for Midland Bank plc (the 'Bank') and its subsidiary and associated undertakings (together 'Midland'). It contains the Directors' Report and Accounts, together with the Auditor's Report thereon, as required by the UK Companies Act 1985. A 1998 *Annual Review* is published as a separate document.

Midland's Accounts and Notes thereon, as set out on pages 66 to 119, are prepared in accordance with UK generally accepted accounting principles ('UK GAAP'), which differ in certain respects from US generally accepted accounting principles ('US GAAP') (see Note 37 of the Notes on the Accounts). UK GAAP, as applied to banks, include the Statements of Recommended Accounting Practice ('SORPs') issued by the British Bankers' Association and the Irish Bankers' Federation. In order to comply with US reporting requirements, three years' profit and loss information is presented.

Certain information relating to Midland's activities is presented separately for domestic and international operations. For this purpose, domestic operations reflect the activities of UK Banking, excluding UK business with foreign correspondent banks, of Asset Finance and the UK-based activities of HSBC MIDLAND. International operations reflect the activities of International Banking, HSBC MIDLAND's operations overseas and UK business with foreign correspondent banks.

The abbreviations '£m' and '£bn' represent millions and thousands of millions of pounds sterling respectively.

Exchange rates

In this *Annual Report and Accounts*, all amounts are expressed in pounds sterling unless otherwise specified. The following table sets forth, for the years and dates indicated, the US dollar exchange rate for pounds sterling based on the noon buying rate in New York City for cable transfers in pounds sterling as certified for customs purposes by the Federal Reserve Bank of New York (the 'noon buying rate'). The average rate means the average of the exchange rates on the last business day of each month during the year.

US dollar: pound sterling noon buying rates:	At year end	Average	High	Low
1998	**1.664**	**1.658**	**1.719**	**1.615**
1997	1.643	1.640	1.711	1.578
1996	1.712	1.573	1.712	1.495
1995	1.554	1.580	1.644	1.530
1994	1.567	1.539	1.637	1.462

The noon buying rate on 1 March 1999 was US$1.606 = £1. No representation is made that pounds sterling amounts have been, could have been, or could be converted into US dollars at that rate.

The rate used in translating US dollar-denominated assets and liabilities at 31 December 1998 was US$1.658 = £1 (1997: US$1.647). The average rate used by the Bank in translating US dollar-denominated results of overseas branches and subsidiary and associated undertakings for the year ended 31 December 1998 was US$1.657 = £1 (1997: US$1.638; 1996: US$1.571).

Business Description

Introduction

Midland is a United Kingdom-based financial services group providing banking and financial services to personal and business customers in the United Kingdom and overseas. Midland's operations outside the United Kingdom are primarily in Europe and Latin America, with a wide range of banking services including loans, deposits, payments, treasury and capital markets, trade services and private banking. In addition, Midland has a full range of foreign exchange, money market and capital markets operations in New York and Tokyo.

The Bank's principal subsidiary undertakings as at 31 December 1998, all of which are wholly-owned, and their principal geographic areas of activity were:

Forward Trust Group Limited	United Kingdom
Forward Trust Rail Limited	United Kingdom
Griffin Credit Services Limited	United Kingdom
Midland Bank Trust Company Limited	United Kingdom
Midland Bank Offshore Limited	Jersey
Midland Life Limited	United Kingdom

The Bank is a wholly-owned subsidiary undertaking of HSBC Holdings plc ('HSBC Holdings') which, together with its subsidiary and associated undertakings, is referred to as the 'HSBC Group'. The HSBC Group is one of the largest banking and financial services organisations in the world, with over 5,000 offices in 79 countries and territories. Its total assets at 31 December 1998 were £291 billion. The Bank is the HSBC Group's principal operating subsidiary undertaking in Europe.

Midland groups its activities into two core business segments, **Banking** which comprises UK Banking, International Banking and HSBC MIDLAND and **Asset Finance.**

On 27 November 1998, HSBC Holdings announced that it is creating a global brand for the HSBC Group, using HSBC and the hexagon symbol everywhere it operates. The legal names of Midland and its subsidiary undertakings will change, where appropriate, after obtaining all necessary regulatory and other approvals, in order to be consistent with the new branding.

UK Banking

Midland provides a wide range of banking and financial services to personal and business customers. Services are provided through a branch network and via telephone and PC. The network of approximately 1,700 branches includes 21 outlets within Morrisons supermarkets, which are open the same hours as their host supermarkets. Routine customer telephone calls are handled by four Customer Service Centres which work in partnership with Midland's branches to provide an extended hours telephone banking enquiry service. Customers are also offered 24-hour access, through Service*Plus*, to an Interactive Voice Response service.

Midland is a founder shareholder with a 20 per cent stake in British Interactive Broadcasting ('BiB') which has been established to deliver digital interactive services to television viewers in the UK. Subscribers to BiB will be able to access an electronic shopping centre, enabling them to order and pay for a range of goods and services from their home. Midland is providing the payment handling infrastructure for debit and credit payments and will be introducing a TV Banking service through Open...., the marketing name of BiB.

Midland has centralised routine processing, which was previously completed by individual branches, and cheques and credits paid in through the retail branch network, along with the majority of customer instructions received by branches, are processed at fifteen District Service Centres. Routine credit control work for personal customers is being transferred to three new service centres.

The services provided include:

- Current accounts – The key element in the customer relationship remains the provision of current accounts and the associated core services. At 31 December 1998 Midland had over five million personal current accounts and approximately 700,000 business current accounts. Midland has maintained its overall market share of 25 per cent of all accounts of young people aged between 16 and 20.

  Additionally, almost one third of new students choose Midland as their main bank. Midland remains focused on the quality of service it provides and regularly asks customers for their opinions. The Bank's core personal banking proposition achieved a 'best buy' status in the UK Consumer Association's *Which?* report in October 1998. It also singled Midland out as having a significantly lower level of mistakes than the average for providers of current accounts.

- Loans – Midland provides a wide range of lending services for personal and business customers. In 1998, Midland's domestic housing loan portfolio grew by 10 per cent through the provision of fixed and variable rate mortgages and equity release loans. As at 31 December 1998 the portfolio balance exceeded £12 billion.

- Savings accounts – Midland offers a range of term and call savings products to both the personal and business markets. During 1998 Midland carried out a comprehensive review of savings accounts, simplifying the product range and ensuring consistency of interest rate pricing between products.

- ATMs – The Bank has a comprehensive self-service automated teller machine ('ATM') network consisting of approximately 2,200 machines sited at Midland branches and approximately a further 575 at non-branch sites such as supermarkets and underground stations. These, together with bilateral arrangements with other banks and building societies and machines with the CIRRUS acceptance mark, provide access to over 23,000 ATMs in the UK. Internationally, approximately 430,000 ATMs are available through the CIRRUS acceptance mark.

- Direct banking – Midland provides full service person-to-person banking by telephone, 24 hours a day, 365 days a year through First Direct. First Direct is the UK's leading telephone banking service with over 880,000 customers and attracts on average 10,000 new cheque accounts per month. First Direct introduced a PC banking service in 1998, and over 68,000 customers are already using this facility.

- Wealth management – The Bank sells life, pensions, investment and general insurance products acting as 'company representative' for the sale of regulated products sourced from Midland Life Limited and Midland Unit Trust Management Limited under the terms of the UK Financial Services Act 1986. These products are sold to customers by financial planning managers

Business Description (continued)

UK Banking *(continued)*

through the branch network and by telephone. Revenue from life assurance, general insurance and investment products grew by 26 per cent to £319 million in 1998. Funds under management of Midland Life Limited and Midland Unit Trust Management Limited were £5.6 billion at 31 December 1998 (1997: £4.9 billion). The Bank also provides investment management and independent financial advisory services to more affluent personal customers. Funds under management were £3.5 billion at 31 December 1998 (1997: £3.0 billion).

- Cards – The Bank issues credit cards under both the MasterCard and VISA payment schemes. For business customers the Bank provides business, corporate and purchasing cards. The Bank is also a major merchant acquirer for both credit card and debit card transactions. The SOLO debit card, launched in 1997, has now extended debit card facilities to nearly 900,000 new customers, an increase of 40 per cent during 1998. During July 1998 an agreement was reached at UK industry level for the implementation of Integrated Circuit Card technology on debit and credit cards. This initiative will help to reduce counterfeit fraud and will provide a platform for future business developments.

- Stockbroking – Midland Stockbrokers provides an execution-only share dealing service to retail investors via the retail branch network and directly by telephone. It also supports the share dealing requirements of external intermediaries.

- Custody services – Midland includes the specialist global custody division of the HSBC Group, offering full global, regional and UK sub-custodian services in over 65 markets world-wide. It also acts as trustee to unit trusts and engages in agency stocklending of both fixed income and equity instruments.

- Trade services – The Bank provides trade and international banking services including documentary credits, bills and short-term structured trade finance under the name HSBC Trade Services.

- Corporate and correspondent banking – Midland Corporate Banking has responsibility for the Bank's largest corporate and institutional clients. Relationships are managed through a number of specialist industry groups in co-operation with all areas of Midland and the HSBC Group to provide a broad range of banking products and services. The Bank's City of London Corporate Office provides a dedicated service to the more complex Midland Corporate Banking relationships with retail branches handling the remainder.

International Banking

Midland's overseas operations are primarily in Europe and Latin America, coupled with a wide range of banking services including loans, deposits, payments, treasury and capital markets, trade services and private banking.

Midland has offices based in 28 countries and territories, principally in Europe, with a number of offices in Latin America.

The Bank has branches in Australia, the Czech Republic, France, Greece, Guernsey, the Isle of Man, Italy, Japan, Jersey, Malta, Panama, Spain, Sweden and the United States.

Midland has representative offices in Argentina, Bahrain, Brazil, Chile, the Hong Kong Special Administrative Region, Ireland, Mexico, Russia, Singapore, Taiwan and Venezuela.

Midland also operates through the following overseas subsidiary undertakings: in Armenia, Midland Armenia Bank jsc; in the Cayman Islands, Midland Bank Trust Corporation (Cayman) Limited; in Greece, Midland Pantelakis Securities S.A.; in Guernsey, Midland Bank Offshore Limited; in Ireland, Midland International Financial Services (Ireland) Limited; in the Isle of Man, Midland Bank Offshore Limited; in Jersey, Midland Bank Offshore Limited; and in Turkey, Midland Bank A.S.

Business with emerging markets (principally in Latin America), which is generally short-term trade and/or capital markets-related, is managed centrally in London; the representative offices in the relevant countries are used to identify profitable business opportunities.

Long-term Less Developed Country ('LDC') debt exposure includes Brady bonds issued as a result of debt restructuring by Argentina, Brazil, Mexico and Venezuela and loans to certain other countries where debt negotiations are taking place. A portfolio of equity investments is held, arising from debt:equity swaps. Long-term debt exposures and debt:equity investments in Latin America continue to be reduced.

HSBC MIDLAND

HSBC MIDLAND comprises the treasury and capital markets operations of Midland in London, New York and Tokyo, together with smaller operations in Madrid, Milan, Paris and Prague.

HSBC MIDLAND's activities include a full range of foreign exchange, including currency options, money market and capital markets operations. Interest rate, bond and equity derivative products are also delivered to its customer base. A computerised spot and forward foreign exchange order service is available from London. Additionally, a number of corporate clients have the facility to deal directly through Midland's FX-Direct foreign exchange dealing system. Nine UK regional treasury centres provide direct access to treasury services for customers on a local basis.

HSBC MIDLAND has a significant share of the foreign exchange market in London and is prominent in the Asian, Middle Eastern and East European currency markets. It is also well established in the interest rate markets. In capital markets, HSBC MIDLAND's business is conducted in the name of HSBC Markets, a vehicle under which a number of the operating arms of the HSBC Group have been brought together. HSBC MIDLAND continues to retain its position as a leading new debt issuance house in the international capital markets.

Midland is also prominent in the UK Government bond market and the Eurosterling bond market. HSBC Futures provides comprehensive coverage of the London International Financial Futures and Options Exchange and has achieved a prominent position globally. It is also represented on most of the leading overseas financial futures exchanges.

Asset Finance

Midland, through Forward Trust Group Limited and its subsidiary undertakings, is one of the leading suppliers in the UK of instalment finance, leasing and invoice finance products, principally to business customers.

A comprehensive range of asset finance products and related services is offered to corporate customers. The business includes divisions specialising in vehicle and rail rolling stock finance. Asset finance is also available for plant and equipment and a specialised finance division arranges large and complex leases.

Griffin Credit Services Limited offers invoice finance, credit management and credit protection services to business customers, together with debt recovery services.

Competition

Although market growth in recent years has remained relatively limited, the UK financial services industry has continued to attract new entrants, often well established non-financial companies with large customer bases, or insurance companies. Among the new entrants are several banks which have been started by supermarkets, generally as joint ventures with existing banks.

The effects of mergers and acquisitions among the established industry players, particularly in the retail sector, and of de-mutualisations among life insurers and building societies are still emerging, particularly in the form of more aggressive competition and cost economies. Bank and building society networks have reduced by over 20 per cent during the last decade with some large banks continuing to reduce their network size.

Midland has continued its commitment to a relatively stable network with managers at local level having sufficient authority to provide a quick and efficient service. Branch staff can concentrate on customer service because of the support received from centralised processing and telephone enquiry services. As information and communication technologies advance it continues to become easier to gain access to large numbers of customers without incurring the costs of a physical distribution infrastructure. Following the lead established by Midland's First Direct, the major banks now offer telephone banking facilities. Most of these, however, are enhancements to the service for existing account holders. First Direct is a stand-alone service which continues to attract large numbers of new customers and is the market leader. Many major firms in the retail financial services markets, Midland and First Direct included, are also investing in PC or TV-based home banking services.

Consolidation has also taken place in the wholesale markets, where Midland is competing with the largest international banking groups and investment houses. Midland's membership of the HSBC Group, however, provides considerable strengths, with access to research and advice, and treasury and capital markets world-wide.

Business Description (continued)

European Economic and Monetary Union

Throughout Midland's businesses, comprehensive planning and testing was undertaken for the introduction of the single European currency in 11 European Union member states (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain) on 1 January 1999. Within Midland, all conversion weekend tasks were completed successfully and Midland was able to trade and settle in euros when the markets opened on Monday 4 January 1999.

Midland is offering a range of euro services including current accounts, payments and cash management services, loans and deposits, treasury and capital markets services, and custody and trade services. Although the UK has not joined the single European currency, UK businesses with operations in, or trading links with businesses based in, the euro area are affected. In addition those that buy from or sell to UK subsidiaries of continental European corporations, which have decided that they will trade in euros, may also be affected. Midland will continue to support its business customers through the provision of information to assist them in addressing the challenges and exploiting the opportunities arising from the introduction of the euro.

In 1999, Midland will be further developing its euro service proposition for potential UK entry together with a detailed plan to deliver it.

Financial Review

Summary of Financial Performance

	1998 £m	1997 £m	1996 £m
Net interest income	**2,237**	2,203	2,051
Other operating income	**1,805**	1,839	1,587
Operating income	**4,042**	4,042	3,638
Depreciation and amortisation	**(291)**	(231)	(200)
Other operating expenses	**(2,006)**	(2,092)	(2,064)
Operating profit before provisions	**1,745**	1,719	1,374
Provisions for bad and doubtful debts	**(196)**	(129)	(172)
Provisions for contingent liabilities and commitments	**(59)**	(3)	(3)
Amounts written off fixed asset investments	**(1)**	(4)	(40)
Operating profit	**1,489**	1,583	1,159
Share of operating (loss)/profit in associated undertakings	**(1)**	9	21
Gains on disposal of			
– investments	**28**	24	91
– tangible fixed assets	**6**	9	1
Profit on ordinary activities before tax	**1,522**	1,625	1,272
Tax on profit on ordinary acitivities	**(479)**	(559)	(408)
Profit on ordinary activities after tax	**1,043**	1,066	864
Minority interests	**(1)**	(15)	(15)
Profit attributable to shareholders	**1,042**	1,051	849

In 1998, operating profit before provisions was £1,745 million, an increase of 2 per cent over 1997. Excluding the results of Trinkaus & Burkhardt KGaA and Guyerzeller Bank AG, which were transferred to a fellow HSBC Group subsidiary on 31 December 1997, this represented a 7 per cent increase over 1997's operating profit before provisions.

Operating profit, at £1,489 million, was 6 per cent lower than in 1997. UK Banking achieved an operating profit of £1,153 million, 15 per cent higher than in 1997, while Asset Finance increased by 19 per cent to £148 million. HSBC MIDLAND reported a lower operating profit of £38 million, due to decreased dealing profits. Within International Banking, an increase in operating profit was recorded by most businesses, although operating profit was £157 million lower at £150 million, due to reduced debt and interest recoveries and the transfer of Trinkaus & Burkhardt KGaA and Guyerzeller Bank AG. In 1997, exceptional debt recoveries of £98 million were made on the disposal of Latin American debt.

Net interest income increased by £34 million to £2,237 million, or by £121 million if the results of the transferred subsidiaries are excluded from 1997's results. An increase in average interest-earning assets, growth in current accounts and improved spreads on mortgages contributed to higher net interest income.

Other operating income decreased by £34 million to £1,805 million but, excluding the results of the transferred subsidiaries, increased by £104 million, or 6 per cent. This increase reflected growth in wealth management activities. Higher fee and commission income also came from current accounts, cards, mortgages and lending to corporate customers. New business growth in vehicle finance contributed to increased operating lease income. Dealing profits were lower, reflecting difficult trading conditions in most major markets.

Operating expenses reduced by £26 million to £2,297 million. Excluding the results of the transferred subsidiaries, operating expenses increased by £118 million or 5 per cent. The cost:income ratio continued to improve, decreasing to 56.8 per cent in 1998.

The charge for bad and doubtful debts was £67 million higher than in 1997, mainly because of lower recoveries from the sale of Latin American debt.

During the first half of 1998, the Financial Services Authority issued a consultation paper containing proposals for extending the review of customers who may have been disadvantaged when transferring from or opting out of occupational pension schemes. A charge of £60 million for the amount of redress potentially payable to customers has been included within provisions for contingent liabilities and commitments.

Financial Review (continued)

Summary of Financial Performance (continued)

In 1997, operating profit before provisions rose 25 per cent to £1,719 million. Operating profit was 37 per cent higher at £1,583 million. Net interest income increased mainly as a result of strong balance sheet growth in business, personal and mortgage lending.

There was higher fee and commission income, largely in UK Banking, mainly from personal and business lending and insurance. Operating lease income rose significantly following the acquisition of £1.2 billion of operating leased assets. Operating expenses increased by less than 3 per cent and Midland improved its cost:income ratio to 57.5 per cent. The charge for bad and doubtful debts was lower than in 1996 following improved recoveries and a higher net release of provisions resulting from sales of Latin American debt.

Net interest income

	1998 £m	1997 £m	1996 £m
Net interest income	**2,237**	2,203	2,051
Average interest-earning assets	**88,434**	84,029	77,039

In 1998, net interest income increased by £34 million to £2,237 million, or by £121 million if the results of the transferred subsidiaries are excluded from 1997's results. Average interest-earning assets increased by £4 billion, or £10 billion excluding those relating to the subsidiaries transferred on 31 December 1997. This increase, reflecting continued growth in lending to personal and business customers in UK Banking and increased holdings of debt securities, together with growth in current accounts and improved spreads on mortgages, contributed to higher net interest income. This was partly offset by lower interest spread caused by competitive pressures within the domestic market, which affected spreads on personal savings and cards, and a flatter sterling yield curve affecting net interest income in HSBC MIDLAND. Lower interest recoveries from Latin American debt, together with the cost of funding the growth in the operating lease portfolio, also contributed to the lower spread. The decrease in interest spread was partly mitigated by an increased contribution from higher levels of net free funds, resulting in an overall reduction in the net interest margin to 2.53 per cent.

In 1997, net interest income increased reflecting improved customer recruitment and continued growth in lending and deposit balances, together with the benefit of improved spreads in the branch network, particularly on mortgage lending as discounts rolled off. A reduction in the level of interest suspended and foregone mainly due to lower non-performing loans also contributed to the growth. These increases were partly offset by the funding of operating leased assets which contributed to an overall reduction in net interest margin of 4 basis points from 2.66 per cent in 1996 to 2.62 per cent in 1997.

Prevailing average interest rates, interest yields, interest spreads and interest margins

	1998 %	1997 %	1996 %
Midland Bank plc UK base lending rate	**7.2**	6.6	6.0
London interbank offered rate ('LIBOR')			
Three months pounds sterling	**7.3**	6.9	6.0
Six months eurodollar	**5.5**	5.8	5.5
US prime rate	**8.4**	8.4	8.3
Interest yield (i)			
Domestic	**7.3**	7.0	6.7
International	**7.2**	6.4	6.0
Total	**7.3**	7.0	6.6
Interest spread (ii)			
Domestic	**1.9**	2.2	2.2
International	**1.3**	1.2	1.0
Total	**1.9**	2.1	2.1
Interest margin (iii)			
Domestic	**2.5**	2.7	2.8
International	**1.9**	1.8	1.7
Total	**2.5**	2.6	2.7

(i) *Interest yield is the average interest rate earned on average interest-earning assets.*

(ii) *Interest spread is the difference between the average interest rate earned on average interest-earning assets and the average interest rate paid on average interest-bearing funds.*

(iii) *Interest margin is net interest income as a percentage of average interest-earning assets.*

Net interest income *(continued)*

Domestic yields, spreads and margins

In 1998, domestic yield increased from 7.0 per cent to 7.3 per cent, principally reflecting an increase in average sterling interest rates during the year. Competitive pressures on retail liability products and credit cards resulted in a narrowing in spread. Growth in average interest-earning assets, primarily in finer margin lending to large corporate borrowers and fixed rate mortgage lending, led to a change in asset mix. The cost of funding the growth in the operating lease portfolio and an increase in lower yielding treasury assets also contributed to the lower margin. An increased contribution from higher levels of net free funds partially offset the reduction in spread.

In 1997, domestic yield increased from 6.7 per cent to 7.0 per cent, principally reflecting an increase in average sterling interest rates during the year. This effect was partly offset by a relatively flat yield in the UK-based activities of HSBC MIDLAND, due primarily to a change in currency mix in debt securities from sterling to lower yielding US dollar securities. Overall domestic spread was unchanged, at 2.2 per cent. An increase in spread in UK Banking, in particular on variable rate mortgage lending as incentive discounts rolled off and as product spread widened, and on savings products, was offset by a decrease in spread in the UK-based activities of HSBC MIDLAND, reflecting the impact of rising short-term rates on money market operations. The funding of increased operating lease balances, following the acquisition of Forward Trust Rail Services Limited, decreased margin by 6 basis points. Domestic margin decreased from 2.8 per cent to 2.7 per cent.

International yields, spreads and margins

In 1998, international yield increased from 6.4 per cent to 7.2 per cent, principally due to the transfer out of Midland of Trinkaus & Burkhardt KGaA which had lower yielding assets. International spread increased from 1.2 per cent to 1.3 per cent reflecting the effect of the transfer out of Midland of Trinkaus & Burkhardt KGaA, partially offset by reduced debt:equity interest receipts and interest recoveries in the year. International margin increased from 1.8 per cent to 1.9 per cent.

In 1997, international yield increased from 6.0 per cent to 6.4 per cent reflecting an increase in debt:equity interest receipts in Latin America, a reduction in the level of net interest suspended and foregone, reflecting increased interest recoveries in Latin America, and a reduction in non-performing debt following the transfer of Midland Bank SA. International spread increased from 1.0 per cent to 1.2 per cent, reflecting an increase in debt:equity interest receipts, the reduced level of net interest suspended and foregone, and the reduction in non-performing debt. International margin increased from 1.7 per cent to 1.8 per cent.

Other operating income

	1998 £m	1997 £m	1996 £m
Dividend income	**2**	11	3
Fees and commissions receivable	**1,632**	1,682	1,391
Fees and commissions payable	**(357)**	(400)	(234)
Foreign exchange	**173**	236	142
Interest rate derivatives	**4**	18	53
Debt securities	**17**	(36)	20
Equities and other trading	**(70)**	17	19
Dealing profits	**124**	235	234
Operating lease income	**300**	245	107
Increase in the value of long-term assurance business attributable to shareholders	**73**	39	72
Other	**31**	27	14
Total other operating income	**1,805**	1,839	1,587

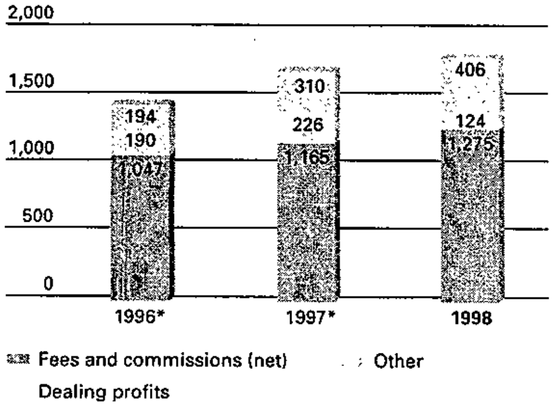
In 1998, other operating income decreased by £34 million to £1,805 million, but excluding the results of the transferred subsidiaries, increased by £104 million or 6 per cent. Wealth management activities, which include sales of investment, insurance and private banking products, showed strong growth, with increased cross sales and higher funds under management. Higher fee and

Financial Review (continued)

Other operating income *(continued)*
commission income also came from current accounts, cards, mortgages and lending to corporate customers. New business growth in vehicle finance contributed to increased operating lease income

In 1997, other operating income of £1,839 million was £252 million higher than 1996. Net fees and commissions grew by £125 million, or 11 per cent, to £1,282 million. In UK Banking higher fee income was achieved with the branch network increasing contributions from personal overdrafts, current accounts, mortgages, cards and insurance. Germany also contributed higher fee income, principally from private client business. Operating lease income rose by £138 million to £245 million following the acquisition during the year by Forward Trust of £1.2 billion of operating leased assets.

Other operating income (£m)



* *Restated to exclude the results of Trinkaus & Burkhardt KGaA and Guyerzeller Bank AG.*

Dealing profits

The table below shows the total of dealing profits, which exclude the cost of associated staff and other administrative expenses, and dividend and net interest income attributable to dealing activities. The net interest income on securities trading arises on marked-to-market debt securities and treasury bills.

Securities held for dealing purposes include British Government securities, other government securities and certificates of deposit and securities issued by banks.

In 1998, HSBC MIDLAND reported lower dealing profits, reflecting difficult trading conditions in most major markets. Whilst there were good performances from foreign exchange and money markets, other areas suffered from exceptional market volatility.

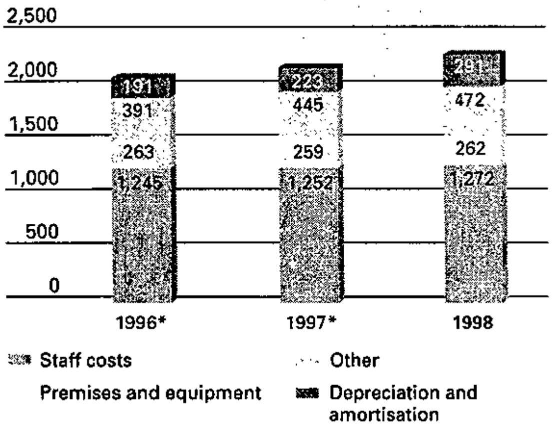
In 1997, HSBC MIDLAND dealing profits improved principally due to higher profits from foreign exchange trading. Overall, total dealing profits were in line with 1996 as dealing profits from international operations, particularly from debt securities trading, were lower.

	1998			1997			1996		
	Dealing profits £m	Dividend and net interest income £m	Total £m	Dealing profits £m	Dividend and net interest income £m	Total £m	Dealing profits £m	Dividend and net interest income £m	Total £m
Foreign exchange	173	2	175	236	(1)	235	142	—	142
Interest rate derivatives	4	33	37	18	23	41	53	8	61
Debt securities	17	3	20	(36)	77	41	20	79	99
Equities and other trading	(70)	18	(52)	17	11	28	19	18	37
	124	56	180	235	110	345	234	105	339

Operating expenses

	1998 £m	1997 £m	1996 £m
Staff costs	**1,272**	1,347	1,367
Premises and equipment (excluding depreciation and amortisation)	**262**	275	283
Other administrative expenses	**472**	470	414
Administrative expenses	**2,006**	2,092	2,064
Depreciation and amortisation	**291**	231	200
Operating expenses	**2,297**	2,323	2,264
	%	%	%
Cost:income ratio	**56.8**	57.5	62.2
Full-time equivalent staff numbers at 31 December	**42,929**	42,601	43,019

Operating expenses (£m)



* *Restated to exclude the results of Trinkaus & Burkhardt KGaA and Guyerzeller Bank AG.*

In 1998, operating expenses reduced by £26 million to £2,297 million. Excluding the results of the transferred subsidiaries, operating expenses showed an increase of 5 per cent, or £118 million.

Staff costs, excluding those of the transferred subsidiaries, rose by 2 per cent compared with 1997, largely as a result of pay awards. In 1998 the costs of temporary staff have been reclassified from other staff costs to other administrative expenses. Prior year comparative figures have been restated accordingly. Premises and equipment costs were broadly in line with 1997. Within administrative expenses, communications and stationery costs increased as a result of higher business volumes while marketing costs were lower than in 1997, which included the costs of launching the new Bank Account. Depreciation charges, excluding those relating to the transferred subsidiaries, increased by 30 per cent, including the effect of the growth in operating leased assets. Midland's cost:income ratio continued to improve, decreasing to 56.8 per cent in 1998.

In 1997, operating expenses increased by less than 3 per cent. Total staff costs were 1 per cent lower and premises and equipment costs reduced due to lower vacant space charges. Depreciation costs increased reflecting the growth in operating leased assets, and higher business volumes contributed to an increase in communications and stationery costs. Marketing costs rose following a range of successful initiatives in 1997 including the launch of the new Bank Account and increased spending in First Direct. Midland achieved an improvement in its cost:income ratio to 57.5 per cent from 62.2 per cent in 1996.

Provisions for bad and doubtful debts

	1998 £m	1997 £m	1996 £m
Banking			
UK Banking	**180**	206	183
International Banking	**(8)**	(83)	(31)
HSBC MIDLAND	**10**	—	—
Asset Finance	**14**	6	20
Total bad and doubtful debts charge	**196**	129	172
Analysis of total charge:			
Charge for specific provisions	**175**	92	151
Charge for general provisions	**21**	37	21
	196	129	172

The charge for bad and doubtful debts was £67 million higher than in 1997, which included higher recoveries from the sale of Latin American debt in International Banking. In UK Banking, new specific provisions rose from £283 million to £298 million, while releases and recoveries increased from £118 million to £138 million. The general provision charge was £16 million lower than in 1997. Excluding the transferred subsidiaries, the 1998 charge for bad and doubtful debts was £72 million higher than in 1997.

In 1997, the bad debt charge was £43 million lower than in 1996 following improved recoveries and a higher net release of provisions resulting

Financial Review (continued)

Provisions for bad and doubtful debts *(continued)*

from sales of Latin American debt. New specific provisions fell from £357 million to £340 million. Releases and recoveries rose from £206 million to £248 million. The general provision charge was £16 million higher than in 1996.

Taxation

A reconciliation of the charge for taxation in the profit and loss account with the amount computed by applying the statutory rate of corporation tax to profit on ordinary activities before taxation is given in the table below:

In 1998. the effective tax rate reduced mainly reflecting a charge in 1997 to make full provision for deferred tax in Forward Trust, the lower rate of UK corporation tax in 1998, and a lower general bad debt charge in 1998.

In 1997, the increase in the effective rate of tax reflected the deferred tax provision referred to above, together with the absence of the tax free profit on the sale of Midland's investment in 3*i* in 1996.

	1998		1997		1996	
	£m	%	£m	%	£m	%
Taxation at UK corporation tax rate of 31% (1997: 31.5%, 1996: 33%)	472	31.0	512	31.5	420	33.0
General bad debt charge	6	0.4	12	0.7	7	0.6
Other non-deductible items including unrelieved losses	23	1.5	19	1.2	40	3.3
Items covered by previously unrecognised capital losses	(3)	(0.2)	(5)	(0.3)	(27)	(2.2)
Overseas offices subject to (lower)/ higher rates of tax	(5)	(0.3)	8	0.5	16	1.2
Advance corporation tax recognised	—	—	—	—	(12)	(0.9)
Forward Trust deferred tax:						
Full provision	—	—	45	2.8	—	—
Tax rate reduction	(4)	(0.2)	(34)	(2.1)	—	—
Prior year adjustments	(9)	(0.6)	(3)	(0.2)	(37)	(3.0)
Other items	(1)	(0.1)	5	0.3	1	0.1
Overall tax charge	479	31.5	559	34.4	408	32.1

Results of Principal Business Segments

Detailed segmental information by class of business is shown in the Financial Review and in Note 34b of the Notes on the Accounts; geographic analyses are shown in Note 34a.

Profit on ordinary activities before tax for each of the years in the three-year period ended 31 December 1998 is summarised in the table below.

	1998 £m	1997 £m	1996 £m
Banking			
UK Banking	**1,153**	1,000	730
International Banking			
Overseas businesses	**127**	87	33
Developing countries debt management	**23**	145	76
Trinkaus & Burkhardt KGaA and Guyerzeller Bank AG	**—**	75	77
	150	307	186
HSBC MIDLAND	**38**	152	146
	1,341	1,459	1,062
Asset Finance	**148**	124	97
Operating profit	**1,489**	1,583	1,159
Share of operating (loss)/profit in associated undertakings	**(1)**	9	21
Gains on disposal of investments and tangible fixed assets	**34**	33	92
Profit on ordinary activities before tax	**1,522**	1,625	1,272

Banking

UK Banking

	1998 £m	1997 £m	1996 £m
Net interest income	**1,920**	1,759	1,475
Other operating income	**1,256**	1,144	1,051
Operating income	**3,176**	2,903	2,526
Depreciation and amortisation	**(139)**	(105)	(100)
Other operating expenses	**(1,643)**	(1,586)	(1,508)
Operating profit before provisions	**1,394**	1,212	918
Provisions for bad and doubtful debts	**(180)**	(206)	(183)
Provisions for contingent liabilities and commitments	**(60)**	(2)	(3)
Amounts written off fixed asset investments	**(1)**	(4)	(2)
Operating profit	**1,153**	1,000	730
Share of operating (loss)/profit in associated undertakings	**(10)**	(2)	4
Gains on disposal of investments and tangible fixed assets	**12**	11	76
Profit on ordinary activities before tax	**1,155**	1,009	810

In 1998, UK Banking's operating profit grew by 15 per cent to £1,153 million. Continued emphasis on broadening the range, competitiveness and accessibility of wealth management services proved successful: revenue from life assurance, general insurance and investment products grew by 26 per cent to £319 million. Higher personal and business current accounts, and increases in personal and business lending and cards, together with improved spreads on mortgages, contributed to a rise in net interest income. This growth was partially offset by reduced spreads on personal savings and cards. There was good growth in fee and commission income from personal current accounts and card services, and from private banking, where there was a strong performance in acquiring new funds under discretionary portfolio management. Growth in operating income, combined with continued tight control over growth in operating expenses, resulted in an improvement in UK Banking's cost:income ratio from 58.3 per cent to 56.1 per cent. Provisions for bad and doubtful debts were £26 million lower at £180 million, including a lower general bad debt charge. Provisions for contingent liabilities and commitments were £58 million higher than in 1997. During the first half of 1998, the Financial Services Authority issued a consultation paper containing proposals for extending the review of customers who may have been disadvantaged when transferring from or opting out of occupational pension schemes. A charge of £60 million for the

Financial Review (continued)

Results of Principal Business Segments *(continued)*

UK Banking *(continued)*

amount of redress potentially payable to customers has been included within provisions for contingent liabilities and commitments.

In 1997, UK Banking's operating profit grew by 37 per cent to £1,000 million. Net interest income was £284 million higher than in 1996, reflecting growth in business, personal and mortgage lending, money market deposits and current accounts and improved spreads on mortgage and savings products. Higher fee and commission income was also achieved, mainly arising from personal overdrafts, mortgages, cards and insurance. UK Banking's cost:income ratio improved from 63.7 per cent to 58.3 per cent. Provisions for bad and doubtful debts were £23 million higher at £206 million.

International Banking

	1998 £m	1997* £m	1996* £m
Net interest income	158	175	156
Other operating income	79	63	77
Operating income	237	238	233
Depreciation and amortisation	(4)	(3)	(4)
Other operating expenses	(92)	(91)	(120)
Operating profit before provisions	141	144	109
Provisions for bad and doubtful debts	8	88	38
Provisions for contingent liabilities and commitments	1	—	—
Amounts written off fixed asset investments	—	—	(38)
Operating profit	150	232	109
Share of operating profit in associated undertakings	9	9	17
Gains on disposal of investments and tangible fixed assets	1	2	11
Profit on ordinary activities before tax	160	243	137

** Restated to exclude the results of Trinkaus & Burkhardt KGaA and Guyerzeller Bank AG.*

In 1998, International Banking reported an operating profit of £150 million, a reduction of £82 million excluding the results of the transferred subsidiaries. Operating profits of overseas businesses increased by £40 million, with most European operations, in particular the Channel Islands and the Isle of Man, Turkey, Greece and France, and also Australia, reporting significantly improved results. The 1997 results included higher interest recoveries, mainly from income on Latin American debt:equity investments, and bad debt recoveries from the disposal of Latin American debt following the HSBC Group's direct investments in Latin America.

In 1997, results for France, the Channel Islands and Turkey improved significantly. Corporate banking profits in Greece were enhanced by the acquisition of a shipping portfolio. Following the HSBC Group's direct investments in Latin America, bad debt recoveries rose on the sale of Latin American debt in the market.

HSBC MIDLAND

	1998 £m	1997 £m	1996 £m
Net interest income	151	170	204
Net fees and commissions payable	(30)	(39)	(38)
Dealing profits	112	208	160
Other operating income	82	169	122
Operating income	233	339	326
Depreciation and amortisation	(7)	(5)	(3)
Other operating expenses	(178)	(182)	(177)
Operating profit before provisions	48	152	146
Provisions for bad and doubtful debts	(10)	—	—
Operating profit	38	152	146
Gains on disposal of investments and tangible fixed assets	21	18	5
Profit on ordinary activities before tax	59	170	151

In 1998, HSBC MIDLAND reported operating profit of £38 million compared with £152 million in 1997. Net interest income decreased by £19 million, primarily reflecting the impact of a flatter sterling yield curve. Dealing profits were 46 per cent lower at £112 million, reflecting difficult trading conditions in most major markets. While there were good performances from foreign exchange and money markets, other areas suffered from exceptional market volatility particularly in the latter half of the year. Provisions for bad and doubtful debts were £10 million higher than in 1997.

In 1997, HSBC MIDLAND reported operating profit of £152 million, up £6 million, or 4 per cent, on 1996. Net interest income was £34 million, or 17 per cent, lower at £170 million, reflecting higher money-market short-term funding rates and flatter sterling and US dollar yield curves. Dealing profits of £208 million were £48 million higher than in 1996, due to strong foreign exchange earnings. There was a £13 million increase in gains on disposal of investments.

Asset Finance

	1998 £m	1997 £m	1996 £m
Net interest income	8	12	114
Other operating income	388	325	181
Operating income	396	337	295
Depreciation and amortisation	(141)	(110)	(84)
Other operating expenses	(93)	(97)	(94)
Operating profit before provisions	162	130	117
Provisions for bad and doubtful debts	(14)	(6)	(20)
Operating profit	148	124	97
Share of operating loss in associated undertakings	—	(2)	—
Profit on ordinary activities before tax	148	122	97

In 1998, operating profit increased by £24 million, or 19 per cent, over 1997. The increase reflects the benefit of a full year's contribution from the rail business and the provision made in 1997 to cover lower rentals from finance lease customers under tax variation clauses. In addition, new business growth in vehicle and asset finance and a rise in fee income from factoring have contributed to the improved performance. Depreciation was £31 million higher reflecting the growth in the operating leased asset portfolio. Other operating expenses were tightly controlled at levels broadly in line with 1997. Less favourable trading conditions resulted in an increase in the bad debt charge.

In 1997, operating profit rose by £27 million, or 28 per cent, to £124 million due to growth in the portfolio of leased assets and continued expansion of invoice finance and debt management services. The rail business, acquired in February 1997, contributed £56 million to 1997's operating profit. The effect of the change in the rate of corporation tax from 33 per cent to 31 per cent, announced in the UK Government's July 1997 Budget, necessitated a provision of £18 million to cover lower rentals from some finance lease customers under tax variation clauses. In addition, costs were incurred in restructuring the business. Increased depreciation costs reflected the growth in operating leased assets.

Financial Review (continued)

Average Consolidated Balance Sheet and Net Interest Income

	1998			1997			1996		
	Average balance £m	Interest £m	Average rate %	Average balance £m	Interest £m	Average rate %	Average balance £m	Interest £m	Average rate %
Assets									
Treasury bills and other eligible bills									
Domestic	2,737	167	6.1	2,270	151	6.7	2,854	185	6.5
International	289	48	16.6	306	35	11.4	152	15	9.7
	3,026	215	7.1	2,576	186	7.2	3,006	200	6.6
Loans and advances to banks (i)									
Domestic	11,786	679	5.8	10,192	549	5.4	9,863	500	5.1
International	2,721	233	8.6	3,972	250	6.3	4,169	205	4.9
	14,507	912	6.3	14,164	799	5.6	14,032	705	5.0
Loans and advances to customers (i)									
Domestic	48,270	3,980	8.2	42,114	3,322	7.9	36,592	2,767	7.6
International	3,772	245	6.5	6,457	471	7.3	7,478	479	6.4
	52,042	4,225	8.1	48,571	3,793	7.8	44,070	3,246	7.4
Debt securities									
Domestic	16,692	1,009	6.0	13,197	786	6.0	10,706	639	6.0
International	2,167	120	5.5	5,521	291	5.3	5,225	325	6.2
	18,859	1,129	6.0	18,718	1,077	5.8	15,931	964	6.1
Total average interest-earning assets	88,434	6,481	7.3	84,029	5,855	7.0	77,039	5,115	6.6
Provisions for bad and doubtful debts									
Domestic	(942)			(952)			(954)		
International	(120)			(277)			(427)		
	(1,062)			(1,229)			(1,381)		
Cash and balances at central banks	371			489			331		
Items in the course of collection from other banks	2,044			1,862			1,767		
Equity shares	18			477			538		
Other assets, prepayments and accrued income	15,555			16,589			16,920		
Interests in associated undertakings	82			97			118		
Tangible fixed assets	2,848			2,490			1,425		
Total average assets and interest income	108,290	6,481	6.0	104,804	5,855	5.6	96,757	5,115	5.3
Percentage of total average assets applicable to international operations	9.4%			18.8%			21.6%		

(i) *'Loans accounted for on a nonaccrual basis' and 'Loans on which interest has been accrued but suspended' have been included in 'Loans and advances to banks' or 'Loans and advances to customers'. Interest income on such loans has been included in the consolidated profit and loss account to the extent that it has been received.*

Average Consolidated Balance Sheet and Net Interest Income *(continued)*

	1998			1997			1996		
	Average balance £m	Interest £m	Average rate %	Average balance £m	Interest £m	Average rate %	Average balance £m	Interest £m	Average rate %
Liabilities and shareholders' funds									
Interest-bearing demand deposits									
Domestic	21,614	795	3.7	19,031	583	3.1	15,788	460	2.9
International	1,107	55	5.0	1,703	63	3.7	1,554	60	3.9
	22,721	850	3.7	20,734	646	3.1	17,342	520	3.0
Money market demand deposits									
Domestic	3,781	266	7.0	3,620	175	4.8	5,125	242	4.7
International	227	21	9.3	1,018	40	3.9	918	59	6.5
	4,008	287	7.2	4,638	215	4.6	6,043	301	5.0
Savings deposits									
Domestic	5,988	364	6.1	7,357	396	5.4	10,785	509	4.7
International	413	20	4.8	456	22	4.8	2,385	97	4.1
	6,401	384	6.0	7,813	418	5.4	13,170	606	4.6
Other time deposits									
Domestic	31,964	1,806	5.7	27,286	1,469	5.4	18,942	927	4.9
International	4,240	273	6.4	6,308	394	6.2	5,199	306	5.9
	36,204	2,079	5.7	33,594	1,863	5.5	24,141	1,233	5.1
Debt securities in issue									
Domestic	5,348	365	6.8	2,949	181	6.1	1,224	76	6.2
International	269	25	9.3	1,454	79	5.4	1,633	104	6.4
	5,617	390	6.9	4,403	260	5.9	2,857	180	6.3
Subordinated liabilities (ii)									
Domestic	3,360	254	7.6	3,237	239	7.4	2,971	211	7.1
International	—	—	—	156	11	7.1	188	13	6.9
	3,360	254	7.6	3,393	250	7.4	3,159	224	7.1
Total average interest-bearing liabilities	78,311	4,244	5.4	74,575	3,652	4.9	66,712	3,064	4.5
Non-interest-bearing customer accounts									
Domestic	6,365			5,825			6,287		
International	72			145			896		
	6,437			5,970			7,183		
Other liabilities	18,742			19,738			18,925		
Minority interests	2			142			179		
Shareholders' funds	4,798			4,379			3,758		
Total average liabilities and shareholders' funds and interest expense	108,290	4,244	3.9	104,804	3,652	3.5	96,757	3,064	3.2
Percentage of total average liabilities and shareholders' funds applicable to international operations	7.8%			15.8%			18.6%		

(ii) *Subordinated liabilities are fully subordinated to depositors and all other creditors.*

Financial Review (continued)

Average Consolidated Balance Sheet and Net Interest Income (continued)

	1998		1997		1996	
	£m	Average rate %	£m	Average rate %	£m	Average rate %
Net interest income	**2,237**		2,203		2,051	
Interest income as a percentage of average interest-earning assets		**7.3**		7.0		6.6
Interest expense as a percentage of average interest-bearing liabilities		**5.4**		4.9		4.5
Interest spread		**1.9**		2.1		2.1
Net interest margin		**2.5**		2.6		2.7

(a) Balances and transactions between domestic and international operations are excluded. The average balance due from international to domestic for 1998 was £1,763 million (1997: £3,243 million; 1996: £2,908 million) and net interest paid by international to domestic for 1998 was £82 million (1997: £147 million; 1996: £101 million).

(b) Average balances are based upon daily averages for most areas of Midland's banking activities with monthly or less frequent averages used elsewhere.

Changes in net interest income

The following table allocates changes in net interest income between changes in volume and changes in rates for the last three years. Volume changes are caused by differences in the level of interest-earning assets and of interest-bearing deposits and borrowings. Rate changes result from differences in yields earned on assets and rates paid on liabilities. Changes attributable to a combination of both volume and rate have been allocated to rate.

	1998 and 1997			1997 and 1996		
	Increase/(decrease) due to changes in			Increase/(decrease) due to changes in		
	Average volume £m	Average rate £m	Net change £m	Average volume £m	Average rate £m	Net change £m
Interest income						
Treasury and other eligible bills						
Domestic	31	(15)	16	(38)	4	(34)
International	(2)	15	13	15	5	20
Loans and advances to banks						
Domestic	86	44	130	17	32	49
International	(79)	62	(17)	(10)	55	45
Loans and advances to customers						
Domestic	486	172	658	418	137	555
International	(196)	(30)	(226)	(65)	57	(8)
Debt securities						
Domestic	210	13	223	149	(2)	147
International	(178)	7	(171)	18	(52)	(34)
	358	268	626	504	236	740
Interest expense						
Interest-bearing demand deposits						
Domestic	80	132	212	95	28	123
International	(22)	14	(8)	6	(3)	3
Money market demand deposits						
Domestic	8	83	91	(71)	4	(67)
International	(31)	12	(19)	6	(25)	(19)
Savings deposits						
Domestic	(74)	42	(32)	(162)	49	(113)
International	(2)	—	(2)	(78)	3	(75)
Other time deposits						
Domestic	253	84	337	408	134	542
International	(128)	7	(121)	65	23	88
Debt securities in issue						
Domestic	146	38	184	106	(1)	105
International	(64)	10	(54)	(11)	(14)	(25)
Subordinated liabilities						
Domestic	9	6	15	19	9	28
International	(11)	—	(11)	(2)	—	(2)
	164	428	592	381	207	588
Net interest income						
Domestic	391	(171)	220	151	(52)	99
International	(197)	11	(186)	(28)	81	53
	194	(160)	34	123	29	152

Financial Review (continued)

Assets and Liabilities

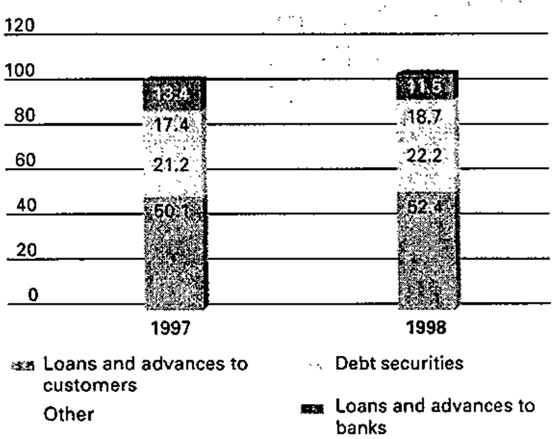
The following table analyses total assets by business segment:

	1998 £m	1997 £m
Banking		
UK Banking	**51,868**	48,591
International Banking	**8,078**	7,556
HSBC MIDLAND	**38,724**	39,960
	98,670	96,107
Asset Finance	**6,176**	5,969
Total assets	**104,846**	102,076

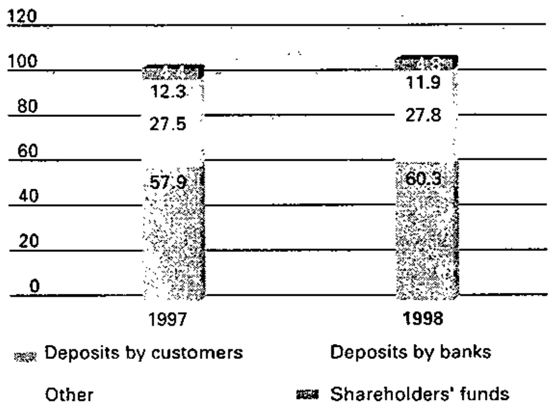
The above figures represent third party assets only; intra Midland balances are excluded.

Total assets were £2.8 billion, or 3 per cent, higher than at 31 December 1997. In UK Banking there was growth in mortgages and term lending to customers, while in HSBC MIDLAND lower money market and reverse repo balances within loans and advances to banks were partly offset by increased holdings of debt securities. Within liabilities, the principal areas of growth were in personal current accounts and deposits, reflecting growth in Midland's customer base, and in business current accounts within UK Banking.

Assets (£bn)



Liabilities (£bn)



Capital measurement and allocation

The Financial Services Authority ('FSA') is the supervisor of the Bank and Midland and, in this capacity, receives information on capital adequacy and sets capital requirements. Responsibility for banking supervision was transferred from the Bank of England to the FSA on 1 June 1998. Individual banking subsidiaries are directly regulated by the appropriate local banking supervisors, which set and monitor capital adequacy requirements for them. Similarly, non-banking subsidiaries are subject to supervision by and the capital requirements of relevant local regulatory authorities. Since 1988, when the governors of the Group of Ten central banks, who form the Basle Committee on Banking Supervision, agreed to guidelines for the international convergence of capital measurement and standards, the banking supervisors of Midland and its banking subsidiaries have exercised capital adequacy supervision within a broadly similar framework.

Under the European Union's Own Funds, Solvency Ratio and Consolidated Supervision Directives, the FSA requires each bank and banking group to maintain an individually prescribed ratio of total capital to risk-weighted assets. Since 30 September 1998, the method the FSA uses to assess the capital adequacy of banks and banking groups has been modified as a result of its implementation of the European Union's Amending Directive (Directive 98/31/EC) to the Capital Adequacy Directive ('CAD2').

Midland's capital resources policy is to maintain its capital base through the diversification of its sources of capital and the efficient allocation of capital. It seeks to maintain at all times a prudent relationship between its total capital, as measured according to the criteria used by the FSA for supervisory purposes, and the varied risks of its business.

Capital adequacy is measured by the ratio of capital to risk-weighted assets, taking into account balance sheet assets and off-balance-sheet transactions, calculated for Midland on a consolidated basis and also for the Bank.

Midland's capital is divided into two tiers: tier 1, comprising shareholders' funds excluding revaluation reserves, and minority interests; and tier 2, comprising general loan loss provisions, property revaluation reserves and qualifying subordinated loan capital. The amount of qualifying tier 2 capital cannot exceed that of tier 1 capital, and term subordinated loan capital may not exceed 50 per cent of tier 1 capital. There are also limitations on the amount of general provisions which may be included in the tier 2 capital. Deductions in respect of goodwill and intangible assets, and unconsolidated investments and investments in the capital of banks, are made from tier 1 capital and total capital, respectively.

Under CAD2, banking operations are categorised as either trading book (broadly, marked-to-market activities) or banking book (all other activities) and risk-weighted assets are determined accordingly. Banking book risk-weighted assets are measured by means of a hierarchy of risk-weights classified according to the nature of each asset and counterparty, taking into account any eligible collateral or guarantees. Banking book off-balance-sheet items giving rise to credit, foreign exchange or interest rate risk are assigned weights appropriate to the category of the counterparty, taking into account any eligible collateral or guarantees. Trading book risk-weighted assets are determined by taking into account market-related risks, such as foreign exchange, interest rate and equity position risks, as well as counterparty risk.

Capital analysis

The table on page 24 is an analysis of Midland's regulatory capital position and risk-weighted assets at 31 December 1998 and 1997.

At 31 December 1998 Midland's total regulatory capital amounted to £7,918 million, compared with £7,600 million at 31 December 1997. During 1998, Midland's total capital ratio decreased from 11.4 per cent to 11.1 per cent and its tier 1 capital ratio increased from 6.7 per cent to 6.8 per cent.

Tier 1 capital increased by £372 million in 1998, mainly due to profit retentions. Qualifying tier 2 capital decreased by £16 million.

Total risk-weighted assets increased by £4,225 million, largely due to growth in customer lending.

Financial Review (continued)

Capital analysis *(continued)*

	1998 £m	1997 £m
Composition of capital		
Tier 1		
Shareholders' funds and minority interests	4,821	4,449
Tier 2		
Fixed asset revaluation reserve	51	65
General provisions	344	328
Undated subordinated loan capital	1,252	1,259
Qualifying dated subordinated loan capital	1,792	1,803
Total qualifying Tier 2 capital	3,439	3,455
Unconsolidated investments	(288)	(277)
Investments in other banks	(49)	(22)
Other deductions	(5)	(5)
Total capital	7,918	7,600
Total risk-weighted assets	71,051	66,826
	%	%
Total capital: risk-weighted assets	11.1	11.4
Tier 1 capital: risk-weighted assets	6.8	6.7

Market Risk Management

Market risk

Market risk is the risk that interest rates, foreign exchange rates or equity and commodity prices will move and result in profits or losses to Midland. Market risk arises on financial instruments which are valued at current market prices (mark-to-market basis) and those valued at cost plus any accrued interest (accruals basis).

Midland makes markets in interest and exchange rate and equity derivative instruments, as well as in debt and other securities. Trading risks arise either from customer-related business or from position taking.

Market risk is managed within risk limits approved by the Midland Asset and Liability Management Committee ('MALCO') and by the HSBC Group Executive Committee. HSBC Group Market Risk, an independent unit within HSBC Holdings, develops risk management policies and measurement techniques, and reviews limit utilisation on a daily basis.

In addition, a Market Risk Control unit in each office reviews market risk positions on a daily basis and reports limit utilisation to Midland and HSBC Group senior management each day. Market risk exposures are reviewed by a sub-committee of MALCO each week while the utilisation of market risk limits is reviewed by MALCO each month. Risk limits are determined for each location and within location, for each portfolio. Limits are set by product and risk type with market liquidity being a principal factor in determining the level of limits set. Only those offices with sufficient derivative product expertise and appropriate control systems are authorised to trade derivative products. Limits are set using a combination of risk measurement techniques, including position limits, sensitivity limits, as well as value at risk ('VAR') limits at a portfolio level. Similarly, option risks are controlled through full revaluation limits in conjunction with limits on the underlying variables that determine the option's value. Actual risk levels compared with approved limits are monitored daily by the Market Risk Control unit in each office and by HSBC Group Market Risk.

VAR is a technique which estimates the potential losses that could occur on risk positions taken due to movements in market rates and prices over a specified time horizon and to a given level of confidence. Midland's VAR, calculated on a variance/covariance basis, uses historical one-day movements in market rates and prices, a 95 per cent confidence level and takes account of correlations between different markets and rates. The one-day movement in market prices is calculated by reference to market data from the last two years. Aggregation of VAR from different risk types is based upon the assumption of independence between risk types.

Market risk (continued)

Midland's VAR should be viewed in the context of the limitations of the methodology used. These include:

- The model assumes that changes in risk factors follow a normal distribution. This may not be the case in reality and may lead to an underestimation of the probability of extreme market movements.
- The use of a one-day holding period assumes that all positions can be liquidated or hedged in one day. This does not fully capture the market risk arising from times of illiquidity, when one day liquidation or hedging may not be possible.
- The use of a 95 per cent confidence level does not take account of any losses that might occur beyond this level of confidence.
- The use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature.
- The assumption of independence between risk types may be incorrect and therefore result in VAR not fully capturing market risk where correlation between variables is exhibited.
- VAR is calculated at the close of business with intra-day exposures not being subject to intra-day VAR calculations.
- VAR does not necessarily capture all of the higher order market risks and as such may underestimate VAR.

The Midland VAR should not therefore be viewed as a maximum amount that Midland can lose on its market risk positions. Midland recognises these limitations by augmenting the VAR limits with other position and sensitivity limit structures, as well as with stress testing, both on individual portfolios and on a consolidated basis. Midland's stress testing regime provides senior management with an assessment of the impact of extreme events on the market risk exposures of Midland.

Value at risk measurement techniques have been applied in respect of treasury activities throughout the year. The value at risk for all interest rate risk and foreign exchange risk positions at 31 December 1998 was £8.6 million (£5.0 million at 31 December 1997). The average value at risk during 1998 was £7.0 million (£5.2 million for 1997).

Value at risk related to foreign exchange positions at 31 December 1998 was £1.1 million (£1.1 million at 31 December 1997). The average value at risk for 1998 was £1.6 million with a maximum of £3.7 million and a minimum of £0.6 million in the year. The average daily foreign exchange profit for 1998 was £0.7 million (£0.9 million for 1997). The value at risk and average dealing profit information noted excludes structural foreign currency exposures, since related gains or losses are taken through reserves.

Value at risk at 31 December 1998 related to interest rate exposures, including interest rate risk related to accrual books, was £8.4 million (£4.8 million at 31 December 1997). The average for 1998 was £6.8 million, the maximum was £14.0 million and the minimum £3.7 million. The average daily revenue earned from treasury-related interest rate activities for 1998 was £0.8 million (£0.8 million for 1997).

Financial Review (continued)

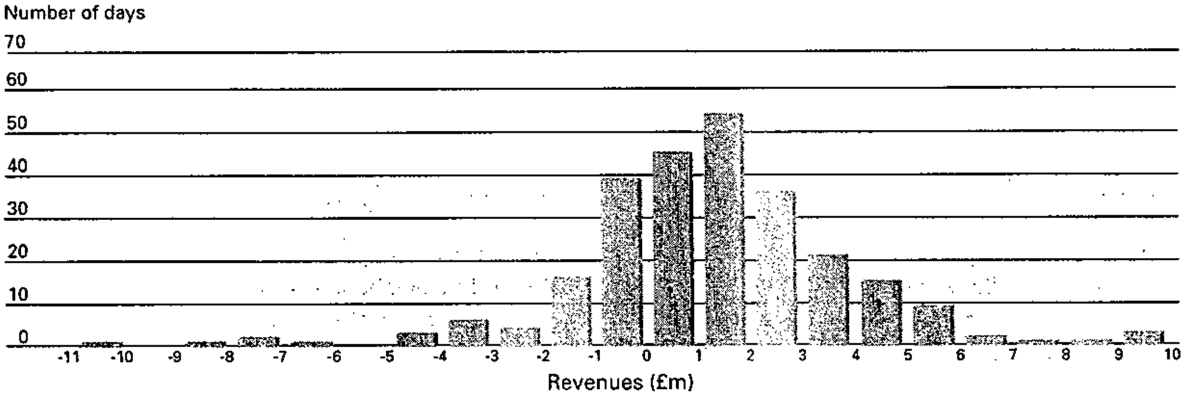
Market risk *(continued)*

Daily distribution of market risk revenues

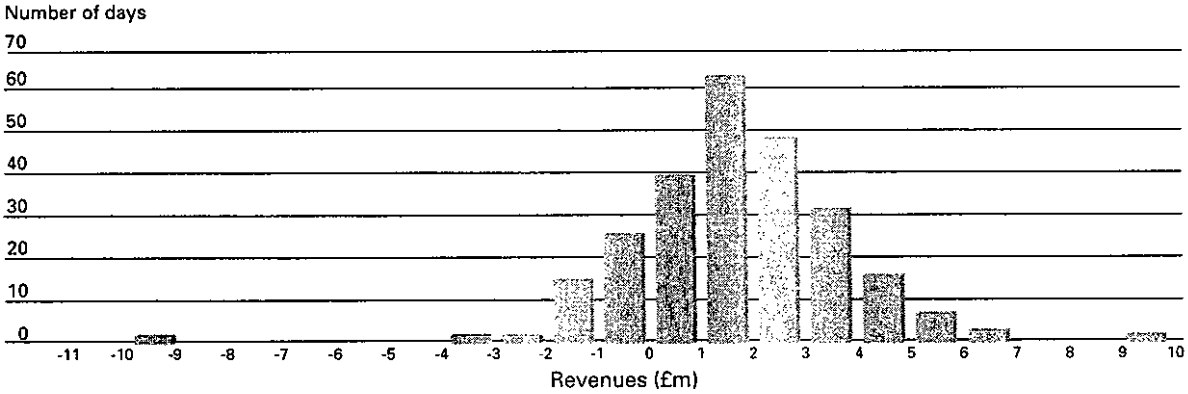
The average daily revenue earned from market-risk-related treasury activities in 1998, including accrual book net interest income and funding related to dealing positions, was £1.2 million compared with £1.7 million in 1997. The standard deviation of this daily revenue was £2.7 million (£2.2 million in 1997).

An analysis of the frequency distribution of daily revenues in 1998 shows a maximum daily loss of £10.5 million, with 73 out of 260 days showing losses. The most frequent result was a daily revenue of between £1 million and £2 million, with 54 occurrences. The highest daily revenue was £9.9 million.

Daily distribution of market risk revenues 1998



Daily distribution of market risk revenues 1997



Trading activities

Value at risk measurement techniques have been applied in respect of trading activities during the year. The value at risk for all trading interest rate, foreign exchange and equity risk positions at 31 December 1998 was £2.0 million (£1.5 million at 31 December 1997).

Foreign exchange exposure

Midland's foreign exchange exposures comprise the following: those which arise from foreign exchange dealing within Midland's treasury centres; structural foreign currency translation exposures; and currency exposures originated by Midland's banking businesses. The latter are transferred to local treasury units where they are managed together with exposures which result from dealing within approved limits. Structural foreign currency translation exposures are discussed under non-trading activities, below.

Value at risk related to foreign exchange dealing positions at 31 December 1998 was £1.1 million (£1.1 million at 31 December 1997).

Interest rate exposure

Midland's interest rate exposures comprise those originating in its treasury trading activities and structural interest rate exposures; both are managed under limits described on page 24. Interest rate risk arises in both dealing portfolios and accrual books which are discussed under non-trading activities, below.

Value at risk at 31 December 1998 related to trading interest rate exposures was £1.4 million (£1.0 million for 1997) and the average for 1998 was £2.0 million, the maximum was £3.6 million and the minimum was £1.0 million.

Equities exposure

Midland's equities exposure arises from equity derivatives transactions. Value at risk relating to equity derivatives positions at 31 December 1998 was £0.5 million (£0.4 million for 1997).

Non-trading activities

Foreign exchange exposure

The Bank's structural foreign currency exposure is represented by the net asset value of its foreign currency equity and subordinated debt investments in branches and subsidiary and associated undertakings. These foreign currency investments amounted to the foreign currency equivalent of £97 million (2.0 per cent of shareholders' funds) at 31 December 1998, a decrease from £117 million (2.6 per cent of shareholders' funds) at 31 December 1997. Gains or losses on structural foreign currency exposures are taken to reserves.

Structural foreign currency exposures are managed within Midland with the primary objective of ensuring, where practical, that Midland's and individual banking subsidiary undertakings' tier 1 capital ratios are protected from the effect of movements in exchange rates. This is achieved by capital being denominated broadly in proportion to the corresponding foreign-currency-denominated risk-weighted assets.

Interest rate exposure

Structural interest rate risk arises primarily from the employment of non-interest bearing liabilities, such as shareholders' funds and some current accounts, as well as fixed rate loans and liabilities other than those generated by treasury business.

The Bank and each major subsidiary undertaking assess the structural interest rate risks which arise in their businesses and either transfer such risks to their local treasury centres or to separate books managed by their local asset and liability management committees. These interest rate positions are regularly monitored by these committees and quantitative models are used to assess the potential net interest income and market value effects of these interest rate positions in different interest rate scenarios on a monthly basis.

Whilst the primary objective of such interest rate risk management is to limit potential adverse effects of interest rate movements on net interest income, the Bank also seeks to enhance net interest income subject to risk limits approved by MALCO and the HSBC Group Executive Committee.

The following sensitivity analysis table gives the estimated impact, as at 31 December 1998, on Midland's earnings over the following year of a hypothetical immediate and sustained increase of 1 per cent in interest rates, analysed by currency.

The modelling techniques used break down financial instruments into constituent cash flows which are then subjected to a 1 per cent parallel shift in the projected yield curve to calculate the impact on interest income over a twelve month period. The types of instruments which are included are debt securities, interest rate swaps and loans and deposits.

Financial Review (continued)

Non-trading activities *(continued)*

The table shows that Midland would be exposed to a potential hypothetical £43 million loss, or 3 per cent of profit before tax, on future earnings over the twelve months to 31 December 1999 based on a 1 per cent parallel upward shift in the yield curve. A 1 per cent parallel downward shift in the yield curve would result in a potential hypothetical £43 million profit.

Interest rate sensitivity

	Total	Sterling	US dollars	Euro legacy currencies
	£m	£m	£m	£m
1998	(43)	(27)	(7)	(9)
1997	(16)	4	(15)	(5)

Liquidity Management

Liquidity is managed primarily through HSBC MIDLAND in London to ensure that Midland's cash flows are appropriately balanced, avoiding any concentration of maturity or source that might impede its ability to fund its assets or to meet its liability obligations. Where cash flow imbalances arise, Midland's policy is for such imbalances to be covered by holdings of defined quality liquid assets in accordance with the HSBC Group's established ratios of liquid assets to customer deposits. Midland's structural liquidity profile is also actively managed in line with strategic objectives, covering both the distribution of sources and maturities of capital, term funding and deposits, and the product types and maturities of lending to customers.

Core retail deposits (current accounts and savings deposits payable on demand or at short notice) form a significant part of Midland's overall funding. Considerable importance is attached to this core deposit base which over the years has been stable and predictable. The HSBC Group prefers to grow its balance sheet through increasing core retail deposits where possible. Professional market funds are accessed for the purpose of providing additional funding, maintaining a presence in money markets and optimising asset and liability maturities. Of Midland's non-sterling asset base, approximately half is denominated in US dollars and is partially funded through US dollar-denominated capital issues and loan stock, supplemented by time deposits taken from the eurocurrency interbank market, principally from central banks, other banks, corporate customers and other commercial institutions.

The sources of such deposits, by type of institution and country, are monitored in order to avoid an undesirable dependence on any particular institution or category of depositor.

Midland has for some years operated a liquidity management policy based on consolidated net cash flows which conforms to the FSA's arrangements for the supervision of major UK banks' sterling liquidity. Central to these arrangements is the requirement for banks to be able to survive five working days without the renewal of any net maturing wholesale liabilities, and after the leakage of 5 per cent of the gross retail deposit base, for which purpose a minimum coverage ratio of specified liquid assets must be maintained.

This ratio is computed daily with the position being managed so as to exceed the minimum ratio. In addition to complying with these FSA requirements on sterling liquidity, Midland also adopts the same consolidated cash flow methodology for managing its all-currency 0–5 working day liquidity exposures and targets 0–30 working day cumulative refinancing exposures on an all-currency basis.

Overseas units maintain sufficient liquidity to meet their day-to-day needs and local regulatory requirements unless specific arrangements are made for HSBC MIDLAND in London to provide the necessary support.

Operational Risk Management

Operational risk is the risk of economic loss arising through fraud, unauthorised activities, error, omission or inefficiency. It is inherent to every entity and covers a wide spectrum of issues. Midland manages this risk through a controls-based environment in which processes are documented, authorisation is independent and where transactions are reconciled and monitored. This is supported by an independent programme of periodic reviews undertaken by internal audit. Midland also maintains contingency facilities to support operations in the event of disasters.

Credit Risk Management

Credit risk is the risk that a customer or counterparty of Midland will be unable or unwilling to meet a commitment that it has entered into with a Midland company. It arises from the lending, trade finance, treasury and other activities undertaken by Midland companies. Midland has in place policies and procedures for the control and monitoring of such risk.

Midland has a well established credit risk management process, encompassing credit approvals, the control of exposures (including those to borrowers in financial difficulty), credit policy direction to business units and the monitoring and reporting of exposures both on an individual basis and a portfolio basis. Local management is responsible for the quality of its credit portfolios and follows a credit process involving delegated approval authorities and credit procedures, the objective of which is to build and maintain risk assets of high quality.

Within the overall framework of HSBC Group policy, credit policy direction is provided by the Head of Credit and Risk in conjunction with other senior executive officers. Regular reviews are undertaken to assess and evaluate levels of risk concentration, including those to individual industry sectors and products. Midland's concentration of risk to individual countries is controlled within the overall level of HSBC Group country limits with sub-limits by maturity and type of business. Transactions with higher risk countries are considered on a case-by-case basis.

Special attention is paid to the management of problem loans. Where deemed appropriate, specialist units are established to provide intensive management and control to maximise recoveries of doubtful debts.

Financial Review (continued)

Loans and Advances

Analysis of loans and advances to banks and loans and advances to customers by geographic area and by type of customer

The following tables analyse loans by domicile of the lending office and by type of customer.

	1998 £m	1997 £m	1996 £m	1995 £m	1994 £m
Loans and advances to banks					
Domestic	**8,503**	11,159	10,100	6,199	8,443
International					
United Kingdom	**1,880**	990	769	1,004	758
Continental Europe	**739**	485	2,627	3,700	2,857
United States	**—**	24	192	150	552
Rest of the world	**401**	740	1,287	1,375	387
Total international	**3,020**	2,239	4,875	6,229	4,554
	11,523	13,398	14,975	12,428	12,997
Specific bad and doubtful debt provisions	**(7)**	(19)	(31)	(47)	(64)
Loans and advances to banks	**11,516**	13,379	14,944	12,381	12,933
Loans and advances to customers					
Domestic					
Customers domiciled in the United Kingdom					
Local and national government and government-owned utilities	**464**	592	27	18	122
Agriculture, forestry and fishing	**1,256**	1,257	1,055	952	919
Manufacturing and other production	**5,430**	5,724	5,055	4,562	3,854
Construction	**974**	928	842	878	1,066
Non-bank financial and services	**14,223**	14,710	12,189	10,322	9,932
Property companies	**2,745**	2,148	1,802	1,605	1,558
Individuals — mortgages	**12,066**	11,046	9,596	8,447	7,292
— other	**6,254**	5,407	5,100	4,401	4,232
	43,412	41,812	35,666	31,185	28,975
Overseas residents	**3,968**	3,896	3,470	2,495	2,231
Lease financing	**1,682**	1,979	1,724	1,517	1,541
Total domestic	**49,062**	47,687	40,860	35,197	32,747
International					
United Kingdom	**1,635**	1,402	1,490	1,814	1,272
Continental Europe	**1,879**	1,464	3,345	4,824	4,251
United States	**—**	—	287	1,266	801
Rest of the world	**810**	681	617	830	96
Total international	**4,324**	3,547	5,739	8,734	6,420
	53,386	51,234	46,599	43,931	39,167
General and specific bad and doubtful debt provisions	**(1,015)**	(1,091)	(1,247)	(1,383)	(1,387)
Loans and advances to customers	**52,371**	50,143	45,352	42,548	37,780

Analysis of loans and advances to banks and loans and advances to customers by maturity and by interest sensitivity

The following tables analyse gross loans and advances to banks and to customers at 31 December 1998, by residual maturity and by interest sensitivity.

Loans and advances to banks

		International		
	Domestic £m	United Kingdom £m	Continental Europe £m	Rest of the world £m
Maturity				
1 year or less	7,041	1,880	703	401
5 years or less but over 1 year	929	—	35	—
Over 5 years	533	—	1	—
	1,462	—	36	—
	8,503	1,880	739	401
Interest sensitivity (over 1 year)				
Fixed rate	13	—	3	—
Variable rate	1,449	—	33	—
	1,462	—	36	—

Loans and advances to customers

		International		
	Domestic £m	United Kingdom £m	Continental Europe £m	Rest of the world £m
Maturity				
1 year or less	17,282	1,290	973	494
5 years or less but over 1 year	14,713	69	750	269
Over 5 years	17,067	276	156	47
	31,780	345	906	316
	49,062	1,635	1,879	810
Interest sensitivity (over 1 year)				
Fixed rate	8,676	62	336	262
Variable rate	23,104	283	570	54
	31,780	345	906	316

The table above includes domestic loans and advances to construction and property companies at 31 December 1998 which are due in one year or less, £1,418 million; in five years or less but over one year, £1,527 million; and over five years, £774 million.

Foreign outstandings

Midland restricts its exposure to the risk of payment difficulties arising with respect to individual countries and regions through a central HSBC Group system of internally determined country limits which relate to both economic and political risks. Exposures to individual countries and regions and cross-border exposure in aggregate are kept under continuous review.

The table opposite shows the geographic distribution of total outstandings, amounting to £102 billion, £101 billion and £96 billion at 31 December 1998, 1997 and 1996, respectively, comprising loans, accrued interest, acceptances, interest-bearing deposits placed with other banks, other interest-earning investments and all other monetary assets. The breakdown is based on the country of domicile of the borrower or guarantor of ultimate risk.

Approximately 93 per cent (91 per cent in 1997 and 1996) of total outstandings was in respect of customers in the United Kingdom, continental Europe and the United States.

	1998 %	1997 %	1996 %
United Kingdom	77	74	72
Continental Europe	12	12	15
United States	4	5	4
Rest of the world	7	9	9
	100	100	100

As shown in the table above, Midland's business is predominantly with countries and regions with

Financial Review (continued)

Foreign outstandings *(continued)*

developed economies. Outstandings to Latin America accounted for 2 per cent (2 per cent in 1997 and 1996) of total outstandings. Outstandings to Indonesia, South Korea and Thailand, the three Asian countries that have negotiated arrangements with the International Monetary Fund, accounted for less than 1 per cent (less than 1 per cent in 1997 and 1996) of total outstandings.

Cross-border outstandings to borrowers in countries which individually represented in excess of 0.75 per cent of total assets including acceptances at 31 December 1998 with comparatives for 31 December 1997 and 1996, were:

	1998		1997		1996	
	Total outstandings £bn	Percentage of total assets %	Total outstandings £bn	Percentage of total assets %	Total outstandings £bn	Percentage of total assets %
France	**2.6**	**2.5**	1.6	1.6	1.0	1.0
Germany	**2.9**	**2.7**	3.3	3.2	1.9	1.9
Italy	**1.5**	**1.4**	1.5	1.5	—	—
Japan	**1.2**	**1.2**	2.7	2.6	1.7	1.7
Mexico	**0.8**	**0.8**	0.8	0.7	0.8	0.8
United States	**3.7**	**3.5**	4.7	4.5	2.7	2.7

The following table analyses cross-border outstandings by type of borrower in countries which individually represented in excess of 1 per cent of total assets, including acceptances, at 31 December 1998, 1997 and 1996.

	Government and official institutions £m	Banks and other financial institutions £m	Commercial, industrial and other £m	Total £m
1998				
France	**989**	**1,215**	**444**	**2,648**
Germany	**593**	**2,275**	**39**	**2,907**
Italy	**232**	**1,278**	**15**	**1,525**
Japan	**70**	**1,085**	**80**	**1,235**
United States	**101**	**2,794**	**805**	**3,700**
1997				
France	3	1,468	160	1,631
Germany	1,231	1,984	58	3,273
Italy	242	1,295	12	1,549
Japan	55	2,484	151	2,690
United States	936	3,294	443	4,673
1996				
France	47	820	105	972
Germany	719	1,098	76	1,893
Japan	70	1,564	94	1,728
United States	—	1,660	1,032	2,692

Loan concentrations

Information relating to industry concentrations, gross of specific provisions, is given within Note 14 of the Notes on the Accounts.

Concentrations of credit risk

Midland provides a diverse range of financial services both in the United Kingdom and internationally. As a result, its portfolio of financial instruments with credit risk is highly diversified with no exposures to individual industries or economic groupings totalling more than 10 per cent of consolidated total assets, except as follows:

(a) the Bank's position as one of the principal UK clearing banks means that the majority of Midland's exposure to credit risk is concentrated in the United Kingdom. Within the United Kingdom, Midland's credit risk is diversified over a wide range of industrial and economic groupings; and

Loan concentrations *(continued)*

(b) Midland's position as part of a major international banking group means that it has a significant concentration of exposure to banking counterparties. The majority of credit risk to the banking industry at 31 December 1998 and 31 December 1997 was concentrated in Europe (including the United Kingdom). Concentrations of credit risk arising from off-balance-sheet transactions are discussed on page 43.

There are no special collateral requirements relating to industrial concentrations with the exception of exposures to the property sector. The majority of exposures to the property and construction industry and the residential mortgage market are secured on the underlying property.

Bad and doubtful debts

It is Midland's policy that each operating company will make provisions for bad and doubtful debts on a basis that is prudent and consistent and meets the requirements of local regulatory bodies, subject to meeting the overall supervisory direction of the Financial Services Authority.

There are two basic types of provisions, specific and general, both of which are considered in terms of the charge and in terms of the amount outstanding.

The specific provision represents the quantification of actual and expected losses from identified accounts and is deducted from loans and advances in the balance sheet.

Except for provisions on smaller balance homogenous loans, which are assessed on a portfolio basis, and country risk provisions, which are established in line with HSBC Group standards, the amount of specific provision raised is assessed on a case-by-case basis with consideration given to the following factors:

- the financial standing of the customer, including a realistic assessment of the likelihood of repayment of the loan within an acceptable period and the extent of Midland's other commitments to the same customer;
- the realisable value of any security for the loan; and
- the costs associated with obtaining repayment and realisation of the security.

The general provision is intended to augment the specific provision as cover for those elements of the loan book which are already impaired at the balance sheet date, but which will not be specifically identified as such until some time in the future. Midland maintains a general provision equivalent to a minimum percentage of lending as set from time to time, currently 0.6 per cent. This level has been determined as appropriate taking into account the structure and risk characteristics of the loan portfolio and an evaluation of historic levels of latent risk, and its continuing appropriateness is regularly reviewed. The general provision is also deducted from loans and advances in the balance sheet but, unlike specific provisions, forms part of Midland's capital base.

Provided that there is a realistic prospect of interest being paid at some future date, interest on doubtful loans continues to be charged to the customer's account, although it is not credited to interest income but to an interest suspense account in the balance sheet which is netted against the relevant receivable balance. On receipt of cash (other than from the realisation of security), suspended interest is recovered and taken into interest income. Amounts received from the realisation of security are used to recover any specific provisions before suspended interest.

When it becomes apparent that recovery of interest is unlikely, interest ceases to be accrued or suspended and is no longer charged to the customer's account.

When there is no prospect of recovering principal or interest, the outstanding debt and any suspended balances are written off.

Financial Review (continued)

Bad and doubtful debts *(continued)*

Movements in provisions for bad and doubtful debts

	1998 £m	1997 £m	1996 £m	1995 £m	1994 £m
Domestic					
At 1 January	972	924	942	969	1,113
Effect of foreign exchange rate and other movements	20	4	(5)	(3)	(1)
Charge for the year	200	219	206	176	162
Amounts written off	(320)	(203)	(248)	(225)	(341)
Recoveries of amounts written off in previous years	40	28	29	25	29
Amounts transferred on acquisition of subsidiary undertakings	—	—	—	—	7
At 31 December	912	972	924	942	969
Comprising:					
Specific provisions	574	650	646	701	777
General provisions	338	322	278	241	192
	912	972	924	942	969
International					
At 1 January	138	354	488	482	1,029
Effect of foreign exchange rate and other movements	(4)	(1)	(54)	24	(18)
(Release)/charge for the year	(4)	(90)	(34)	22	(64)
Amounts written off	(21)	(5)	(68)	(54)	(506)
Recoveries of amounts written off in previous years	1	8	22	14	22
Amounts transferred on (disposal)/ acquisition of subsidiary undertakings	—	(128)	—	—	19
At 31 December	110	138	354	488	482
Comprising:					
Specific provisions	110	138	345	461	444
General provisions	—	—	9	27	38
	110	138	354	488	482
Total					
Comprising:					
Specific provisions	684	788	991	1,162	1,221
General provisions	338	322	287	268	230
	1,022	1,110	1,278	1,430	1,451

	1998 %	1997 %	1996 %	1995 %	1994 %
Total customer provisions as a percentage of gross loans and advances to customers	1.9	2.1	2.7	3.1	3.5
General provisions as a percentage of net loans and advances to customers	0.6	0.6	0.6	0.6	0.6
As a percentage of average gross loans and advances to banks and customers for the year:					
Charge for specific provisions	0.3	0.2	0.3	0.3	0.2
Total provisions charged	0.3	0.2	0.3	0.4	0.2
Amounts written off net of recoveries	0.5	0.3	0.5	0.5	1.6

Bad and doubtful debts (continued)

The £104 million reduction in the specific provision in 1998 occurred largely because of an increase in the value of amounts written off. However, non-performing loans also reduced in 1998 as a result of recoveries and write-offs and the ratio of provisions to non-performing loans increased from 78 per cent to 82 per cent. The domestic charge in 1998 included £21 million for general provisions (£37 million in 1997) with the specific charge little changed between the two periods. The major influence behind the lower international release in 1998 was the much reduced release of provisions on the sale of Latin American debt.

In 1997, there was a reduction of £168 million in the level of provisions for bad and doubtful debts. This reduction comprised a £203 million fall in specific provisions, partly offset by a £35 million rise in general provisions due to growth in loans and advances. The reduction in the level of outstanding specific provisions was mainly the result of amounts transferred on the disposal of subsidiary undertakings and releases resulting from sales of Latin American debt.

Analysis of amounts written off by type of customer

	1998		1997		1996		1995		1994	
	£m	%	£m	%	£m	%	£m	%	£m	%
Agriculture, forestry and fishing	1	—	1	—	1	—	2	1	5	1
Manufacturing, construction, property and other production	97	28	93	45	82	26	103	37	137	16
Financial and services	110	33	28	14	77	24	49	17	127	15
Individuals	112	33	84	40	91	29	77	28	84	10
Overseas customers	21	6	2	1	65	21	48	17	493	58
Other	—	—	—	—	—	—	—	—	1	—
	341	100	208	100	316	100	279	100	847	100

Analysis of provisions by type of customer

	1998		1997		1996		1995		1994	
	£m	%	£m	%	£m	%	£m	%	£m	%
Specific provisions										
Domestic										
Agriculture, forestry and fishing	8	1	10	1	6	—	8	1	9	1
Manufacturing, construction, property and other production	189	18	168	15	148	12	255	18	294	20
Financial and services	128	13	278	25	329	26	280	19	281	19
Individuals	249	24	194	18	162	13	157	11	187	13
Other	—	—	—	—	1	—	1	—	6	1
Total domestic	574	56	650	59	646	51	701	49	777	54
International	110	11	138	12	345	27	461	32	444	30
Specific provisions	684	67	788	71	991	78	1,162	81	1,221	84
General provisions	338	33	322	29	287	22	268	19	230	16
Total provisions	1,022	100	1,110	100	1,278	100	1,430	100	1,451	100

Domestic specific provisions declined by £76 million in 1998, primarily due to a £150 million reduction in respect of the financial and services sector, as a result of increased write-offs. This was partially offset by increases in respect of other commercial sectors and a £55 million rise in provisions against individuals, following growth in the non-mortgage personal loan book. The reduced level of international provisions at the end of 1998 was primarily a reflection of write-offs during the year.

Financial Review (continued)

Bad and doubtful debts *(continued)*

In 1997, the total level of domestic specific provisions was little changed as at 31 December 1997 compared with 1996. However, there was some redistribution across market sectors with a reduction in respect of the financial and services sector being offset by increases in relation to the production sectors of the economy and the personal market. The £207 million decrease in specific provisions against international business largely reflected the disposal of subsidiary undertakings and releases in relation to Latin American debt.

Credit risk elements

The SEC defines credit risk elements as (i) loans accounted for on a nonaccrual basis, (ii) accruing loans which are contractually past due 90 days or more as to principal or interest payments and (iii) loans not included in (i) and (ii) which are 'troubled debt restructurings' as defined in Statement of Financial Accounting Standards ('SFAS') No. 15 'Accounting by Debtors and Creditors for Troubled Debt Restructurings'. Credit risk elements also cover potential problem loans which are not included in the above three classifications. Such loans are discussed below.

However, the US accounting practice of classifying loans in accordance with the guidelines of the SEC is not, in normal circumstances, followed by UK banks. As a result, Midland's credit risk elements are classified, as shown in the table below, as either 'Loans accounted for on a nonaccrual basis' or 'Loans on which interest has been accrued but suspended'. Both of these classifications reflect situations where management has serious doubts as to the ability of the customer to comply with the loan repayment terms, with provisions having been raised as required.

There are no loans which are contractually past due 90 days or more or any loans classified as troubled debt restructurings that are not included in the table below.

Domestic loans on which interest has been accrued but suspended fell by £135 million in 1998, with reductions recorded in all major business units. International loans on which interest has been accrued but suspended fell by £39 million in 1998, principally reflecting sales of Latin American debt, and reductions in France.

Interest income included in the consolidated profit and loss account for the year ended 31 December 1998, applicable to non-performing loans (i.e. 'Loans accounted for on a nonaccrual basis' and 'Loans on which interest has been accrued but suspended'), was £25 million (1997: £71 million; 1996: £52 million). Interest income which would have been included under the original terms of such loans was £83 million (1997: £84 million; 1996: £102 million).

Potential problem loans

At 31 December 1998, there were no significant potential problem loans, other than the amounts shown in the table below. These loans are those where known information about possible credit problems of borrowers causes management to have serious doubts as to the ability of such borrowers to comply with the present loan repayment terms.

Impaired loans

Under SFAS No. 114 'Accounting by Creditors for Impairment of a Loan', as amended by SFAS No. 118 'Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosure', a loan which is within the scope of the Statement is considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (both principal and interest) according to the contractual terms of the loan agreement.

	1998 £m	1997 £m	1996 £m	1995 £m	1994 £m
Loans accounted for on a nonaccrual basis					
Domestic	**533**	520	591	780	1,024
International	**22**	36	243	322	317
	555	556	834	1,102	1,341
Loans on which interest has been accrued but suspended					
Domestic	**624**	759	824	983	820
International	**67**	106	136	252	272
	691	865	960	1,235	1,092

Credit risk elements (continued)

SFAS No. 114 applies to all loans which are identified for evaluation, uncollateralised as well as collateralised, except:

(i) large groups of smaller-balance homogenous loans which are collectively evaluated for impairment;
(ii) loans which are measured at fair value or at the lower of cost or fair value;
(iii) leases; and
(iv) debt securities as defined in SFAS No. 115 'Accounting for Certain Investments in Debt and Equity Securities'.

Impaired loans represent those reported as non-performing in the table reported on page 36 and amounted to £1,246 million at 31 December 1998. Of this total, loans which were included within the scope of SFAS No. 114 amounted to £914 million. The impairment reserve in respect of impaired loans estimated in accordance with the provisions of SFAS No. 114 is not significantly different from the UK GAAP provision of £380 million held for such loans.

Midland has determined that having compared the value of the impaired loan portfolio calculated in accordance with SFAS No. 114 with the carrying value under UK GAAP no adjustment to net income or shareholders' funds as stated in accordance with US GAAP is required.

During the year ended 31 December 1998, impaired loans, including those excluded from SFAS No. 114, averaged £1,300 million, on which £25 million, as disclosed on page 36, was recognised in interest income.

Investment Securities

The book value of investment securities, analysed by type of borrower, is as shown in the following table:

	1998 £m	1997 £m	1996 £m
US Treasury and other US Government agencies and corporations	**1,036**	1,164	1,195
Issued by UK Government	**3,216**	3,208	3,438
Other government debt securities	**2,483**	1,046	1,192
Other debt securities	**989**	1,221	995
Total debt securities	**7,724**	6,639	6,820
Equity shares	**15**	20	142
Total investment securities	**7,739**	6,659	6,962

Midland had no securities classified as held-to-maturity securities at 31 December 1998, 1997 and 1996.

The following table analyses the maturities and weighted average yields of debt securities which meet the definition of securities available for sale under SFAS No. 115 at 31 December 1998:

	1 year or less		5 years or less but over 1 year		10 years or less but over 5 years		
	Balance £m	Yield %	Balance £m	Yield %	Balance £m	Yield %	Total £m
US Treasury and other US Government agencies and corporations	**421**	**6.0**	**615**	**7.0**	**—**	**—**	**1,036**
Issued by UK Government	**2,017**	**8.4**	**1,199**	**7.6**	**—**	**—**	**3,216**
Other government debt securities	**1,659**	**2.5**	**785**	**6.2**	**39**	**3.8**	**2,483**
Other debt securities	**570**	**3.4**	**384**	**5.9**	**35**	**2.5**	**989**
Book values	**4,667**		**2,983**		**74**		**7,724**
Market values	**4,662**		**3,061**		**76**		**7,799**

The weighted average yield for each range of maturities in the above table is calculated by dividing the annualised interest income in relation to securities held as at 31 December 1998 by the amortised cost of securities at that date. The yields do not include the effect of related derivatives.

Financial Review (continued)

Investment Securities *(continued)*

The gross unrealised gains and losses on securities available for sale at 31 December 1998 and 1997 are analysed as follows:

	1998				1997			
	Book value £m	Gross unrealised holding gains £m	Gross unrealised holding losses £m	Market value £m	Book value £m	Gross unrealised holding gains £m	Gross unrealised holding losses £m	Market value £m
US Treasury and other US Government agencies and corporations	**1,036**	**13**	**(8)**	**1,041**	1,164	4	—	1,168
Issued by UK Government	**3,216**	**27**	**(2)**	**3,241**	3,208	10	(1)	3,217
Other government debt securities	**2,483**	**47**	**(12)**	**2,518**	1,046	67	(3)	1,110
Other debt securities	**989**	**12**	**(2)**	**999**	1,221	10	(1)	1,230
Total debt securities	**7,724**	**99**	**(24)**	**7,799**	6,639	91	(5)	6,725
Equity shares	**15**	**5**	**—**	**20**	20	7	—	27
	7,739	**104**	**(24)**	**7,819**	6,659	98	(5)	6,752

At 31 December 1998, Midland held the following securities available for sale which exceeded 10 per cent of shareholders' funds:

	1998	
	Amortised cost £m	Market value £m
Issued by UK Government	**3,216**	**3,241**
Issued by Japanese Government	**1,220**	**1,229**

Securities available for sale

The proceeds on disposal and amounts received on maturity of securities available for sale during the year ended 31 December 1998 were £12,317 million (1997: £4,916 million; 1996: £1,541 million), on which gross realised gains of £26 million (1997: £22 million; 1996: £95 million) and gross realised losses of £nil (1997: £2 million; 1996: £1 million) arose.

The amount received on maturity of securities available for sale during the year ended 31 December 1998 was £8,886 million (1997: £2,298 million; 1996: £180 million). The proceeds on disposal of securities available for sale during the year ended 31 December 1998 were £3,431 million (1997: £2,618 million; 1996: £1,361 million).

The cost of securities available for sale purchased during the year ended 31 December 1998 was £13,078 million (1997: £5,433 million; 1996: £3,281 million).

Deposits

Year end non-interest-bearing and interest-bearing deposits, analysed between domestic and international, were as follows:

	1998 £m	1997 £m
Domestic		
Non-interest-bearing	**6,284**	6,569
Interest-bearing	**59,088**	59,499
	65,372	66,068
International		
Non-interest-bearing	**202**	87
Interest-bearing	**6,607**	4,014
	6,809	4,101

The analysis shown includes short-term borrowings which are analysed further on page 39.

At 31 December 1998, the aggregate amount of deposits by foreign depositors in domestic offices was £16,506 million (1997: £17,785 million; 1996: £12,769 million).

Interest rates on deposits are varied from time to time, being set and published by the Bank.

An analysis of the average amount of, and the average rate paid on, domestic and international deposits by banks and customer accounts by type is shown on page 19.

Deposits *(continued)*

At 31 December 1998, the maturity of domestic certificates of deposit and other time deposits was:

	1998			
	Certificates of deposit £m	%	Other time deposits £m	%
3 months or less	**1,206**	**50**	**15,452**	**77**
6 months or less but over 3 months	**657**	**27**	**1,797**	**9**
12 months or less but over 6 months	**459**	**19**	**700**	**4**
Over 12 months	**83**	**4**	**2,050**	**10**
	2,405	**100**	**19,999**	**100**

Certificates of deposit and other time deposits, most of which were in denominations of US$100,000 or more, have fixed maturity dates and bear interest at rates which reflect money market rates.

At 31 December 1998, certificates of deposit and other time deposits, most of which were in denominations of US$100,000 or more, issued by international offices amounted to £3,049 million.

Further analyses of deposits by banks and customer accounts at 31 December 1998 and 1997 are shown in Notes 21 and 22 respectively of the Notes on the Accounts.

Short-term borrowings

Short-term borrowings are not shown separately on the balance sheet but are included in deposits. Short-term borrowings include securities sold under agreements to repurchase, commercial paper and other short-term borrowings.

Midland had liabilities relating to securities sold under agreements to repurchase as follows:

	1998		1997		1996	
	Balance £m	Weighted average rate %	Balance £m	Weighted average rate %	Balance £m	Weighted average rate %
At 31 December	**3,457**	**5.2**	3,196	6.4	2,557	5.1
Average during the year	**4,182**	**5.9**	3,414	5.8	4,296	4.8
Maximum outstanding at any month end	**5,742**		3,653		5,182	

Other than securities sold under agreements to repurchase, Midland had no significant short-term borrowings.

Derivatives

Off-balance-sheet financial instruments, commonly referred to as derivatives, are contracts whose characteristics are derived from those of underlying assets, interest and exchange rates or indices. They include futures, forwards, swap and option transactions in the foreign exchange, interest rate and equities markets. Deals are negotiated directly with customers, with Midland acting as a counterparty, or can be dealt through exchanges.

Users of derivatives typically want to convert an unwanted risk generated by their business to a more acceptable risk, or cash. Derivatives provide an effective tool for companies to manage the financial risks associated with their business and, as a consequence, there has been a significant growth in derivatives transactions in recent years.

Midland, through its dealing operations, acts as an intermediary between a broad range of users, structuring deals to develop risk management products to suit individual customer needs. As a result, Midland can accumulate significant open positions in derivatives portfolios. These positions are managed constantly to ensure that they are within acceptable risk levels, with offsetting deals being

Financial Review (continued)

Derivatives *(continued)*

undertaken to achieve this where necessary. As well as acting as a dealer, Midland also uses derivatives (principally interest rate swaps) in the management of its own asset and liability portfolios and structural positions.

Type of instruments

Exchange rate contracts include spot and forward foreign exchange contracts, cross currency swaps, currency futures, currency options and similar instruments.

Forward foreign exchange contracts are agreements to buy or sell fixed amounts of currency at agreed rates of exchange on a specified future date.

Cross currency swaps are agreements to exchange, and on termination of the swap re-exchange, principal amounts denominated in different currencies. Cross currency swaps may involve the exchange of interest payments in one specified currency for interest payments in another specified currency for a specified period.

Currency futures are agreements to buy or sell standard amounts of a specified currency at an agreed exchange rate on a standard future date.

Currency options give the buyer the right, but not the obligation, to buy or sell specified amounts of currency at agreed rates of exchange on or before a specified date.

Interest rate contracts include interest rate swaps, interest rate futures, forward rate agreements ('FRAs') and interest rate options, caps and floors.

Interest rate swaps involve the exchange of interest rate obligations with a counterparty for a specified period without exchanging the underlying (or notional) principal. Midland may enter a swap transaction either as an intermediary (i.e. guaranteeing one or both counterparties) or as a direct counterparty.

Interest rate futures are agreements to buy or sell a standard amount of a specified fixed income security or time deposit at an agreed interest rate on a standard future date.

FRAs give the buyer the ability to determine the underlying rate of interest for a specified period commencing on a specified future date (the 'settlement date'). There is no exchange of principal and settlement is effected on the settlement date. The settlement amount is calculated by reference to the difference between the contract rate and the market rate prevailing on the settlement date.

Interest rate options give the buyer the right, but not the obligation, to fix the rate of interest on a future deposit or security (e.g. gilt options), for a specified period and commencing on a specified future date.

Interest rate caps and floors give the buyer the ability to fix the maximum or minimum rate of interest. There is no facility to deposit or draw down funds, instead the writer pays to the buyer the amount by which the market rate exceeds or is less than the cap rate or floor rate respectively. A combination of an interest rate cap and floor is known as an interest rate collar.

Accounting policies for derivatives

Derivatives are used to manage interest rate risk and currency exposure arising from Midland's own asset and liability portfolios and structural positions. These derivatives include qualifying hedges and positions that synthetically alter the characteristics of other specified financial instruments.

To qualify as a hedge, the derivative must effectively reduce the price or interest rate risk of the asset, liability or anticipated transaction to which it is linked and be designated as a hedge. Accordingly, changes in the market value of the derivative must be highly correlated with changes in the market value of the underlying hedged item over the life of the hedge contract. If these criteria are met, the derivative is accounted for on the same basis as the underlying hedged item. Derivatives used for hedging purposes include swaps, forward rate agreements, futures and purchased options.

Interest rate swaps are also used to synthetically alter the interest rate characteristics of financial instruments. In order to qualify for synthetic alteration, a derivative instrument must be linked to specific individual, or pools of similar, assets and liabilities, by the notional principal and interest rate risks of the associated instruments and must achieve a result that is consistent with defined risk management objectives. If these criteria are met, accrual based accounting is applied, that is, income or expense is recognised and accrued to the next settlement date in accordance with the contractual terms of the agreements.

Accounting policies for derivatives *(continued)*

Any profit or loss arising on the termination of a qualifying derivative is deferred and amortised to earnings over the remaining original life of the terminated contract. Where the underlying asset, liability or position is sold or terminated, the qualifying derivative is immediately marked to market through the profit and loss account.

Derivatives that do not qualify as hedges or synthetic alterations are marked to market through the profit and loss account, with profits and losses included within dealing profits.

Analysis of derivatives contract amount and replacement cost

The following table gives a summary of the outstanding notional principal contract amounts with third parties and the cost of replacing the contracts at current market rates if counterparties were not to meet their commitments under the contracts at 31 December 1998 and 31 December 1997. Contract amounts as shown indicate the volume of transactions outstanding; they do not represent values at risk.

At 31 December 1998, the total notional principal of outstanding contracts with third parties was £922 billion, compared with £799 billion at 31 December 1997. The net increase of £123 billion, or 15 per cent, is principally in interest rate contracts and arises mainly in London and Tokyo. The increase in London was primarily in interest rate swaps and FRAs due to increased business volumes and higher customer demand, while the increase in Tokyo was mainly in interest rate futures. The increase in the positive mark-to-market value of interest rate contracts since December 1997 was mainly in interest rate swaps in London, and reflects lower long-term interest rates in major currencies. The replacement cost amount increased to £8.2 billion at 31 December 1998 from £7.6 billion at 31 December 1997.

	1998		1997	
	Contract amount £m	Replacement cost £m	Contract amount £m	Replacement cost £m
Exchange rate contracts	**348,541**	**3,731**	332,845	4,177
Interest rate contracts	**559,754**	**3,195**	455,039	2,221
Equities contracts	**14,154**	**1,237**	11,557	1,199
Total	**922,449**	**8,163**	799,441	7,597

The tables on page 42 provide an analysis of notional principal amounts of derivatives by product at 31 December 1998 and 1997, showing those contracts undertaken for trading purposes and those used for asset and liability management purposes (non-trading). The sum total of the contract amounts outstanding is greater than the total outstanding with third party counterparties shown above since it includes internal deals undertaken for asset and liability management purposes. An analysis of positive and negative mark-to-market values is also shown. Positive amounts represent the replacement cost values whilst negative amounts represent losses on contracts where the current mark-to-market value is less than the value contracted.

Financial Review (continued)

Derivatives *(continued)*

	1998				
	Contract amounts			Mark-to-market value	
	Trading £m	Non-trading* £m	Total £m	Positive £m	Negative £m
Exchange rate contracts					
Spot and forward foreign exchange	260,131	8,287	268,418	2,248	2,333
Currency swaps, futures and options purchased	53,578	667	54,245	1,467	824
Currency options written	33,518	—	33,518	—	722
Other foreign exchange	1,292	—	1,292	16	26
	348,519	8,954	357,473	3,731	3,905
Interest rate contracts					
Interest rate swaps	284,811	22,292	307,103	2,655	2,917
Interest rate futures, FRAs and options purchased	231,896	1,609	233,505	540	133
Interest rate options written	37,179	—	37,179	—	304
	553,886	23,901	577,787	3,195	3,354
Less: not recognised in the balance sheet				72	59
Balance sheet values				3,123	3,295
Equities contracts					
Equity futures and options purchased	5,560	—	5,560	1,237	2
Equity options written	8,594	—	8,594	—	1,448
	14,154	—	14,154	1,237	1,450

	1997				
	Contract amounts			Mark-to-market value	
	Trading £m	Non-trading* £m	Total £m	Positive £m	Negative £m
Exchange rate contracts					
Spot and forward foreign exchange	254,739	3,298	258,037	2,889	2,542
Currency swaps, futures and options purchased	44,082	473	44,555	1,229	615
Currency options written	32,428	—	32,428	—	674
Other foreign exchange	1,542	—	1,542	59	95
	332,791	3,771	336,562	4,177	3,926
Less: not recognised in the balance sheet				1	—
Balance sheet values				4,176	3,926
Interest rate contracts					
Interest rate swaps	239,736	28,527	268,263	1,920	2,297
Interest rate futures, FRAs and options purchased	174,675	334	175,009	301	55
Interest rate options written	29,984	—	29,984	—	180
	444,395	28,861	473,256	2,221	2,532
Less: not recognised in the balance sheet				28	31
Balance sheet values				2,193	2,501
Equities contracts					
Equity futures and options purchased	4,494	—	4,494	1,199	—
Equity options written	7,063	—	7,063	—	1,363
	11,557	—	11,557	1,199	1,363

* *including internal deals*

Risks associated with derivatives

Derivative instruments are subject to both market risk and credit risk.

The market risk associated with derivatives can be significant since large positions can be accumulated with a substantially smaller initial outlay than is required in cash markets.

Recognising this, only certain offices within Midland with sufficient derivative product expertise and appropriate control systems are authorised to trade derivative products. The management of market risk arising from derivatives business is monitored by Midland and by HSBC Group Market Risk, in combination with market risks arising from on-balance-sheet instruments. Market risk is discussed on page 24.

Unlike assets recorded on the balance sheet, where the credit risk is typically the full amount of the principal value together with any unrealised interest accrued or mark-to-market gain, the credit risk relative to a derivative is principally the replacement cost of any contract with a positive mark-to-market gain and an estimate for the potential future change in value, reflecting the volatilities affecting the contract. Credit risk on contracts having a negative mark-to-market value is restricted to the potential future change in value.

Credit risk on derivatives is therefore small in relation to a comparable balance sheet risk. In addition, credit exposure with individual counterparties can be reduced by close-out netting agreements which allow for positive and negative mark-to-market values on different transactions to be offset and settled by a single payment in the event of default by either party. Such agreements are enforceable in the jurisdictions of the major market makers and Midland has executed close-out netting agreements with the majority of these counterparties, notwithstanding the fact that Midland deals only with the most creditworthy counterparties.

The following table analyses the replacement cost of all third party exchange rate, interest rate and equities contracts with positive mark-to-market gains, after netting where possible, by maturity and by category of counterparty at 31 December 1998 and 31 December 1997. The table shows that the replacement cost of derivatives is predominantly with banks and under five years.

Replacement cost	Residual maturity				
	Less than 1 year £m	1–5 years £m	Over 5 years £m	**Total 1998 £m**	Total 1997 £m
Government	21	27	61	**109**	106
Banks	2,976	2,211	715	**5,902**	5,694
Non-bank financial institutions					
Exchanges with margining requirements	122	4	1	**127**	33
Other	696	326	178	**1,200**	929
Other sectors	429	261	135	**825**	835
Total 1998	**4,244**	**2,829**	**1,090**	**8,163**	
Total 1997	4,693	2,260	644		7,597

A maturity profile of the contract amounts of third party derivative contracts outstanding at 31 December 1998 and 31 December 1997 shows that the majority of contracts are executed over the counter and mature within one year.

Contract amount	Residual maturity				
	Less than 1 year £m	1–5 years £m	Over 5 years £m	**Total 1998 £m**	Total 1997 £m
Exchanges with margining requirements	93,853	17,439	17	**111,309**	73,745
Other	577,171	188,005	45,964	**811,140**	725,696
Total 1998	**671,024**	**205,444**	**45,981**	**922,449**	
Total 1997	584,649	181,886	32,906		799,441

Derivatives used for trading purposes

Contracts for trading purposes are undertaken both for Midland's own account and to service its corporate customer base, including designing structured products to meet the specific requirements of customers. Derivatives are used for trading purposes in order to generate income from customer-driven business and dealing income from market fluctuations.

The average mark-to-market values for the years ended 31 December 1998 and 31 December 1997 are analysed below. Positive amounts represent replacement cost values, whilst negative amounts represent unrealised losses on contracts where the current mark-to-market value is less than the value contracted.

Financial Review (continued)

Derivatives used for trading purposes *(continued)*

	1998 £m	1997 £m
Average mark-to-market value		
Exchange rate contracts		
Assets	**3,630**	4,248
Liabilities	**(3,930)**	(4,279)
Interest rate contracts		
Assets	**2,414**	3,076
Liabilities	**(2,354)**	(3,135)
Equities contracts		
Assets	**1,280**	1,095
Liabilities	**(1,449)**	(1,242)

Mark-to-market values are determined by reference to market rates prevailing on the date of valuation or by discounting future cash flows. Asset and liability balances arising from derivative contracts are not netted, except where a legal right of set-off exists.

Assets, including gains, resulting from derivatives which are marked to market, are included within 'Other assets' in the Consolidated Balance Sheet (on page 67). Liabilities, including losses, resulting from such contracts are included in 'Other liabilities'.

Dealing revenues arising from derivative instruments are analysed on page 12.

Derivatives used for non-trading purposes

The majority of the transactions undertaken for non-trading purposes are between business units within Midland, one of which is a trading desk, which may then lay off the resulting position by trading in the external market. Internal positions are integral to Midland's asset and liability management and are included within analyses of non-trading positions below.

For the year ended 31 December 1998, gross interest income on non-trading derivative activities was £84 million (1997: £123 million; 1996: £222 million) and gross interest payable was £85 million (1997: £48 million; 1996: £152 million). Other operating income, relating to terminated contracts, was £3 million (1997: £2 million; 1996: £4 million).

	1998 £m	1997 £m	1996 £m
At 1 January	**32,632**	37,928	44,088
New contracts	**15,933**	15,489	20,730
Matured and amortised contracts	**(15,824)**	(20,619)	(22,588)
Terminated contracts	**(234)**	(410)	(1,272)
Effect of foreign exchange rate and other movements	**348**	244	(3,030)
At 31 December	**32,855**	32,632	37,928

The preceding table summarises, by contract amount, the activity in non-trading derivatives.

Of the above non-trading derivatives, £16,735 million related to contracts maturing in 1999, £14,133 million to contracts maturing in 2000 to 2003 and £1,987 million to contracts maturing in 2004 and thereafter.

For non-trading interest rate swaps, including cross currency interest rate swaps of £336 million, the weighted average fixed pay rates, weighted average variable receive rates and related contract amounts by maturity at 31 December 1998 were as follows:

	1998 Contract amount £m	1998 Fixed pay rate %	1998 Variable receive rate %
Contracts maturing			
Within 1 year	**2,322**	**6.1**	**5.1**
Between 1 and 5 years	**4,866**	**6.4**	**5.5**
Over 5 years	**1,620**	**6.6**	**6.2**
Total	**8,808**		

For non-trading interest rate swaps, including cross currency interest rate swaps of £50 million, the weighted average variable pay rates, weighted average fixed receive rates and related contract amounts by maturity at 31 December 1998 were as follows:

	1998 Contract amount £m	1998 Variable pay rate %	1998 Fixed receive rate %
Contracts maturing			
Within 1 year	**6,082**	**6.1**	**7.0**
Between 1 and 5 years	**7,514**	**6.4**	**7.0**
Over 5 years	**207**	**5.2**	**6.2**
Total	**13,803**		

For non-trading interest rate swaps, including cross currency interest rate swaps of £281 million, which are basis swaps (i.e. the interest payable and receivable are both calculated by reference to variable interest rates; the swap contains no fixed interest receivable or payable leg), the weighted average variable pay rates, weighted average variable receive rates and related contract amounts by maturity at 31 December 1998 were as follows:

	1998 Contract amount £m	1998 Variable pay rate %	1998 Variable receive rate %
Contracts maturing			
Within 1 year	**56**	**4.5**	**6.2**
Between 1 and 5 years	**281**	**3.4**	**5.0**
Over 5 years	**11**	**3.7**	**5.4**
Total	**348**		

Derivatives used for non-trading purposes *(continued)*

The contract amounts at 31 December 1998 and 31 December 1997 of each type of non-trading exchange rate contract, excluding cross currency interest rate swaps which are included in interest rate swaps detailed above, are analysed by currency in the following table:

	1998 £m	1997 £m
US dollars	**4,275**	2,324
Japanese yen	**514**	46
German marks	**300**	7
French francs	**11**	49
Sterling	**1,249**	140
Other	**1,938**	732
Total	**8,287**	3,298

Of the above non-trading exchange rate contracts, £8,275 million related to contracts maturing in 1999 and £12 million to contracts maturing in 2000 to 2003.

At 31 December 1998, Midland had no significant derivative instruments held or issued which were accounted for as hedges of anticipated transactions.

The mark-to-market value of all contracts undertaken for non-trading purposes, including internal deals undertaken for asset and liability management purposes, at 31 December 1998 and 1997 is analysed as follows:

	1998 £m	1997 £m
Exchange rate contracts		
Assets	**17**	2
Liabilities	**(19)**	(12)
Interest rate contracts		
Assets	**877**	273
Liabilities	**(422)**	(163)

The methods of determining mark-to-market values for assets and liabilities arising from derivative contracts used for non-trading purposes are the same as for derivative contracts used for trading purposes, as set out above.

Fair Value of Financial Instruments

SFAS No. 107 'Disclosures about Fair Value of Financial Instruments' requires disclosure of the estimated fair values of financial instruments, both on-balance-sheet and off-balance-sheet. The following disclosures represent Midland's best estimate of those fair values. Where possible, fair values have been estimated using market prices for the financial instruments. Where market prices are not available, fair values have been estimated using quoted prices for financial instruments with similar characteristics, or otherwise using a suitable valuation method.

The fair value information presented below is subject to certain assumptions and limitations, including:

- Midland operates as a going concern.
- No active market exists for trading many financial instruments which arise in the normal course of banking business, such as loans and deposits.
- Techniques used in estimating fair values rely partly on certain assumptions, including applicable discount rates, timing of cash flows and anticipated future credit experience. Attention is drawn to the fact that relatively minor changes in these assumptions could result in significant adjustments to estimated fair value.
- The fair value of financial instruments is estimated as at the balance sheet date. The amounts which will actually be paid or received on the maturity or settlement date may differ significantly from the amounts shown.
- Midland has excluded from its estimate of fair value intangible assets such as values placed on core deposits, credit card relationships, its branch network and customer relationships, and other goodwill. Management believes that such items are essential to a full evaluation of Midland's worth.
- Certain non-financial assets and liabilities are excluded from the disclosure as required by SFAS No. 107.

As a result of the limitations outlined above, the aggregate fair value amounts disclosed do not represent the underlying value of Midland or the amounts which will actually be paid or realised on settlement or maturity. Users of fair value information are advised to exercise caution when making comparisons with similar financial institutions.

Financial Review (continued)

Fair Value of Financial Instruments *(continued)*

The following table lists financial assets and liabilities where fair value is equal to carrying value because they are carried in the balance sheet at market value or they are short-term in nature or re-price frequently:

Assets

Cash and balances at central banks
Items in the course of collection from other banks
Treasury bills and other eligible bills
Debt securities not held as investment securities
Equity shares not held as investment securities
Other assets
Prepayments and accrued income

Liabilities

Deposits by banks repayable on demand
Customer accounts repayable on demand
Items in the course of transmission to other banks
Other liabilities
Accruals and deferred income
Provisions for liabilities and charges

The methods used to estimate fair values of other financial instruments are as follows:

Debt securities and equity shares held as investment securities and other participating interests
Listed investment securities are valued at middle market prices and unlisted investment securities at a valuation which takes into consideration future earnings streams, valuations of equivalent quoted securities and uses other relevant techniques.

Loans and advances to banks and loans and advances to customers
The fair value of personal and corporate loans has been estimated by segregating them into groups with similar characteristics and discounting the expected future cash flows of each group at rates which incorporate allowances for anticipated future credit experience and administration costs. In the case of loans to LDCs, fair value has been estimated by reference to secondary market prices, where available.

Deposits by banks and customer accounts
Fair values have been estimated by discounting future cash flows using interest rates currently offered on deposits of similar maturity.

Debt securities in issue and subordinated liabilities
Fair value has been estimated using quoted market prices at the balance sheet date.

Financial guarantees and loan commitments
Contingent liabilities and commitments are credit-related instruments which include acceptances, letters of credit, guarantees and commitments to extend credit. The contractual amounts represent the amounts at risk should the contract be fully drawn upon and the client default. Since a significant portion of guarantees and commitments are expected to expire without being drawn upon, the total of the contract amounts is not representative of future liquidity requirements.

Note issuance facilities ('NIFs') and revolving underwriting facilities ('RUFs') are commitments by Midland to provide standby funds for debt issues of a customer up to a predetermined limit (NIFs) or to underwrite a debt issue up to a certain limit (RUFs). The credit risk involved in extending NIFs and RUFs is essentially the same as extending credit facilities to a customer.

Other commitments are commitments to lend to a customer up to a predetermined limit. The commitment may be conditional or unconditional and have either a fixed maturity date or be open ended. The risk involved in making such commitments is essentially the same as extending credit facilities to a customer.

All financial guarantees and loan commitments are subject to Midland's normal credit policies. Collateral requirements are based on management's credit assessment of the customer. The majority of financial guarantees and loan commitments expire unfunded. Income is generated from these instruments in the form of fees and commissions.

Midland is party to a variety of financial guarantees and loan commitments. As described above, all financial guarantees and loan commitments are subject to Midland's normal credit policies, and the majority expire unfunded. Based upon Midland's current fee structures, and taking into account re-pricing characteristics, management believes that the replacement cost of such contracts is not material.

Derivative financial instruments
The mark-to-market values of derivative financial instruments are shown under derivatives used for trading purposes and derivatives used for non-trading purposes above.

The following table gives details of fair values of financial instruments:

Fair Value of Financial Instruments *(continued)*

	1998			1997		
	Carrying value £m	Fair value adjustment (i) £m	Fair value £m	Carrying value £m	Fair value adjustment (i) £m	Fair Value £m
Assets						
Trading						
Treasury bills and other eligible bills	2,562	—	2,562	2,974	—	2,974
Debt securities	11,010	—	11,010	10,779	—	10,779
Derivatives	8,091	—	8,091	7,568	—	7,568
Non-trading						
Cash and balances at central banks	533	—	533	559	—	559
Items in the course of collection from other banks	2,043	—	2,043	2,052	—	2,052
Loans and advances to banks and customers	63,887	400	64,287	63,522	49	63,571
Debt securities	7,724	75	7,799	6,639	86	6,725
Derivatives relating to debt securities	—	(32)	(32)	—	(44)	(44)
Equity shares	15	5	20	20	7	27
Other derivatives	373	345	718	19	171	190
Liabilities						
Trading						
Short positions in debt securities	2,001	—	2,001	3,016	—	3,016
Derivatives	8,650	—	8,650	7,790	—	7,790
Non-trading						
Deposits by banks and customer accounts	72,181	8	72,189	70,169	10	70,179
Items in the course of transmission to other banks	1,216	—	1,216	1,132	—	1,132
Debt securities in issue	5,014	11	5,025	4,737	—	4,737
Subordinated liabilities	3,380	(45)	3,335	3,297	13	3,310
Derivatives relating to subordinated liabilities	—	(176)	(176)	—	(104)	(104)
Other derivatives	80	329	409	24	131	155

(i) *Positive/negative fair value adjustments are favourable/unfavourable, respectively, on the asset side of the balance sheet. Positive/negative fair value adjustments are unfavourable/favourable, respectively, on the liability side of the balance sheet.*

Other Information

Supervision and Regulation

The FSA is responsible for authorising and supervising UK institutions in accordance with the UK Banking Act 1987. Within Midland, the Bank, Forward Trust Group Limited and Midland Bank Trust Company Limited are the main authorised institutions supervised by the FSA. The Banking Act sets out the requirements for banks to report, and in certain cases obtain consent for, large individual exposures and large exposures to related borrowers, and the minimum criteria for authorisation. The Banking Act permits the FSA to obtain independent reports from the reporting accountants for authorised institutions, usually their auditors, as to the adequacy of systems of internal control and accounting and internal records. The FSA also has statutory powers to object, on prudential grounds, to persons who are, or intend to become, controllers of 10 per cent or more of the voting power of an authorised institution. A deposit protection scheme, originally established under the UK Banking Act 1979 and continued under the UK Banking Act 1987, was amended during 1995 to be consistent with the Deposit Guarantee Directive under the terms of the EU Single Market. The scheme is administered by a statutory body and provides a measure of protection for deposits denominated in euros or European Economic Area ('EEA') member country currencies made with the EEA offices of authorised institutions in the event of their insolvency. The scheme is funded by contributions made by authorised institutions. Depositors with an insolvent institution are entitled to receive 90 per cent of their protected deposits subject to a maximum payment to any one depositor of £18,000 (or euros 20,000 if greater).

The FSA regulates UK banks and banking groups by monitoring their performance through interviews and regular prudential reporting which, under the Banking Act, may be subject to review by Reporting Accountants, at their request. Midland's senior executives attend regular meetings with the FSA and these meetings are used by the FSA to ensure that authorised institutions are conducting their business in a prudent manner and with due regard for the prudential guidelines which it has issued. Fundamental matters relating to Midland's business, such as strategic and operating plans, risk control, loan portfolio composition and organisational changes are regularly discussed.

Midland's securities and investment businesses in the United Kingdom, including the sale of personal financial services in the investment field through the Bank's branches, are regulated under the Financial Services Act 1986 ('FS Act'). The FS Act established a framework for strengthening investor protection by the regulation of investment businesses and securities markets. Every investment firm is required to join one or more Self-Regulating Organisations ('SROs') or be directly authorised by the FSA. The Bank is subject to regulation both by the FSA under the powers of the Banking Act, and the relevant SROs under the FS Act. In recognition of the industry's desire to avoid duplication, agreement was reached between the FSA and the relevant SROs that the FSA would act as 'lead regulator' in monitoring compliance with the capital requirements for the securities and investment businesses undertaken by banks. Additionally, the FSA provides the staff under contract to the SROs for the regulation of investment business.

The Personal Investment Authority ('PIA'), which Midland joined in 1995, takes responsibility for the regulation of the majority of investment business for retail investors. Midland is also regulated by the Investment Management Regulatory Organisation ('IMRO') for its collective investment scheme trusteeship activity. The Securities and Futures Authority ('SFA') regulates Midland for its custody and Midland's branch share dealing.

In due course, the SROs, to which have been delegated certain powers by the FSA under the FS Act, will also be merged into the new FSA. The exact timing of this change is unknown at present but it is expected to be during the Year 2000.

Monetary Policy

Low and stable inflation remains the cornerstone of UK monetary policy. The Government sets an inflation target which is reviewed in each Budget Statement. The Government's current target is to achieve underlying inflation as measured by the retail price index, excluding mortgage interest payments, of 2.5 per cent. The Bank of England is responsible for setting short-term interest rates to achieve that target and its Monetary Policy Committee meets monthly to decide on the appropriate level.

Monetary Policy *(continued)*

Monetary policy is assumed to influence inflation with a lag so that base rates are set on a judgement of inflation prospects up to two years ahead.

Since the introduction of inflation targets, inflation has recorded its best performance for nearly 50 years and since 1993, the underlying measure has ranged between 2.0 and 3.5 per cent. In 1998, underlying inflation averaged 2.6 per cent, compared with 2.8 per cent in 1997 and 3 per cent in 1996, and has had no significant impact on Midland's operations.

Description of Premises

Midland has a substantial network of premises, including an extensive branch network in the United Kingdom. Midland has about 2,000 premises, principally in the United Kingdom, of which approximately 1,000 are either freehold or long leasehold. The Bank's head office is at Poultry, London, England.

Further details are included in Note 19 of the Notes on the Accounts.

On 30 March 1998, HSBC Holdings announced its intention to develop a new Headquarters building at London's Canary Wharf, bringing together some 8,000 staff from HSBC Holdings and its subsidiaries including Midland. Midland's London branches will remain but its head office departments will relocate to the new building.

On 19 October 1998, Midland finalised its contract with Canary Wharf Limited to acquire a 999 year lease for the new 1.1 million sq. ft. building, which is currently under construction.

Board of Directors

Directors

J R H Bond, *Chairman*
Age 57. Chairman from 1 January 1998 and a Director since 1993. Group Chairman of HSBC Holdings plc. Chairman of HSBC Americas, Inc. and HSBC Bank USA. A Director of The Hongkong and Shanghai Banking Corporation and The Saudi British Bank and a non-executive Director of the London Stock Exchange and Orange Plc. Chairman of the Institute of International Finance and a member of the Banking Advisory Group of the International Finance Corporation.

K R Whitson, *Deputy Chairman*
Age 56. Deputy Chairman from 1 January 1998; appointed a Director and Deputy Chief Executive in 1992; and Chief Executive from 1994 to 31 March 1998. Group Chief Executive of HSBC Holdings plc and Deputy Chairman of the Supervisory Board of Trinkaus & Burkhardt KGaA. A Director of The Hongkong and Shanghai Banking Corporation, HSBC Americas, Inc., Hongkong Bank of Canada and HSBC Roberts S.A. de Inversiones. A non-executive Director of the Financial Services Authority.

W R P Dalton, *Chief Executive*
Age 55. A Director and Chief Executive from 1 April 1998. An executive Director of HSBC Holdings plc. Chairman of Forward Trust Group Limited. President and Chief Executive Officer, Hongkong Bank of Canada from 1992 to December 1997. A Director of HSBC Investment Bank Holdings plc. A non-executive Director of MasterCard International Inc. and a non-executive Director and Chairman of Young Enterprise Limited.

D W Baker, *Chief Operating Officer*
Age 56. Chief Operating Officer from November 1998 and a Director since 1996. Chairman of Midland Bank Pension Trust Limited. A non-executive Director of Market Harborough Building Society.

* **J F Devaney**
Age 52. A Director since 1994. Formerly Chairman of Eastern Group plc. A non-executive Director of British Steel plc.

* **R Emerson**
Age 49. A Director since 1996. Director of Taxation and Treasury at Glaxo Wellcome plc. Formerly a partner of Coopers & Lybrand.

S K Green
Age 50. A Director since 1995. An executive Director of HSBC Holdings plc. Chairman of HSBC Investment Bank Holdings plc and a Director of Guyerzeller Bank AG. Group Treasurer of HSBC Holdings plc from 1992 to February 1998.

*** A J Hales**
Age 50. A Director since 1994. Chief Executive of Allied Domecq PLC and a non-executive Director of Aston Villa plc.

*** Sir Wilfrid Newton**, CBE *(retiring on 28 April 1999)*
Age 70. A Director since 1992. A non-executive Director of HSBC Holdings plc and Chairman of Raglan Properties plc, Jacobs Holdings PLC and Mountcity Holdings Limited. A non-executive Director of Maunsell Holdings Limited and Sketchley plc. Former Chairman of Mass Transit Railway Corporation and of London Regional Transport. A non-executive Director of The Hongkong and Shanghai Banking Corporation from 1986 to 1992.

R M J Orgill
Age 60. A Director since 1994. Deputy Chief Executive from 1994 to November 1998. Global Head of Corporate and Institutional Banking for the HSBC Group since November 1998. A Director of HSBC Investment Bank Holdings plc and of The Hongkong and Shanghai Banking Corporation.

*** A C Reed (Mrs)**
Age 42. A Director since 1996. Divisional Director, Financial Control at Marks & Spencer plc. A Director of BBC Children in Need Limited.

*** H A Rose**
Age 58. A Director since 1997. Deputy Chairman of The Rover Group Limited.

* *Independent non-executive Directors*

Secretary

I B Marshall
Age 49. Joined the HSBC Group in 1995.

Registered Office
Poultry, London, EC2P 2BX

Senior Executives

A C Armishaw
Age 36. Chief Executive, First Direct. Joined Midland in 1994.

D C Budd
Age 45. General Manager, Central Division. Joined the HSBC Group in 1972.

G S Cardona
Age 47. General Manager, International. Joined the HSBC Group in 1985.

R L Carlson
Age 54. Head of Information Technology. Joined the HSBC Group in 1982.

S A Donohoe
Age 57. General Manager, Service and Sales. Joined Midland in 1960.

R J Duke
Age 48. General Manager Operations, Retail Banking Services. Joined Midland in 1971.

M G H Heald
Age 48. Treasurer, HSBC MIDLAND. Joined the HSBC Group in 1989.

R P Hennessy
Age 45. Chief Financial Officer. Joined the HSBC Group in 1982.

B E Hine
Age 53. Head of Human Resources. Joined the HSBC Group in 1985.

A R F Hughes
Age 47. General Manager, Marketing. Joined Midland in 1969.

A M Keir
Age 40. General Manager, Midlands Division. Joined Midland in 1981.

D J Mills
Age 55. General Manager, Retail Banking Services. Joined Midland in 1962.

N V Moss
Age 43. General Manager, Personal Financial Services. Joined Midland in 1984.

G E Picken
Age 49. Chief Executive, Forward Trust Group and Chairman, First Direct. Joined Midland in 1971.

W E Roberts
Age 52. General Manager, Wales. Joined Midland in 1962.

B Robertson
Age 44. General Manager, Northern Division. Joined the HSBC Group in 1975.

T Robson
Age 54. General Manager, Southern Division. Joined Midland in 1962.

C S Smith
Age 52. Head of Credit and Risk. Joined Midland in 1964.

R G Spence
Age 39. General Manager, Card Services. Joined Midland in 1978.

Report of the Directors

Results for 1998

The consolidated profit for the year attributable to the shareholders of the Bank was £1,042 million.

An interim dividend for 1998 of £300 million has been paid on the ordinary share capital during the year and the Directors have resolved to pay a further interim dividend for 1998 of £350 million.

Further information about the results is given in the consolidated profit and loss account on page 66.

Principal Activities and Business Review

Midland provides a comprehensive range of banking, financial and related services.

The Bank has approximately 1,700 branches in the United Kingdom. Outside the United Kingdom it has branches in Australia, the Czech Republic, France, Greece, Guernsey, the Isle of Man, Italy, Japan, Jersey, Malta, Panama, Spain, Sweden and the United States; it has representative offices in Argentina, Bahrain, Brazil, Chile, the Hong Kong SAR, Mexico, Russia, Singapore, Taiwan and Venezuela; and has subsidiary undertakings in Armenia, the Cayman Islands, Greece, Guernsey, Ireland, the Isle of Man, Jersey and Turkey.

A review of the development of the business of Midland during the year and an indication of likely future developments are given in the Business Description and Financial Review on pages 4 to 47.

Valuation of Freehold and Long Leasehold Land and Buildings

Freehold and long leasehold properties were revalued by professionally qualified valuers in November 1998 in accordance with Midland's policy of annual valuation.

Board of Directors

The objectives of the management structures within Midland, headed by the Board of Directors and led by the Chairman, are to deliver sustainable value to shareholders. Implementation of the strategy set by the Board is delegated to the Midland Executive Committee under the leadership of the Chief Executive.

The Board meets regularly and between meetings Directors receive information about the activities of committees and developments in the Bank's business. All Directors have full and timely access to all relevant information and may take independent professional advice if necessary.

The names of Directors serving at the date of this report are listed on pages 50 and 51.

W R P Dalton was appointed a Director and Chief Executive on 1 April 1998. B H Asher retired on 28 February 1998 and Sir Archibald Forster, H H Jacobi and Sir William Purves retired on 27 May 1998.

J R H Bond, S K Green, Sir Wilfrid Newton, A C Reed and K R Whitson will retire by rotation at the Annual General Meeting. With the exception of Sir Wilfrid Newton, who will retire, they each offer themselves for re-election.

Board Committees

The Board has appointed a number of committees consisting of certain Directors and senior executives. The following are the principal committees:

Executive Committee

The Executive Committee meets regularly and operates as a general management committee under the direct authority of the Board. The members of the Executive Committee are W R P Dalton (Chairman), D W Baker, D C Budd, M G H Heald, R P Hennessy, D J Mills, G E Picken, B Robertson and C S Smith.

Audit Committee

The Audit Committee meets regularly with Midland's senior financial, internal audit and compliance management and the external auditor to consider the Bank's financial reporting, the nature and scope of audit reviews and the effectiveness of the systems of internal control and compliance. The members of the Audit Committee are J F Devaney (Chairman), R Emerson, Mrs A C Reed and H A Rose, all of whom are non-executive Directors.

Report of the Directors (continued)

Property Committee

The Property Committee meets regularly to supervise and control the development of the new Head Office building in Docklands. The members of the Committee are Sir Wilfrid Newton (Chairman), W R P Dalton, D J Flint (Finance Director of HSBC Holdings plc), S K Green and K R Whitson.

Corporate Governance

In June 1998, the Committee on Corporate Governance (the Hampel Committee) published its principles of good governance and code of best practice (the Combined Code). The Bank is committed to high standards of corporate governance. The Directors believe the Bank has complied throughout the year with the relevant provisions of the Combined Code on Corporate Governance introduced by the London Stock Exchange in June 1998.

Internal control

The Directors are responsible for internal control within Midland and have designed procedures for the safeguarding of assets against unauthorised use or disposition; for the maintenance of proper accounting records; and for the reliability of financial information used within the business or for publication. Such procedures can only provide reasonable and not absolute assurance against material errors, losses or fraud.

The key procedures that the Directors have established and which are designed to provide effective internal control within Midland, include the following:

Authority to operate Midland is delegated to the Chief Executive within limits set by the Board of Directors or the Executive Committee. The appointment of executives to the most senior positions within Midland requires the approval of the Board of Directors. Functional, operating and financial reporting standards are established by HSBC Holdings plc's Head Office management for application across the whole HSBC Group. These are supplemented by operating standards set by the Midland management, as required.

Systems and procedures are in place in Midland to report on and control the major financial risks: credit; changes in the market prices of financial instruments; funding of assets; operational error and fraud. Exposure to these risks is monitored by the Executive Committee and the Asset and Liability Management Committee.

Comprehensive annual financial plans are prepared, reviewed and approved by the Board of Directors and the Executive Committee. Results are monitored regularly and reports on progress compared with plan are prepared monthly. A strategic plan is prepared every three years. Financial accounting and reporting and certain management reporting standards have been established. Centralised functional control is exercised over all computer system developments and operations for the HSBC Group as a whole and common systems are employed where possible for similar business processes. Credit and market risks are measured and reported on in Midland and aggregated for review of risk concentrations on an HSBC Group-wide basis.

Responsibilities for financial performance against plans and for capital expenditure, credit exposures and market risk exposures are delegated with limits to line management. In addition, functional management in the HSBC Group's Head Office set policies, procedures and standards in the areas of finance; legal and regulatory compliance; internal audit; human resources; credit; market risk; computer systems and operations; property management; and for certain global product lines.

The internal audit function, which is centrally controlled, monitors compliance with policies and standards and the effectiveness of internal control structures across the HSBC Group. The work of the internal audit function is focused on areas of greatest risk as determined by a risk management approach. The head of this function reports to the Chairman and the Audit Committee. The HSBC Group's and Midland's independent auditor, KPMG Audit Plc, reviews such internal controls and conducts such tests and other auditing procedures as it considers necessary to express the opinion in its report on the financial statements. KPMG Audit Plc has free access to the Audit Committee, with and without members of management present, to discuss its audit and its findings as to the integrity of Midland's financial reporting and the adequacy of the internal control structure.

Annual reviews of the systems of internal control throughout the HSBC Group are conducted against a

Internal control *(continued)*

detailed checklist, which covers internal controls from both a financial and non-financial perspective, and their effectiveness is reported on to the Audit Committee.

The Audit Committee has reviewed the effectiveness of the overall system of internal control throughout 1998 and the subsequent period up to 22 February 1999 when the financial statements were signed. The review has been undertaken before formal guidance has been issued as to the scope of such a review and the procedures to be undertaken and may, therefore, require some amendment once guidance has been received.

Remuneration

The functions of the Remuneration Committee are fulfilled by the Remuneration Committee of the Board of the Bank's parent company, HSBC Holdings plc. Its members are Baroness Dunn (Chairman), H Sohmen and Sir Peter Walters who are all non-executive Directors of HSBC Holdings plc.

Policy

The Remuneration Committee is responsible for determining the remuneration policy of the HSBC Group, including the terms of bonus schemes, share option schemes and other long-term incentive schemes, and for determining the individual remuneration packages of Midland executive Directors and other senior employees. No Directors are involved in deciding their own remuneration.

The Remuneration Committee strives to ensure that total remuneration is fair and attractive to potential employees, whilst motivating and retaining existing high calibre staff. The remuneration packages are structured to take due account of levels and composition of pay and the market positioning in the many countries and businesses in which the HSBC Group operates. In appropriate circumstances, performance-related payments and share awards are provided with the objective of rewarding achievement and aligning the interests of the individual with those of the HSBC Group's shareholders. The Remuneration Committee seeks to respond to the variety of environments and circumstances which are faced by different businesses in different markets at different times.

In determining the terms of annual bonus and incentive schemes, individual remuneration awards, retirement benefit arrangements, notice periods and severance terms, the Remuneration Committee considers the practices and levels of remuneration in appropriate comparator companies which operate in similar industry sectors and territories to those in which the individual HSBC Group company operates and the executive Director or employee is employed. Due regard is paid to advice rendered by external professional consultants.

As part of the recent review of the HSBC Group's five-year strategy, it has been decided to extend the use of the existing share schemes so that more employees are able to participate in the success they help to create. The vesting of all awards will be subject to the attainment of total shareholder return targets.

Basic salary and benefits

Salaries are reviewed annually in the context of individual and business performance, market practice and internal relativities. Allowances and benefits are largely determined by local market practice.

Annual performance-related payments

The level of performance-related payment depends upon the performance of the Bank, constituent businesses and the individual concerned. Key measures of success include achievement of financial goals, concerning both revenue generation and expense control; maintenance of customer relationships; full utilisation of professional skills; and adherence to the HSBC Group's ethical standards. The HSBC Group has a long history of paying close attention to its customers in order to provide value for its shareholders. This has been achieved by ensuring that the interests of the HSBC Group and its staff are aligned with those of its shareholders, and that the HSBC Group's approach to risk management serves the interests of all. Closer alignment with the interests of shareholders is intended to be achieved by extending employee participation in the existing share schemes.

Bonus ranges are reviewed in the context of prevailing market practice and overall remuneration.

Report of the Directors (continued)

Long-term share awards

The HSBC Holdings plc Restricted Share Plan is intended to align the interests of executives with those of shareholders by linking executive rewards to the creation of superior shareholder value. This is achieved by focusing on predetermined total shareholder return ('TSR') targets.

HSBC Holdings' executive Directors and Group General Managers have been eligible to receive conditional awards under the Restricted Share Plan since 1996. The Restricted Share Plan will be extended to other senior executives from 1999. Participants in the Restricted Share Plan are not eligible to participate in the HSBC Holdings Executive Share Option Scheme, although options previously granted remain valid.

Participants in the Restricted Share Plan are also eligible to participate in the HSBC Holdings Savings-Related Share Option Scheme on the same terms as other eligible employees.

Pensions

Pension arrangements to contractual retirement age of 60 for the executive Directors are provided under the Midland Bank Pension Scheme and the HSBC Holdings Overseas (No.1) Pension Plan.

Only basic salary is pensionable. None of the Directors is subject to the earnings cap introduced by the 1989 Finance Act.

The principal Midland pension scheme is the Midland Bank Pension Scheme, the assets of which are held in a separate trust fund. The Pension Scheme is administered by Midland Bank Pension Trust Limited whose Board of 19 Directors (eight of whom are elected by employees and one by pensioners) meets quarterly. It has three sub-committees which monitor and review investment performance, discretionary benefits and administration and communications. The Pension Scheme does not invest in shares of the Bank's parent company or in any of its subsidiary undertakings.

The pension entitlements earned by the current Directors in this scheme during the year are shown below.

	Accrued annual pension at 31December 1998	*Increase in accrued pension during 1998, excluding any increase for inflation*	*Transfer value relating to increase in accrued pension*
	£'000	£'000	£'000
D W Baker	96	6	93
R M J Orgill	57	14	268

The pension arrangements for W R P Dalton to contractual retirement age of 60 are provided under the HSBC Holdings Overseas (No.1) Pension Plan on a defined contribution basis, with an employer contribution of £129,000 having been made during 1998.

Directors' service contracts

No executive Director has a service contract with the Bank or any of its subsidiaries with a notice period in excess of one year or with provisions for pre-determined compensation on termination which exceeds one year's salary and benefits in kind. Non-executive Directors are appointed for fixed terms not exceeding three years.

Directors' emoluments

The emoluments of the Directors of the Bank for 1998 were as follows:

	Fees	*Salary and other remuneration*	*Benefits in kind*	*Discretionary bonuses* [6]	*Total 1998*	*Total 1997*
	£'000	£'000	£'000	£'000	£'000	£'000
D W Baker	25	169	8	45	247	233
W R P Dalton [1]	—	296	—	100	396	—
J F Devaney	34	—	—	—	34	33
R Emerson	33	—	—	—	33	33
Sir Archibald Forster [2]	15	—	—	—	15	35
S K Green [3]	4	—	—	—	4	25
A J Hales	25	—	—	—	25	25
Sir Wilfrid Newton	25	—	—	—	25	25
R M J Orgill	25	238 [4]	8	77	348	394
A C Reed	33	—	—	—	33	33
H A Rose	33	—	—	—	33	16
K R Whitson [5]	—	95	8	—	103	453
Total	252	798	24	222	1,296	1,305

1 *Appointed 1 April 1998.*
2 *Retired on 27 May 1998.*
3 *Up to 28 February 1998.*
4 *Up to 15 November 1998.*
5 *Up to 31 March 1998.*
6 *These discretionary bonuses are in respect of 1998 and will be paid in 1999.*

B H Asher, J R H Bond, H H Jacobi and Sir William Purves received no emoluments from the Bank or from its subsidiary undertakings.

For US disclosure purposes, the aggregate remuneration of Directors and executive officers of the Bank for the year ended 31 December 1998 amounted to £4,950,000, including £557,000 in respect of pension contributions and £629,000 in respect of discretionary bonuses.

1999 conditional awards under the Restricted Share Plan

The Remuneration Committee has decided that conditional awards under the HSBC Holdings plc Restricted Share Plan should be made in 1999 and that the Trustee to the Plan should be provided with funds to acquire HSBC Holdings plc ordinary shares of 75p each between 22 February and 5 March 1999. The 1999 awards to HSBC executive Directors and Group General Managers in respect of 1998 will have an aggregate value at the date of award of £3.025 million and will include awards to the following values to Directors of the Bank:

	£'000
D W Baker	100
J R H Bond	300
W R P Dalton	175
S K Green	175
R M J Orgill	150
K R Whitson	250
Total	1,150

Report of the Directors (continued)

Purpose

The Restricted Share Plan is intended to reward the delivery of sustained financial growth of the HSBC Group. So as to align the interests of Directors and senior employees more closely with those of shareholders, the Restricted Share Plan links the vesting of 1999 awards to the attainment of predetermined TSR targets.

TSR is defined as the growth in share value and declared dividend income during the relevant period. In calculating TSR, dividend income is assumed to be reinvested in the underlying shares.

The vesting of previous years' awards was linked to earnings per share. The performance conditions and vesting rules for those awards are as set out in the Report by the Remuneration Committee in the 1996 and 1997 Annual Report and Accounts.

To illustrate how the Restricted Share Plan is to be applied for 1999 awards, particulars of the terms are set out below.

Vesting schedule

Having regard to the HSBC Group's size and status within the financial sector a benchmark has been established which takes account of:

1. a peer group of nine banks;
2. the five largest banks from each of the United States, the United Kingdom, Continental Europe and the Far East, other than any within 1 above; and
3. the banking sector of the Morgan Stanley Capital International World Index, excluding any within 1 and 2 above.

By combining the above three elements and weighting the average so that 50 per cent is applied to 1, 25 per cent is applied to 2 and 25 per cent is applied to 3, an appropriate market comparator is determined.

For vesting of the 1999 awards to be achieved, the HSBC Group's TSR over a three year period must exceed the mean of the benchmark. The calculation of the share price component with the HSBC Group's TSR will be the average market price over the 20 trading days commencing on the day when the annual results are announced, which in 1999 was 22 February. The starting point will be, therefore, the average over the period 22 February to 19 March inclusive. TSR for the benchmark banks will be based on the published share price for 19 March 1999.

If the HSBC Group's TSR exceeds the benchmark mean, but is less than the top quartile of the benchmark, the shares will be deemed to have vested in full but will be retained by the Trustee for a further two years with release being dependent upon the participant remaining with the HSBC Group. If the HSBC Group's TSR is in the top quartile of the benchmark, an additional award of 20 per cent of the original shares will be added, to be released to the participants two years later, again subject to continued employment. The two-year additional retention period is intended to encourage longer-term shareholding by those concerned.

If the HSBC Group's TSR has not exceeded the benchmark mean at the end of year 3, then the test will be applied over a four year period at the end of year 4; if still not attained, then the test will be applied over a five year period at the end of year 5. If the test is satisfied in either case, the shares will be released after five years, contingent upon continued employment. If the test has not been satisfied by the end of year 5, then the particular share award will be forfeited. No additional shares will be awarded even where the HSBC Group's TSR is in the top quartile where a share award has to rely on the year 4 or year 5 test in order to vest.

The Remuneration Committee retains discretion to allow early release of share awards in the event of termination of employment due to retirement; injury, illness or disability; redundancy or death. Awards will be forfeited if the participant is dismissed or resigns from the HSBC Group.

In the event of any occurrence that would cause awards to vest in whole or in part or not to vest in circumstances which the Remuneration Committee considers to be anomalous, the right is reserved to the Remuneration Committee to make such adjustments as in its absolute discretion it deems appropriate to make.

Directors' Interests

According to the register of Directors' interests maintained by the Bank pursuant to section 325 of the Companies Act 1985, the Directors of the Bank at the year-end had the following interests, all beneficial unless otherwise stated, in the shares and loan capital of HSBC Holdings plc:

	At 1 January 1998[1]	*At 31 December1998*
ordinary shares of HK$10		
J R H Bond	18,259	18,891
W R P Dalton	304	314
S K Green	4,152	4,221
Sir Wilfrid Newton	3,869	4,003
K R Whitson	1,755	1,814
ordinary shares of 75p[2]		
D W Baker	9,124	7,814
J F Devaney	1,602	1,602
A J Hales	1,103	1,141
Sir Wilfrid Newton	2,000	4,500
11.69% subordinated bonds 2002 of £1		
J R H Bond	500,000	500,000
Sir Wilfrid Newton	35,000	—
R M J Orgill	250,000	250,000

1 *Or at date of appointment if later.*
2 *Details of additional interests in ordinary shares of 75p each under the Share Option Schemes and the Restricted Share Plan are set out below.*

Share options (ordinary shares of 75p)

At 31 December 1998, the undernamed Directors held options to acquire the number of HSBC Holdings plc ordinary shares of 75p each set against their respective names. The options were awarded for nil consideration at exercise prices equivalent to the market value at the date of award, except that options awarded under the HSBC Holdings Savings-Related Share Option Scheme are exercisable at a 15 per cent discount to the market value at the date of award. Except as otherwise indicated, there are no performance criteria conditional upon which the outstanding options are exercisable. The market value of the ordinary shares of 75p each at 31 December 1998 was 1,630 pence. The highest and lowest market values during the year were 2,025 pence and 982 pence. Market value is the mid-market price quoted on the London Stock Exchange on the relevant date.

Report of the Directors (continued)

Share options (ordinary shares of 75p) (continued)

	Options held at 1 January 1998[5]	Options awarded during year	Options exercised during year	Options held at 31 December 1998	Exercise price in pence	Date of award	Exercisable from[4]	Exercisable until[4]
Executive Directors								
D W Baker	6,559	—	6,559[3]	—	851.27	8 Mar 1994	8 Mar 1997	8 Mar 2004
	6,250	—	—	6,250	651.80	7 Mar 1995	7 Mar 1998	7 Mar 2005
	1,476	—	—	1,476[1]	700.84	11 Apr 1994	1 Jul 1999	31 Dec 1999
	713	—	—	713[1]	541.80	10 Apr 1995	1 Aug 2000	31 Jan 2001
	6,500	—	—	6,500[2]	1,000.00	1 Apr 1996	1 Apr 1999	1 Apr 2006
	7,000	—	—	7,000[2]	1,504.80	24 Mar 1997	24 Mar 2000	24 Mar 2007
	223	—	—	223[1]	1,356.18	9 Apr 1997	1 Aug 2002	31 Jan 2003
	—	8,000	—	8,000[2]	1,883.00	16 Mar 1998	16 Mar 2001	16 Mar 2008
W R P Dalton	7,568	—	—	7,568	721.84	12 Oct 1993	12 Oct 1996	12 Oct 2003
	10,091	—	—	10,091	851.27	8 Mar 1994	8 Mar 1997	8 Mar 2004
	12,000	—	—	12,000	651.80	7 Mar 1995	7 Mar 1998	7 Mar 2005
	2,875	—	—	2,875[1]	541.80	10 Apr 1995	1 Aug 2000	31 Jan 2001
	12,000	—	—	12,000[2]	1,000.00	1 Apr 1996	1 Apr 1999	1 Apr 2006
Non-executive Directors								
The following hold options awarded by HSBC Holdings plc in respect of their executive responsibilities with that Company:								
J R H Bond	20,181	—	—	20,181	721.84	12 Oct 1993	12 Oct 1996	12 Oct 2003
	20,181	—	—	20,181	851.27	8 Mar 1994	8 Mar 1997	8 Mar 2004
	25,000	—	—	25,000	651.80	7 Mar 1995	7 Mar 1998	7 Mar 2005
	3,183	—	—	3,183[1]	541.80	10 Apr 1995	1 Aug 2000	31 Jan 2001
	25,000	—	—	25,000[2]	1,000.00	1 Apr 1996	1 Apr 1999	1 Apr 2006
S K Green	8,072	—	—	8,072	721.84	12 Oct 1993	12 Oct 1996	12 Oct 2003
	12,108	—	—	12,108	851.27	8 Mar 1994	8 Mar 1997	8 Mar 2004
	15,000	—	—	15,000	651.80	7 Mar 1995	7 Mar 1998	7 Mar 2005
	15,000	—	—	15,000[2]	1,000.00	1 Apr 1996	1 Apr 1999	1 Apr 2006
	1,879	—	—	1,879[1]	917.70	3 Apr 1996	1 Aug 2001	31 Jan 2002
R M J Orgill	10,000	—	—	10,000	651.80	7 Mar 1995	7 Mar 1998	7 Mar 2005
	1,476	—	—	1,476[1]	700.84	11 Apr 1994	1 Jul 1999	31 Dec 1999
	1,273	—	—	1,273[1]	541.80	10 Apr 1995	1 Aug 2000	31 Jan 2001
	10,000	—	—	10,000[2]	1,000.00	1 Apr 1996	1 Apr 1999	1 Apr 2006
K R Whitson	12,613	—	—	12,613	851.27	8 Mar 1994	8 Mar 1997	8 Mar 2004
	20,000	—	—	20,000	651.80	7 Mar 1995	7 Mar 1998	7 Mar 2005
	3,183	—	—	3,183[1]	541.80	10 Apr 1995	1 Aug 2000	31 Jan 2001
	20,000	—	—	20,000[2]	1,000.00	1 Apr 1996	1 Apr 1999	1 Apr 2006

1 *Options awarded under the HSBC Holdings Savings-Related Share Option Scheme.*
2 *The exercise of these options is conditional upon the growth in earnings per share of HSBC Holdings plc over a three-year period being equal to or greater than a composite rate of inflation (comprising 50 per cent of the Hong Kong Composite Consumer Price Index, 35 per cent of the UK Retail Price Index and 15 per cent of the USA All Urban Consumer Price Index) plus 2 per cent per annum.*
3 *Market price at date of exercise (16 March 1998) was 1,885 pence.*
4 *May be advanced to an earlier date in certain circumstances, e.g. retirement.*
5 *Or date of appointment if later.*

No options held by Directors lapsed during the year.

Restricted Share Plan (ordinary shares of 75p)

	Awards held at 1 January 1998[1]	Awards made during year	Monetary value of awards made during year	Awards vested during year	Awards held at 31 December 1998[2]	Year in which awards will vest
			£'000			
J R H Bond	7,884	—	—	—	8,156	2001 or 2002
	—	8,333	150	—	8,613	2002 or 2003
W R P Dalton	4,931	—	—	—	5,101	2001 or 2002
	10,000	—	—	—	10,345[3]	2001
	—	5,556[4]	100	—	5,748	2002 or 2003
S K Green	5,917	—	—	—	6,121	2001 or 2002
	—	6,666	120	—	6,896	2002 or 2003
R M J Orgill	—	1,500	27	—	1,526	2002 or 2003
K R Whitson	5,917	—	—	—	6,121	2001 or 2002
	—	6,666	120	—	6,896	2002 or 2003

Unless otherwise indicated, vesting of these shares is subject to the performance tests described in the Report of the Remuneration Committee in the 1996 and 1997 Annual Report and Accounts being satisfied.

1 *Or at date of appointment if later.*
2 *Includes additional shares arising from scrip dividends.*
3 *Award not subject to performance conditions.*
4 *Held on date of appointment.*

S K Green has a personal interest in £100,000 Midland Bank plc 9% subordinated notes 2005, which he held throughout the year.

Save as stated above, none of the Directors had an interest in any shares or debentures of HSBC Holdings plc or any of its subsidiary undertakings at the beginning or at the end of the year and none of the Directors, or members of their immediate families, was awarded or exercised any right to subscribe for any shares or debentures during the year.

There have been no changes in Directors' interests from 31 December 1998 to the date of this report.

Other Directorships

Executive Directors, if so authorised by the Board, may accept appointments as non-executive Directors of suitable companies which are not part of the HSBC Group. Executive Directors normally would be permitted to take on no more than two such appointments. Any remuneration receivable in respect of these appointments is paid to the Bank.

Employee Communication and Involvement

A wide variety of communication methods is used to maintain and encourage effective two-way communication with employees on key issues including financial and economic factors affecting performance. Consultation arrangements include consultative forums for managers, the continuation of agreed arrangements with the recognised union and Midland's participation in an HSBC European Council. An Employee Focus Survey was undertaken covering over 20,000 employees, the results of which have been followed up and positive actions have ensued. Encouragement for every employee to contribute to the success of the business is made through performance management. Employees are given the opportunity to participate in the HSBC Holdings Savings-Related Share Option Scheme. Ideas from staff for improving Midland's operations and services are sought through 'Bright Ideas', the employee suggestions scheme.

Report of the Directors (continued)

Employment of Disabled Persons

Midland is committed to providing equal opportunities in both employment and the provision of goods and services. The employment of disabled people is included in this commitment and recruitment, training, career development and promotion of disabled people are based on the aptitudes and abilities of the individual. This is reinforced by Midland's adoption of the 'two tick' disability symbol. Midland's continued employment policy means that it will make every effort, if existing employees become disabled, to retain them within the workforce.

Midland believes that good employment policies provide a firm foundation for the provision of its goods and services to disabled people in the community. In 1998 Midland commenced a five year programme to survey and modify its branch network and, by the end of 1998, at least 30 per cent of the network was accessible by disabled people. Midland is a board member of the Employers' Forum on Disability.

Community Involvement and Donations

During 1998 Midland spent £3.8 million in support of community activities in the United Kingdom. This was provided in the form of donations, sponsorship, secondment of staff and gifts in kind. Within this, donations were made for charitable purposes totalling £1.3 million. This figure includes the amount of £344,000 relating to the £1 for £1 staff charity scheme.

The Bank has continued with its major corporate partnerships with three national charities, Age Concern, the National Deaf Children's Society and Shelter, in a series of agreements under which £1 million is donated to specific projects over three years. The partnerships make Midland the largest corporate donor of each charitable organisation.

No political donations were made during the year.

Supplier Payment Policy

The Company subscribes to the Better Payment Practice Code for all suppliers, the four principles of which are to agree payment terms at the outset and stick to them; explain payment procedures to suppliers; pay bills in accordance with any contract agreed with the supplier or as required by law; and tell suppliers without delay when an invoice is contested and settle disputes quickly.

The amount due to the Bank's trade creditors at 31 December 1998 represented 26 days' average daily purchases of goods and services received from those creditors, calculated in accordance with the Companies Act 1985, as amended by Statutory Instrument 1997/571.

Year 2000 Readiness

Midland recognises that the Year 2000 issue has widespread implications for computer and other technology-based systems and equipment. Midland is fully committed to resolving its Year 2000 issues and has been following a detailed implementation plan which addresses all relevant items. Progress is monitored by an Executive Steering Committee which meets monthly and regular reports are provided to Midland's Board and Audit Committee.

As at 31 December 1998, the vast majority of Midland's own systems and equipment had been amended and tested as ready for the new millennium to relevant British Standards Institution requirements. This includes critical computer systems, the vast majority of the Bank's own telecommunication systems, key premises and office equipment. In addition, the Bank's most important suppliers have responded with acceptable confirmation of their own Year 2000 plans. Midland is also testing critical goods and services and making appropriate service agreements over the key millennium change period. In line with Midland's implementation plan, outstanding items are planned to be made compliant and tested by 30 June 1999.

As at 31 December 1998, most business areas had established their contingency plans. These plans include mitigating the effects of any failure to complete remedial work on critical business systems, business continuity plans to address the possibility of systems failure and market resumption plans to address the possibility of the failure of external dependencies. The latter are many and varied, and include third party telecommunications networks and national infrastructure services such as power suppliers. Midland's policy is to liaise and co-operate with third party dependencies both directly and through relevant industry groups. However, Midland is unable to predict the effect if any of the efforts to address the Year 2000 problem fail.

Lack of readiness on the part of third parties would expose Midland to the potential for loss, impairment of business processes and activities, and disruption of financial markets. Midland is addressing these risks through a proactive communication plan which is being co-ordinated with appropriate external parties. Midland's business customers are being actively encouraged to take effective action to resolve their Year 2000 issues.

The total cost of the Year 2000 Programme is estimated to be £43 million. The costs incurred for the twelve months ended 31 December 1998 were £25 million (including £3 million attributable to incremental external costs). Estimated costs to complete the programme are £11 million (including £1 million attributable to incremental external costs). Costs relating to systems changes that are not directly related to the Year 2000 but which do address some Year 2000 issues are not included in these costs.

Auditor

KPMG Audit Plc has expressed its willingness to continue in office. A resolution proposing its reappointment and giving authority to the Directors to determine its remuneration will be submitted to the forthcoming Annual General Meeting.

On behalf of the Board
I B Marshall, *Secretary*

22 February 1999

Statement of Directors' Responsibilities in Relation to Financial Statements

The following statement, which should be read in conjunction with the Auditor's statement of its responsibilities set out in its report on the next page, is made with a view to distinguishing for shareholders the respective responsibilities of the Directors and of the Auditor in relation to the financial statements.

The Directors are required by the Companies Act 1985 to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Bank and its subsidiary undertakings as at the end of the financial year and of the profit or loss for the financial year. The Directors are required to prepare these financial statements on the going concern basis unless it is not appropriate. Since the Directors are satisfied that Midland and the Bank have the resources to continue in business for the foreseeable future, the financial statements continue to be prepared on the going concern basis.

The Directors consider that, in preparing the financial statements (on pages 66 to 119), the Bank has used appropriate accounting policies, consistently applied and supported by reasonable and prudent judgements and estimates, and that all accounting standards which they consider to be applicable have been followed.

The Directors have responsibility for ensuring that the Bank keeps accounting records which disclose with reasonable accuracy the financial position of the Bank and which enable them to ensure that the financial statements comply with the Companies Act 1985.

The Directors have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of Midland and to prevent and detect fraud and other irregularities.

On behalf of the Board
I B Marshall, *Secretary* 22 February 1999

Report of the Auditors, KPMG Audit Plc, to the Members of Midland Bank plc

We have audited the financial statements on pages 66 to 119.

Respective responsibilities of Directors and Auditors

As described on page 64, the Bank's Directors are responsible for the preparation of financial statements. It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you.

Basis of opinion

We conducted our audit in accordance with auditing standards generally accepted in the United Kingdom and in the United States. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Directors in preparation of the financial statements and of whether the accounting policies are appropriate to the Midland Bank Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the financial statements.

United Kingdom opinion

In our opinion the financial statements give a true and fair view of the state of affairs of the Bank and of the Midland Bank Group as at 31 December 1998 and of the profit of the Midland Bank Group for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

United States opinion

In our opinion, the financial statements present fairly, in all material respects, the consolidated financial position of Midland Bank plc and its subsidiary undertakings as of 31 December 1997 and 1998, and the consolidated results of their operations and cash flows for each of the years in the three year period ended 31 December 1998, in conformity with accounting principles generally accepted in the United Kingdom.

Generally accepted accounting principles in the United Kingdom vary in certain significant respects from generally accepted accounting principles in the United States. Application of generally accepted accounting principles in the United States would have affected results of operations for each of the years in the three year period ended 31 December 1998, and shareholders' funds as of 31 December 1998 and 1997, to the extent summarised in Note 37 of Notes on the Consolidated Financial Statements.

KPMG Audit Plc

KPMG Audit Plc
Chartered Accountants
Registered Auditor
London

22 February 1999

Consolidated Profit and Loss Account for the Year Ended 31 December 1998

	Note	1998 £m	1997 £m	1996 £m
Interest receivable				
— interest receivable and similar income arising from debt securities		1,081	1,077	964
— other interest receivable and similar income		5,400	4,778	4,151
Interest payable		(4,244)	(3,652)	(3,064)
Net interest income		2,237	2,203	2,051
Dividend income	3	2	11	3
Fees and commissions receivable		1,632	1,682	1,391
Fees and commissions payable		(357)	(400)	(234)
Dealing profits		124	235	234
Other operating income		404	311	193
Other income		1,805	1,839	1,587
Operating income		4,042	4,042	3,638
Administrative expenses	4	(2,006)	(2,092)	(2,064)
Depreciation and amortisation	19	(291)	(231)	(200)
Operating expenses		(2,297)	(2,323)	(2,264)
Operating profit before provisions		1,745	1,719	1,374
Provisions				
— provisions for bad and doubtful debts	13	(196)	(129)	(172)
— provisions for contingent liabilities and commitments	25	(59)	(3)	(3)
Amounts written off fixed asset investments		(1)	(4)	(40)
Operating profit		1,489	1,583	1,159
Share of operating (loss)/profit in associated undertakings		(1)	9	21
Gains on disposal of				
— investments		28	24	91
— tangible fixed assets		6	9	1
Profit on ordinary activities before tax	5	1,522	1,625	1,272
Tax on profit on ordinary activities	6	(479)	(559)	(408)
Profit on ordinary activities after tax		1,043	1,066	864
Minority interests		(1)	(15)	(15)
Profit for the financial year attributable to shareholders		1,042	1,051	849
Dividends (including amounts attributable to non-equity shareholders)	8	(693)	(644)	(537)
Retained profit for the year	28	349	407	312
		pence	pence	pence
Earnings per ordinary share (basic and diluted)	9	125.3	126.3	101.9

Consolidated Balance Sheet at 31 December 1998

	Note	**1998** **£m**	*1997* £m
Assets			
Cash and balances at central banks		**533**	559
Items in the course of collection from other banks		**2,043**	2,052
Treasury bills and other eligible bills	*10*	**2,562**	2,974
Loans and advances to banks	*11*	**11,516**	13,379
Loans and advances to customers	*12*	**52,371**	50,143
Debt securities	*15*	**18,734**	17,418
Equity shares	*16*	**15**	20
Interests in associated undertakings	*17*	**79**	68
Tangible fixed assets	*19*	**3,250**	2,766
Other assets	*20*	**12,436**	11,827
Prepayments and accrued income		**1,307**	870
Total assets	*29*	**104,846**	102,076
Liabilities			
Deposits by banks	*21*	**11,882**	12,267
Customer accounts	*22*	**60,299**	57,902
Items in the course of transmission to other banks		**1,216**	1,132
Debt securities in issue	*23*	**5,014**	4,737
Other liabilities	*24*	**16,345**	16,516
Accruals and deferred income		**1,092**	1,066
Provisions for liabilities and charges	*25*		
— deferred taxation		**429**	394
— other provisions for liabilities and charges		**406**	328
Subordinated liabilities	*26*		
— undated loan capital		**1,235**	1,241
— dated loan capital		**2,145**	2,056
Minority interests		**3**	2
Called up share capital	*27*	**797**	797
Share premium account	*28*	**1,973**	1,976
Revaluation reserves	*28*	**51**	65
Profit and loss account	28	**1,959**	1,597
Shareholders' funds (including non-equity interests)		**4,780**	4,435
Total liabilities	*29*	**104,846**	102,076
Memorandum items			
Contingent liabilities	*30*		
— acceptances and endorsements		**1,234**	1,214
— guarantees and assets pledged as collateral security		**7,407**	6,344
— other contingent liabilities		**—**	17
		8,641	7,575
Commitments	*30*	**33,742**	30,482

J R H Bond, *Chairman*
W R P Dalton, *Chief Executive and Director*
D W Baker, *Chief Operating Officer and Director*
I B Marshall, *Secretary*

Balance Sheet of Midland Bank plc at 31 December 1998

	Note	1998 £m	1997 £m
Assets			
Cash and balances at central banks		**527**	555
Items in the course of collection from other banks		**2,043**	2,052
Treasury bills and other eligible bills	*10*	**2,529**	2,952
Loans and advances to banks	*11*	**14,455**	15,968
Loans and advances to customers	*12*	**48,459**	46,793
Debt securities	*15*	**18,347**	16,339
Equity shares	*16*	**12**	19
Interests in associated undertakings	*17*	**75**	67
Investments in subsidiary undertakings	*18*	**1,403**	1,393
Tangible fixed assets	*19*	**1,432**	1,000
Other assets	*20*	**9,028**	8,755
Prepayments and accrued income		**1,498**	788
Total assets	*29*	**99,808**	96,681
Liabilities			
Deposits by banks	*21*	**15,389**	15,637
Customer accounts	*22*	**56,357**	54,238
Items in the course of transmission to other banks		**1,217**	1,132
Debt securities in issue	*23*	**4,667**	4,514
Other liabilities	*24*	**12,626**	12,244
Accruals and deferred income		**1,090**	989
Provisions for liabilities and charges	*25*		
— other provisions for liabilities and charges		**303**	196
Subordinated liabilities	*26*		
— undated loan capital		**1,235**	1,241
— dated loan capital		**2,144**	2,055
Called up share capital	*27*	**797**	797
Share premium account	*28*	**1,973**	1,976
Revaluation reserves	*28*	**153**	107
Profit and loss account	*28*	**1,857**	1,555
Shareholders' funds (including non-equity interests)		**4,780**	4,435
Total liabilities	*29*	**99,808**	96,681
Memorandum items			
Contingent liabilities	*30*		
— acceptances and endorsements		**1,221**	1,197
— guarantees and assets pledged as collateral security		**9,671**	8,554
— other contingent liabilities		**—**	17
		10,892	9,768
Commitments	*30*	**33,253**	29,868

J R H Bond, *Chairman*
W R P Dalton, *Chief Executive and Director*
D W Baker, *Chief Operating Officer and Director*
I B Marshall, *Secretary*

Statement of Total Consolidated Recognised Gains and Losses for the Year Ended 31 December 1998

	1998 £m	*1997* £m	*1996* £m
Profit for the financial year attributable to shareholders	**1,042**	1,051	849
Impairment of land and buildings	**(14)**	—	—
Unrealised surplus on revaluation of land and buildings	**6**	54	22
Exchange and other movements	**3**	(20)	(132)
Total recognised gains and losses for the year	**1,037**	1,085	739

Reconciliation of Movements in Consolidated Shareholders' Funds for the Year Ended 31 December 1998

	1998 £m	*1997* £m	*1996* £m
Profit for the financial year attributable to shareholders	**1,042**	1,051	849
Dividends	**(693)**	(644)	(537)
	349	407	312
Other recognised gains and losses relating to the year	**(5)**	34	(110)
New share capital subscribed	**—**	30	524
Goodwill written back on disposals	**1**	11	—
Goodwill written off on acquisitions	**—**	(7)	(5)
Net addition to shareholders' funds	**345**	475	721
Shareholders' funds at 1 January	**4,435**	3,960	3,239
Shareholders' funds at 31 December	**4,780**	4,435	3,960
Shareholders' funds are analysed as follows:			
Equity interests	**4,258**	3,921	3,491
Non-equity interests	**522**	514	469
	4,780	4,435	3,960

Non-equity interests in shareholders' funds comprise proceeds of the issue of US$ non-cumulative preference shares and the £ preferred ordinary share (Note 27), including share premium and after deducting unamortised issue costs.

No note of historical cost profits and losses has been presented as there is no material difference between Midland's results as disclosed in the consolidated profit and loss account and the results on an unmodified historical cost basis.

Statement of Consolidated Cash Flows for the Year Ended 31 December 1998

	Note	1998 £m	1997 £m	1996 £m
Net cash inflow from operating activities	36	**1,520**	2,442	4,372
Dividends received from associated undertakings		**6**	7	14
Returns on investments and servicing of finance				
Interest paid on finance leases and similar hire purchase contracts		**(14)**	(15)	(10)
Interest paid on subordinated loan capital		**(256)**	(290)	(204)
Dividends paid to minority interests		**—**	(3)	(7)
Preference dividends paid		**(39)**	(39)	(34)
Net cash (outflow) from returns on investments and servicing of finance		**(309)**	(347)	(255)
Taxation paid		**(525)**	(369)	(201)
Capital expenditure and financial investment				
Purchase of investment securities		**(13,078)**	(5,433)	(3,281)
Proceeds from sale of investment securities and amounts repaid		**12,317**	4,916	1,541
Purchase of tangible fixed assets	19	**(892)**	(470)	(407)
Proceeds from sale of tangible fixed assets		**102**	128	121
Net cash (outflow) from capital expenditure and financial investments		**(1,551)**	(859)	(2,026)
Acquisitions and disposals				
Cash acquired with subsidiary undertakings		**—**	178	—
Cash disposed of with subsidiary undertakings		**—**	(702)	—
Net cash outflow from acquisition of interest in subsidiary undertakings		**—**	(448)	(36)
Purchase of interest in associated undertakings and other participating interests		**(19)**	(7)	(41)
Proceeds from disposal of associated undertakings and other participating interests		**2**	33	1
Proceeds from disposal of subsidiary undertakings		**3**	41	—
Net cash (outflow) from acquisitions and disposals		**(14)**	(905)	(76)
Equity dividends paid		**(650)**	(550)	(350)
Net cash (outflow)/inflow before financing		**(1,523)**	(581)	1,478
Financing				
Issue of ordinary share capital		**—**	—	400
Issue of preference share capital		**—**	30	124
Subordinated loan capital issued		**197**	330	620
Subordinated loan capital repaid		**(121)**	(101)	—
Repayment of debt of subsidiary undertaking		**—**	(447)	—
Net cash inflow/(outflow) from financing	36	**76**	(188)	1,144
(Decrease)/increase in cash	36	**(1,447)**	(769)	2,622

Notes on the Accounts

1 Basis of preparation

a The accounts have been prepared under the historical cost convention, as modified by the revaluation of certain investments and land and buildings, and in accordance with applicable accounting standards.

The consolidated accounts are prepared in accordance with the special provisions of Part VII Chapter II of the Companies Act 1985 ('the Act') relating to banking groups.

As permitted by Section 230 of the Act, no profit and loss account is presented for the Bank.

In accordance with Financial Reporting Standard ('FRS') 8 'Related Party Disclosures', no disclosure is presented of transactions with entities that are part of the HSBC Group as all voting rights are controlled by HSBC Holdings plc which publishes its own publicly available accounts.

Midland has adopted the provisions of FRS 9 'Associates and Joint Ventures', FRS 10 'Goodwill and Intangible Assets', FRS 11 'Impairment of Fixed Assets and Goodwill' and FRS 14 'Earnings per Share', together with the British Bankers' Association's revised Statement of Recommended Practice 'Advances'.

Midland has applied the transitional arrangements in FRS 10 and goodwill previously eliminated against reserves has not been reinstated.

b Midland's consolidated accounts comprise the accounts of Midland Bank plc ('the Bank') and its subsidiary undertakings (together 'Midland'). Accounts of subsidiary undertakings are made up to 31 December.

The consolidated accounts include the attributable share of the results and reserves of associated undertakings, based on accounts made up to dates not earlier than six months prior to 31 December.

All significant intra-group transactions have been eliminated on consolidation.

A review of the classification of insurance provisions has resulted in the reclassification of amounts previously included in 'Accruals and deferred income' to 'Other provisions for liabilities and charges'. The 1997 comparatives have been restated accordingly.

2 Principal accounting policies

a *Income recognition*

Interest income is recognised in the profit and loss account as it accrues, except in the case of doubtful debts (Note 2b).

Fee income is accounted for in the period when receivable, except where the fee is charged to cover the costs of a continuing service to, or risk borne for, the customer, or is interest in nature. In these cases, the fee is recognised on an appropriate basis over the relevant period.

b *Loans and advances and doubtful debts*

Specific provision is made for doubtful debts as and when they are so considered and, in addition, amounts have been set aside as general provisions for doubtful debts. The specific element relates to individual banking relationships; the general element relates to other exposures not separately identified but known from experience to exist in any portfolio of banking relationships. When there is no longer any realistic prospect of recovery, the outstanding debt is written off.

Interest on doubtful debts is credited to a suspense account which is netted in the balance sheet against the relevant balances.

Assets acquired in exchange for advances in order to achieve an orderly realisation continue to be reported as advances. The asset acquired is recorded at the carrying value of the advance disposed of at the date of the exchange, and provisions are based on any subsequent deterioration in its value.

Midland's residential mortgage origination activities are supported by a range of incentive arrangements, principally discounted rates for the first year and, to a lesser extent, cashbacks. The costs of these incentives are charged to the profit and loss account as they arise.

Notes on the Accounts (continued)

2 Principal accounting policies *(continued)*

c *Debt securities and equity shares*

Debt securities and equity shares intended to be held on a continuing basis are disclosed as investment securities and are included in the balance sheet at cost less provision for any permanent diminution in value.

Where dated investment securities have been purchased at a premium or discount, these premiums and discounts are amortised through the profit and loss account over the period from the date of purchase to the date of maturity. If the date of maturity is at the borrower's option within a specified range of years, the maturity date which gives the most conservative result is adopted. These securities are included in the balance sheet at cost adjusted for the amortisation of premiums and discounts arising on acquisition. The amortisation of premiums and discounts is included in 'Interest receivable'. Any profit or loss on realisation of these securities is recognised in the profit and loss account as it arises and included in 'Gains on disposal of investments'.

Debt securities held for the purpose of hedging are valued on the same basis as the liabilities which are being hedged.

Other debt securities and equity shares are included in the balance sheet at market value. Changes in the market value of such assets are recognised in the profit and loss account as 'Dealing profits' as they arise.

Where securities are sold subject to a commitment to repurchase them at a predetermined price, they remain on the balance sheet and a liability is recorded in respect of the consideration received. Conversely, securities purchased under analogous commitments to resell are not recognised on the balance sheet and the consideration paid is recorded in 'Loans and advances to customers' or 'Loans and advances to banks'.

d *Subsidiary and associated undertakings*

The Bank's investments in subsidiary undertakings are stated at attributable net asset values with the exception of Midland's interest in long-term assurance business as explained in Note 2g below. Changes in net assets of subsidiary undertakings of the Bank are accounted for as movements in the revaluation reserve.

Interests in associated undertakings are stated at Midland's attributable share of their net assets.

Goodwill arises on the acquisition of subsidiary or associated undertakings when the cost of acquisition exceeds the fair value of Midland's share of separable net assets acquired. For acquisitions made on or after 1 January 1998, goodwill is included in the balance sheet and is amortised over its estimated life on a straight-line basis. For acquisitions prior to 1 January 1998, goodwill was charged against reserves in the year of acquisition.

At the date of disposal of subsidiary or associated undertakings, any unamortised goodwill, or goodwill charged to reserves, is included in Midland's share of total net assets of the undertaking in the calculation of the profit or loss on disposal of the undertaking.

e *Tangible fixed assets*

Land and buildings are stated at valuation or cost less depreciation calculated to write off the assets over their estimated useful lives as follows:

- freehold land and land held on leases with more than 50 years to expiry are not depreciated;
- land held on leases with 50 years or less to expiry is depreciated over the unexpired terms of the leases;
- buildings and improvements thereto are depreciated on cost or valuation at the greater of 2 per cent per annum on the straight line basis or over the unexpired terms of the leases.

Equipment, fixtures and fittings are stated at cost less depreciation calculated on the straight line basis to write off the assets over their estimated useful lives, which are generally between five and 20 years.

Operating lease assets are depreciated over their useful economic lives such that, for each asset, rentals (Note 2f) less depreciation are recognised at a constant periodic rate of return on the net cash invested in that asset.

2 Principal accounting policies *(continued)*

f *Finance and operating leases*

Assets leased to customers under agreements which transfer substantially all the risks and rewards associated with ownership, other than legal title, are classified as finance leases. Where Midland is a lessor under finance leases, the amounts due under finance leases, and under hire purchase contracts which are in the nature of finance leases, after deduction of unearned charges, are included in 'Loans and advances to banks' or 'Loans and advances to customers'. Finance charges receivable are recognised over the periods of the leases in proportion to the funds invested after taking into account the effects of taxation.

Where Midland is a lessee under finance leases, the leased assets are capitalised and included in 'Tangible fixed assets' and the corresponding liability to the lessor is included in 'Other liabilities'. Finance charges payable are recognised over the periods of the leases, based on the interest rates implicit in the leases.

All other leases are classified as operating leases and, where Midland is the lessor, are included in 'Tangible fixed assets'. Rentals payable and receivable under operating leases are accounted for on the straight line basis over the periods of the leases and are included in 'Administrative expenses' and 'Other operating income' respectively.

g *Long-term assurance business*

The value placed on Midland's interest in long-term assurance business includes a prudent valuation of the future earnings expected to emerge from business currently in force, together with the surplus retained in the long-term assurance funds. These are determined annually in consultation with independent actuaries and are included in 'Other assets'.

Changes in the value placed on Midland's interest in long-term assurance business are calculated on a post-tax basis and reported in the profit and loss account as part of 'Other operating income' after adjusting for the effective rate of taxation.

Long-term assurance assets and liabilities attributable to policyholders are recognised in Midland's accounts.

h *Deferred taxation*

Deferred taxation is provided on timing differences, using the liability method, between the accounting and taxation treatment of income and expenditure. Provision is made for deferred tax only to the extent that it is probable that an actual liability will crystallise. Deferred tax assets are recognised when recovery is anticipated in the near future without replacement by equivalent assets.

i *Pension and other post-retirement benefits*

Midland operates a number of pension and other post-retirement benefit schemes throughout the world and the majority of staff are members of defined benefit schemes.

For UK defined benefit pension schemes annual contributions are made, on the advice of qualified actuaries, for funding of retirement benefits in order to build up reserves for each scheme member during the employee's working life and used to pay a pension to the employee or dependant after retirement. The costs of providing these benefits are charged to the profit and loss account on a regular basis.

Arrangements for staff retirement benefits in overseas locations vary from country to country and are made in accordance with local regulations and custom.

The cost of providing post-retirement health-care benefits, which is assessed in accordance with the advice of qualified actuaries, is recognised on a systematic basis over employees' service lives. At 1 January 1993, there was an accumulated obligation in respect of these benefits relating to current and retired employees. This is being charged in the profit and loss account in equal instalments over 20 years.

Notes on the Accounts (continued)

2 Principal accounting policies *(continued)*

j *Foreign currencies*

Assets and liabilities denominated in foreign currencies are translated into sterling at the rates of exchange ruling at the year-end. The results of overseas branches and subsidiary and associated undertakings are translated into sterling at the average rates of exchange for the year.

Exchange differences arising from the retranslation of opening foreign currency net investments and the related cost of hedging and exchange differences arising from retranslation of the result for the year from the average rate to the exchange rate ruling at the year-end are accounted for in reserves.

Other exchange differences are recognised in the profit and loss account.

k *Off-balance-sheet financial instruments*

Off-balance-sheet financial instruments arise from futures, forward, swap and option transactions undertaken by Midland in the foreign exchange, interest rate and equity markets.

Accounting for these instruments is dependent upon whether the transactions are undertaken for trading or non-trading purposes. Trading transactions include transactions undertaken for market-making, to service customers' needs and for proprietary purposes, as well as any related hedges. Non-trading transactions are those which are held for hedging purposes as part of Midland's risk management strategy against assets, liabilities, positions or cash flows measured on an accruals basis.

Transactions undertaken for trading purposes are marked to market value and the net present value of any gain or loss arising is recognised in the profit and loss account as 'Dealing profits', after appropriate deferrals for unearned credit margin and future servicing costs.

Non-trading transactions are accounted for on an equivalent basis to the underlying assets, liabilities or net positions. Any profit or loss arising is recognised on the same basis as that arising from the related assets, liabilities or positions.

Assets, including gains, resulting from off-balance-sheet interest rate, exchange rate and equities contracts which are marked to market are included in 'Other assets'. Liabilities, including losses, resulting from such contracts, are included in 'Other liabilities'.

3 Dividend income

	1998	*1997*	*1996*
	£m	£m	£m
Income from equity shares	2	11	3

4 Administrative expenses

	1998 £m	*1997* £m	*1996* £m
a *Staff costs*			
— wages and salaries	**974**	1,062	1,033
— social security costs	**83**	86	84
— other pension costs (Note 4b below)	**112**	122	139
— other staff costs	**103**	77	111
	1,272	1,347	1,367
Premises and equipment (excluding depreciation)	**262**	275	283
Other administrative expenses	**472**	470	414
	734	745	697
	2,006	2,092	2,064

In 1998 the costs of temporary staff have been reclassified from 'other staff costs' to 'other administrative expenses'. Prior year comparative figures have been restated accordingly.

The average number of persons employed by Midland during the year was made up as follows:

	1998	*1997*	*1996*
Banking	**46,122**	47,107	46,839
Asset Finance	**2,284**	2,206	2,546
	48,406	49,313	49,385

b *Retirement benefits*

Within Midland, the Midland Bank Pension Scheme, assets of which are held in a separate trust fund, covers 93 per cent of UK employees. The Midland Bank Pension Scheme comprises a funded defined benefit scheme ('the Principal Scheme'), and a defined contribution scheme which was established on 1 July 1996 for new employees.

Actuarial valuations of the assets and liabilities of the Principal Scheme are carried out triennially by professionally qualified actuaries to determine its financial position and to enable the Bank to determine the level of contributions to be made to the Principal Scheme.

The latest valuation of the Principal Scheme was made at 31 December 1996 by C G Singer, Fellow of the Institute of Actuaries, of Watson Wyatt Partners. At that date the market value of the Principal Scheme's assets was £4,463 million. The actuarial value of the assets represented 107 per cent of the benefits accrued to members, after allowing for expected future increases in earnings and the resulting surplus amounted to £301 million. The method adopted for this valuation was the projected unit method and the main assumptions used were a long-term investment return of 7.6 per cent per annum, salary increases of 4.5 per cent per annum, equity dividend increases and rental growth of 3.5 per cent per annum, and post-retirement pension increases of 3.0 per cent per annum.

As a result of the Finance (No. 2) Act 1997 which came into force in July 1997, pension schemes are no longer able to claim a tax credit on UK equity dividend income. The actuaries have estimated that the effect of this on the Principal Scheme will be largely to offset the surplus shown by the 31 December 1996 valuation and the Bank is accounting for this over the average remaining service lives of the employees in the Principal Scheme in accordance with Urgent Issues Task Force Abstract number 18.

In consultation with the actuaries, the Bank has decided to maintain contributions at 16.1 per cent of pensionable salaries until the next actuarial valuation. The next actuarial valuation is due as at 31 December 1999.

The total pension cost for the year ended 31 December 1998 was £112 million (1997: £122 million; 1996: £139 million) which includes £97 million (1997: £101 million; 1996: £104 million) in respect of the Principal Scheme.

Notes on the Accounts (continued)

4 **Administrative expenses** *(continued)*

b *Retirement benefits (continued)*

Midland also provides post-retirement health-care benefits for certain pensioners and employees, together with their dependent relatives. An actuarial assessment of the liabilities of the scheme, which is unfunded, is carried out on a regular basis by qualified actuaries. The liabilities are evaluated by discounting the expected future claims to a net present value.

The charge relating to post-retirement health-care benefits was £11 million (1997: £17 million; 1996: £17 million).

The latest actuarial assessment, which was made at 31 December 1997, estimated the present value of the post-retirement benefit obligation to be £124 million for Midland and £117 million for the Bank, of which £77 million (1997: £69 million) has been provided for Midland and £72 million (1997: £65 million) has been provided for the Bank. The main financial assumptions used at 31 December 1997 were price inflation of 3 per cent per annum, health-care claims costs escalation of 8.5 per cent per annum, and a discount rate of 7 per cent per annum. The next actuarial assessment will be performed as at 31 December 2000.

c *Directors' emoluments*

The aggregate emoluments of the Directors of the Bank, computed in accordance with Part I of Schedule 6 of the Act were:

	1998	*1997*
	£'000	£'000
Fees	**252**	240
Salaries and other emoluments	**822**	2,019
Discretionary bonuses	**222**	230
	1,296	2,489
Gains on exercise of share options	**68**	232

Aggregate contributions during the year to money purchase pension schemes were £129,000 (1997: £ nil).

Retirement benefits accrue to two Directors under defined benefit schemes and to one Director under a money purchase scheme.

Discretionary bonuses for Directors are based on a combination of individual and corporate performance and are determined by the Group Remuneration Committee of HSBC Holdings plc.

Details of individual Directors' remuneration are disclosed in the 'Report of the Directors' on page 57.

In addition, there are annual commitments under retirement benefit agreements with former Directors of £463,807 (1997: £460,198).

4 Administrative expenses *(continued)*

d *Auditor's remuneration*

Auditor's remuneration amounted to £1.8 million (1997: £2.3 million; 1996: £2.5 million) including £1.0 million (1997: £1.1 million; 1996: £1.1 million) which relates to the Bank. £0.9 million (1997: £2.2 million; 1996: £1.3 million) was paid to the Bank's Auditor and its associates for non-audit work as analysed below:

	1998	*1997*	*1996*
	£'000	£'000	£'000
Regulatory work	**545**	725	580
Tax services	**117**	179	110
Consultancy	**7**	471	423
Acquisition services	**—**	550	—
Other	**193**	307	184
	862	2,232	1,297

Of fees paid to the Auditor for non-audit work, £ nil (1997: £0.6 million; 1996: £ nil) was capitalised as part of the cost of acquisitions made during the year.

5 Profit on ordinary activities before tax

Profit on ordinary activities before tax is stated after:

Income

	1998	*1997*	*1996*
	£m	£m	£m
Aggregate rentals receivable, including capital repayments, under			
— finance leases	**527**	301	221
— hire purchase contracts	**727**	557	560
— operating leases	**300**	245	107
Increase in the value of long-term assurance business	**73**	39	72
Profits less losses on debt securities and equities dealing	**17**	(16)	32
Gain on disposal of investment securities	**26**	20	94

Charges

	1998	*1997*	*1996*
	£m	£m	£m
Charges incurred with respect to subordinated liabilities	**254**	250	224
Finance charges in respect of finance leases and similar hire purchase contracts	**14**	14	7
Hire of plant and machinery	**5**	6	21
Rentals payable on premises held under operating leases	**69**	76	86
Residential mortgage incentives	**36**	45	66

Gains on disposal of investments and tangible fixed assets

Gains on disposal of investments and tangible fixed assets attracted a tax charge of £9 million (1997: £8 million; 1996: £ nil).

Notes on the Accounts (continued)

6 Tax on profit on ordinary activities

The charge for taxation comprises:

	1998 £m	*1997* £m	*1996* £m
United Kingdom corporation tax charge	**423**	455	357
Relief for overseas taxation	**(8)**	(12)	(13)
	415	443	344
Advance corporation tax written back	**—**	—	(12)
United Kingdom corporation tax – prior year	**(11)**	(6)	(24)
	404	437	308
Overseas taxation	**18**	39	43
Deferred taxation (Note 25)	**57**	82	52
	479	558	403
Associated undertakings	**—**	1	5
	479	559	408

During the year Midland provided for UK corporation tax at 31 per cent (1997: 31.5 per cent; 1996: 33 per cent).

The tax charge includes £22 million (1997: £12 million; 1996: £24 million) in respect of the tax attributable to the increase in the value of long-term assurance business attributable to shareholders.

7 Profit of the Bank

The profit of the Bank for the year attributable to shareholders is £984 million (1997: £1,151 million; 1996: £820 million).

8 Dividends

	1998 £m	*1997* £m	*1996* £m
Equity			
Ordinary dividends			
— paid	**300**	250	200
— proposed	**350**	350	300
	650	600	500
Non-equity			
Preference dividends	**39**	36	34
Other finance costs	**4**	8	3
	693	644	537

Non-cumulative dividends of US$1.42 and US$0.355 per share per annum are payable on the Series A1 and the Series A2 US$ preference shares respectively in quarterly instalments.

Non-cumulative dividends of US$1.64 and US$0.41 per share per annum are payable on the Series B1 and the Series B2 US$ preference shares respectively in quarterly instalments.

Non-cumulative dividends of US$1.46 and US$0.365 per share per annum are payable on the Series C1 and the Series C2 US$ preference shares respectively in quarterly instalments.

8 Dividends *(continued)*

Non-cumulative dividends of US$1.528 and US$0.382 per share per annum are payable on the Series D1 and the Series D2 US$ preference shares respectively in quarterly instalments.

Non-cumulative dividends of US$1.344 and US$0.336 per share per annum are payable on the Series 1 and Series 2 US$ Second preference shares respectively in quarterly instalments.

9 Earnings per ordinary share

Basic and diluted earnings per ordinary share are calculated by dividing the profit for the financial year attributable to equity shareholders, after deducting preference dividends and finance costs, of £999 million (1997: £1,007 million; 1996: £812 million) by the weighted average number of ordinary shares in issue in 1998 of 797 million (1997: 797 million; 1996: 797 million).

10 Treasury bills and other eligible bills

	Midland		Bank	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Treasury bills and similar securities	**1,414**	1,291	**1,381**	1,269
Other eligible bills	**1,148**	1,683	**1,148**	1,683
	2,562	2,974	**2,529**	2,952

None of the treasury and other eligible bills have been accounted for as investment securities.

11 Loans and advances to banks

	Midland		Bank	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Remaining maturity				
— repayable on demand	**2,700**	4,130	**2,874**	3,987
— 3 months or less but not repayable on demand	**6,304**	7,696	**7,747**	9,712
— 1 year or less but over 3 months	**1,021**	900	**1,190**	912
— 5 years or less but over 1 year	**964**	216	**1,359**	385
— over 5 years	**534**	456	**1,292**	990
Specific bad and doubtful debt provisions (Note 13)	**(7)**	(19)	**(7)**	(18)
	11,516	13,379	**14,455**	15,968
Amounts include:				
Subordinated			**246**	216
Due from subsidiary undertakings				
— subordinated			**246**	216
— unsubordinated			**3,795**	3,899
			4,041	4,115
Due from fellow subsidiary undertakings				
— unsubordinated	**1,889**	1,670	**1,865**	1,625

Notes on the Accounts (continued)

12 Loans and advances to customers

	Midland		Bank	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Remaining maturity				
— repayable on demand or at short notice	**8,339**	8,211	**8,419**	8,149
— 3 months or less but not repayable on demand or at short notice	**6,066**	7,140	**5,479**	6,891
— 1 year or less but over 3 months	**5,634**	5,261	**4,791**	4,446
— 5 years or less but over 1 year	**15,801**	14,441	**14,388**	12,614
— over 5 years	**17,546**	16,181	**16,364**	15,732
General and specific bad and doubtful debt provisions (Note 13)	**(1,015)**	(1,091)	**(982)**	(1,039)
	52,371	50,143	**48,459**	46,793
Amounts include:				
Due from subsidiary undertakings				
— unsubordinated			**951**	1,341
Due from fellow subsidiary undertakings				
— unsubordinated	**730**	1,330	**730**	1,330
Due from parent undertaking				
— unsubordinated	**85**	21	**85**	21
Due from associated undertakings				
— unsubordinated	**6**	31	**6**	20

Included within loans and advances to customers are equity shares with a book value of £17 million (1997: £19 million) acquired in exchange for advances with an original face value of £137 million (1997: £84 million).

13 Provisions for bad and doubtful debts

a *Movements on provisions for bad and doubtful debts*

	Specific	*General*	*Total*	*Specific*	*General*	*Total*
	1998	**1998**	**1998**	*1997*	*1997*	*1997*
Midland	**£m**	**£m**	**£m**	£m	£m	£m
At 1 January	**788**	**322**	**1,110**	991	287	1,278
Charge to the profit and loss account	**175**	**21**	**196**	92	37	129
Amounts written off	**(341)**	**—**	**(341)**	(208)	—	(208)
Disposal of subsidiary undertakings	**—**	**—**	**—**	(122)	(6)	(128)
Recoveries of amounts written off in previous years	**41**	**—**	**41**	36	—	36
Exchange and other movements	**21**	**(5)**	**16**	(1)	4	3
At 31 December	**684**	**338**	**1,022**	788	322	1,110
Bank						
At 1 January	**766**	**291**	**1,057**	836	251	1,087
Charge to the profit and loss account	**182**	**20**	**202**	95	40	135
Amounts written off	**(330)**	**—**	**(330)**	(193)	—	(193)
Recoveries of amounts written off in previous years	**39**	**—**	**39**	25	—	25
Exchange and other movements	**21**	**—**	**21**	3	—	3
At 31 December	**678**	**311**	**989**	766	291	1,057

	Midland		**Bank**	
	1998	*1997*	**1998**	*1997*
Included in:	**£m**	£m	**£m**	£m
Loans and advances to banks (Note 11)	**7**	19	**7**	18
Loans and advances to customers (Note 12)	**1,015**	1,091	**982**	1,039
	1,022	1,110	**989**	1,057

Notes on the Accounts (continued)

13 Provisions for bad and doubtful debts *(continued)*

b *Movements on suspended interest account*

	Midland			Bank		
	1998	*1997*	*1996*	**1998**	*1997*	*1996*
	£m	£m	£m	**£m**	£m	£m
At 1 January	**95**	123	152	**94**	113	131
Interest suspended in the year	**33**	33	39	**33**	32	35
Suspended interest recovered	**(17)**	(28)	(52)	**(17)**	(28)	(50)
Amounts written off	**(45)**	(22)	(10)	**(45)**	(22)	1
Disposal of subsidiary undertakings	—	(10)	—	—	—	—
Exchange and other movements	**(18)**	(1)	(6)	**(18)**	(1)	(4)
At 31 December	**48**	95	123	**47**	94	113

c *Non-performing loans*

	Midland		Bank	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Loans on which interest has been suspended (net of suspended interest)	**691**	865	**670**	848
Provisions	**(395)**	(516)	**(398)**	(503)
	296	349	**272**	345
Other non-performing loans	**555**	556	**541**	536
Provisions	**(289)**	(272)	**(280)**	(263)
	266	284	**261**	273
Total non-performing loans (net of provisions)	**562**	633	**533**	618

14 Concentrations of exposure

Midland has the following industry concentrations of loans and advances to customers:

	1998	*1997*
	£m	£m
Total gross advances to customers:		
Residential mortgages	**12,347**	11,342
Other personal	**6,412**	5,528
Commercial, industrial and international trade	**15,597**	15,952
Commercial real estate	**3,406**	2,769
Other property related	**1,241**	1,160
Non-bank financial institutions	**3,767**	4,652
Other commercial	**10,663**	9,919
	53,433	51,322

The analysis of concentration of exposure is based on the categories used by Midland to manage the associated risks. Of total loans and advances to customers gross of provisions, £50,716 million (1997: £49,147 million) was advanced by operations located in the United Kingdom.

15 Debt securities

	Midland				Bank			
	Book value	*Market valuation*	*Book value*	*Market valuation*	*Book value*	*Market valuation*	*Book value*	*Market valuation*
	1998	**1998**	*1997*	*1997*	**1998**	**1998**	*1997*	*1997*
	£m	**£m**	£m	£m	**£m**	**£m**	£m	£m
Issued by public bodies								
Investment securities								
— government securities and US Government agencies	**6,735**	**6,800**	5,418	5,495	**6,425**	**6,491**	5,384	5,460
— other public sector securities	**112**	**114**	45	47	**112**	**113**	45	47
	6,847	**6,914**	5,463	5,542	**6,537**	**6,604**	5,429	5,507
Other debt securities								
— government securities and US Government agencies	**3,322**		2,392		**3,298**		1,495	
— other public sector securities	**17**		63		**17**		63	
	3,339		2,455		**3,315**		1,558	
Issued by other bodies								
Investment securities	**877**	**885**	1,176	1,183	**824**	**832**	1,116	1,123
Other debt securities								
— bank and building society certificates of deposit	**5,833**		6,090		**5,833**		6,029	
— other securities	**1,838**		2,234		**1,838**		2,207	
	7,671		8,324		**7,671**		8,236	
	18,734		17,418		**18,347**		16,339	
Due within 1 year	**13,490**		9,843		**13,410**		9,624	
Due 1 year and over	**5,244**		7,575		**4,937**		6,715	
	18,734		17,418		**18,347**		16,339	
Amounts include:								
Subordinated debt securities	**60**		64		**60**		64	
Unamortised net premiums on investment securities	**103**		3		**102**		3	
Investment securities								
— listed on a recognised UK exchange	**3,312**	**3,339**	3,303	3,313	**3,215**	**3,241**	3,209	3,219
— listed elsewhere	**1,899**	**1,933**	1,113	1,172	**1,898**	**1,933**	1,113	1,172
— unlisted	**2,513**	**2,527**	2,223	2,240	**2,248**	**2,262**	2,223	2,239
	7,724	**7,799**	6,639	6,725	**7,361**	**7,436**	6,545	6,630
Other debt securities								
— listed on a recognised UK exchange	**3,375**		1,706		**3,375**		781	
— listed elsewhere	**949**		2,015		**925**		2,015	
— unlisted	**6,686**		7,058		**6,686**		6,998	
	11,010		10,779		**10,986**		9,794	
	18,734		17,418		**18,347**		16,339	

Notes on the Accounts (continued)

15 Debt securities *(continued)*

Where securities are carried at market valuation, and the market valuation is higher than cost, the difference between cost and market valuation is not disclosed as it cannot be determined without unreasonable expense.

The above market valuations do not take account of transactions entered into to hedge the value of Midland's investment securities. If these transactions were included, the market valuation of investment securities would be £7,767 million for Midland (1997: £6,681 million) and £7,404 million (1997: £6,586 million) for the Bank.

Investment securities:

	Cost	*Provisions*	*Book value*
	£m	**£m**	**£m**
Midland			
At 1 January 1998	**6,640**	**(1)**	**6,639**
Additions	**13,077**	**—**	**13,077**
Disposals and amounts repaid	**(12,287)**	**1**	**(12,286)**
Amortisation of discounts and premiums	**(78)**	**—**	**(78)**
Exchange and other movements	**372**	**—**	**372**
At 31 December 1998	**7,724**	**—**	**7,724**
Bank			
At 1 January 1998	**6,545**	**—**	**6,545**
Additions	**13,039**	**—**	**13,039**
Disposals and amounts repaid	**(12,515)**	**—**	**(12,515)**
Amortisation of discounts and premiums	**(79)**	**—**	**(79)**
Exchange and other movements	**371**	**—**	**371**
At 31 December 1998	**7,361**	**—**	**7,361**

16 Equity shares

	Midland				**Bank**			
	Book value	*Market valuation*	*Book value*	*Market valuation*	*Book value*	*Market valuation*	*Book value*	*Market valuation*
	1998	**1998**	*1997*	*1997*	**1998**	**1998**	*1997*	*1997*
	£m	**£m**	£m	£m	**£m**	**£m**	£m	£m
Investment securities								
– listed other than on a recognised UK exchange	**—**	**—**	2	2	**—**	**—**	2	2
– unlisted	**15**	**20**	18	25	**12**	**17**	17	24
	15	**20**	20	27	**12**	**17**	19	26

Where securities are carried at market valuation, and the market valuation is higher than cost, the difference between cost and market valuation is not disclosed as it cannot be determined without unreasonable expense.

16 Equity shares *(continued)*

Investment securities:

	Cost	*Provisions*	*Book value*
	£m	**£m**	**£m**
Midland			
At 1 January 1998	**22**	**(2)**	**20**
Additions	**1**	**—**	**1**
Disposals	**(6)**	**1**	**(5)**
Provisions made	**—**	**(1)**	**(1)**
At 31 December 1998	**17**	**(2)**	**15**
Bank			
At 1 January 1998	**21**	**(2)**	**19**
Additions	**1**	**—**	**1**
Disposals	**(6)**	**1**	**(5)**
Provisions made	**—**	**(1)**	**(1)**
Exchange and other movements	**(2)**	**—**	**(2)**
At 31 December 1998	**14**	**(2)**	**12**

17 Interests in associated undertakings

a *Movements in associated undertakings*

	Midland	**Bank**
	£m	**£m**
At 1 January 1998	**68**	**67**
Additions	**17**	**17**
Write-down to net asset value	**—**	**(9)**
Retained losses	**(7)**	**—**
Exchange and other movements	**1**	**—**
At 31 December 1998	**79**	**75**

	Midland		**Bank**	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Shares in banks	**63**	62	**63**	62
Other	**16**	6	**12**	5
	79	68	**75**	67

None of the associated undertakings are listed.

On the historical cost basis, the Bank's interests in associated undertakings would have been included as follows:

	1998	*1997*
	£m	£m
Cost	**100**	83
Provisions	**(9)**	(9)
	91	74

Notes on the Accounts (continued)

17 Interests in associated undertakings *(continued)*

b *The principal associated undertakings are:*

	Country of incorporation/ registration and operation	*Principal activity*	*Midland's interest in equity capital*
British Arab Commercial Bank Limited	England	Banking	41.5%
British Interactive Broadcasting Limited	England	Digital interactive services	20%
Mondex Holdings Limited	England	Electronic cash	
£1 ordinary A shares			50% *
£1 ordinary B shares			47.5% *
£1 ordinary C shares			50% *
£1 ordinary D shares			50% *

* *The rights attaching to the classes of share vary. The principal rights are the voting rights in Mondex Holdings Limited, which are carried by the A shares, and the beneficial ownership of the Mondex franchise operation in the United Kingdom, which is carried by the B shares.*

18 Investments in subsidiary undertakings

a *Movements on the Bank's interests in shares in subsidiary undertakings*

	£m
At 1 January 1998	**1,393**
Disposals	**(3)**
Repayments	**(38)**
Provisions made	**2**
Revaluation to net asset value	**51**
Exchange and other movements	**(2)**
At 31 December 1998	**1,403**

The above amount represents the direct interests of the Bank in its subsidiary undertakings. None of these interests are listed. Interests in subsidiary undertakings include £14 million (1997: £14 million) representing interests in banks.

On the historical cost basis, the Bank's interests in subsidiary undertakings would have been included as follows:

	1998 **£m**	*1997* £m
Cost	**1,324**	1,392
Provisions	**(37)**	(63)
	1,287	1,329

18 Investments in subsidiary undertakings *(continued)*

b *The principal subsidiary undertakings of the Bank are:*

	Country of registration/ incorporation and operation
Forward Trust Group Limited *	England
Forward Trust Rail Limited *	England
Griffin Credit Services Limited *	England
Midland Bank Trust Company Limited	England
Midland Bank Offshore Limited *	Jersey
Midland Life Limited	England

****Equity capital held indirectly***

The issued capital of the above undertakings is wholly-owned by Midland and, except where indicated otherwise, is held by the Bank. During the year, the business of HSBC Greenwell, formerly disclosed as a principal subsidiary undertaking of the Bank, was transferred to the Bank.

Midland's interests in Trinkaus & Burkhardt KGaA and Guyerzeller Bank AG were both transferred to a fellow subsidiary undertaking of HSBC Holdings plc on 31 December 1997.

Details of all subsidiary undertakings will be annexed to the next Annual Return of the Bank. All of the above subsidiary undertakings are engaged in the business of banking or other financial services.

Notes on the Accounts (continued)

19 Tangible fixed assets

a *Movements on tangible fixed assets*

	Freehold land and buildings	*Long leasehold land and buildings*	*Short leasehold land and buildings*	*Equipment, fixtures and fittings*	*Equipment on operating leases*	*Total*
Midland	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Cost or valuation						
At 1 January 1998	**612**	**52**	**210**	**967**	**2,043**	**3,884**
Additions	**17**	**419**	**7**	**172**	**277**	**892**
Disposals	**(33)**	—	**(5)**	**(136)**	**(149)**	**(323)**
Transfer of accumulated depreciation arising on revaluation	**(21)**	**(3)**	—	—	—	**(24)**
(Deficit)/surplus on revaluation	**(13)**	**5**	—	—	—	**(8)**
Exchange and other movements	**(1)**	—	**1**	**(1)**	—	**(1)**
At 31 December 1998	**561**	**473**	**213**	**1,002**	**2,171**	**4,420**
Accumulated depreciation						
At 1 January 1998	—	—	**(143)**	**(549)**	**(426)**	**(1,118)**
Disposals	**2**	—	**4**	**123**	**98**	**227**
Transfer of accumulated depreciation arising on revaluation	**21**	**3**	—	—	—	**24**
Charge to the profit and loss account	**(26)**	**(3)**	**(5)**	**(122)**	**(135)**	**(291)**
Exchange and other movements	—	—	—	—	**(12)**	**(12)**
At 31 December 1998	**(3)**	—	**(144)**	**(548)**	**(475)**	**(1,170)**
Net book value						
At 31 December 1998	**558**	**473**	**69**	**454**	**1,696**	**3,250**
At 31 December 1997	612	52	67	418	1,617	2,766

19 Tangible fixed assets (continued)

a *Movements on tangible fixed assets (continued)*

	Freehold land and buildings	*Long leasehold land and buildings*	*Short leasehold land and buildings*	*Equipment, fixtures and fittings*	*Equipment on operating leases*	*Total*
Bank	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Cost or valuation						
At 1 January 1998	492	42	188	896	—	1,618
Additions	12	419	11	163	—	605
Disposals	(32)	—	(5)	(115)	—	(152)
Transfer of accumulated depreciation arising on revaluation	(8)	(3)	—	—	—	(11)
Surplus on revaluation	2	5	—	—	—	7
Exchange and other movements	(1)	—	1	(1)	—	(1)
At 31 December 1998	**465**	**463**	**195**	**943**	**—**	**2,066**
Accumulated depreciation						
At 1 January 1998	—	—	(117)	(501)	—	(618)
Disposals	2	—	4	103	—	109
Transfer of accumulated depreciation arising on revaluation	8	3	—	—	—	11
Charge to the profit and loss account	(13)	(3)	(7)	(113)	—	(136)
At 31 December 1998	**(3)**	**—**	**(120)**	**(511)**	**—**	**(634)**
Net book value						
At 31 December 1998	**462**	**463**	**75**	**432**	**—**	**1,432**
At 31 December 1997	492	42	71	395	—	1,000

b *Assets held under finance leases*

The net book amount of equipment, fixtures and fittings included assets held under finance leases of £8 million (1997: £5 million) for Midland and £39 million (1997: £49 million) for the Bank, on which the depreciation charge was £4 million (1997: £3 million) for Midland and £19 million (1997: £16 million) for the Bank. The net book amount of equipment on operating leases included assets held under finance leases of £132 million (1997: £132 million) for Midland on which the depreciation charge was £ nil (1997: £ nil).

c *Valuations*

	Midland		**Bank**	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Cost or valuation of freehold and long leasehold land and buildings:				
At valuation	**615**	664	**509**	534
At cost	**419**	—	**419**	—
	1,034	664	**928**	534
On the historical cost basis, freehold and long leasehold land and buildings would have been included as follows:				
Cost	**1,047**	653	**845**	452
Accumulated depreciation	**(211)**	(200)	**(121)**	(121)
Net book value	**836**	453	**724**	331

Notes on the Accounts (continued)

19 Tangible fixed assets *(continued)*

c *Valuations (continued)*

Midland values its freehold and long leasehold properties on an annual basis. In November 1998, Midland's freehold and long leasehold properties were revalued on an existing use basis or open market value as appropriate or, in the case of a few specialised properties, at depreciated replacement cost. The properties were revalued either by professional external valuers or by professionally qualified staff.

As a result of the revaluation, there was a deficit below the net book value of land and buildings of £17 million (Bank £7 million). £9 million (Bank £ nil) has been charged to the profit and loss account as an impairment loss and is included in 'Depreciation and amortisation'. Other impairment losses of £14 million (Bank £ nil) and the remaining surplus of £6 million (Bank £7 million) have been included in the revaluation reserve at 31 December 1998.

d *Land and buildings occupied for own activities*

	Midland		Bank	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Net book value	**639**	677	**565**	590

Land and buildings with a net book value of £35 million (1997: £46 million) are occupied by other members of the HSBC Group.

e *Payment on account*

Included in the cost and net book value of long leasehold land and buildings is a payment on account in respect of a long leasehold interest of £419 million (1997: £ nil).

20 Other assets

	Midland		Bank	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Bullion	**214**	161	**214**	161
Assets, including gains, resulting from off-balance-sheet interest rate, exchange rate and equities contracts which are marked to market	**8,091**	7,568	**8,073**	7,550
Deferred taxation (Note 25)	**—**	—	**49**	35
Long-term assurance assets attributable to policyholders (Note 24)	**2,678**	2,489	**—**	—
Other	**1,453**	1,609	**692**	1,009
	12,436	11,827	**9,028**	8,755
Assets, including gains, resulting from off-balance-sheet interest rate, exchange rate and equities contracts which are marked to market include unsubordinated amounts due from:				
Subsidiary undertakings			**59**	36
Fellow subsidiary undertakings	**647**	596	**646**	558

Included within 'Other' in the above table is £2 million (1997: £3 million) for Midland and £2 million (1997: £1 million) for the Bank in respect of other participating interests, and £5 million (1997: £ nil) for Midland and £4 million (1997: £ nil) for the Bank of unamortised goodwill.

20 Other assets *(continued)*

'Other' also includes the surplus retained in long-term assurance funds and the net present value of policies in force. These assets form part of the total value of Midland's interest in long-term assurance business as follows:

	1998 £m	*1997* £m
Net tangible assets of Midland Life Limited and Midland Life International Limited	22	49
Surplus retained in long-term assurance funds and net present value of policies in force	232	204
Total long-term assurance business attributable to shareholders	254	253

The increase in the value of long-term assurance business attributable to shareholders which is included in the consolidated profit and loss account amounts to £73 million (1997: £39 million, 1996: £72 million) before tax and £51 million (1997: £27 million, 1996: £48 million) after tax.

The key assumptions used in determining the value of policies in force are:

	1998	*1997*
Risk discount rate (net of tax)	12.5%	12.5%
Economic assumptions (gross of tax)		
Investment return on unit-linked funds	6.9%	8.3%
Investment return on non-linked funds	5.0%	6.3%
Expense inflation	4.5%	4.5%

The composition of the net tangible assets relating to long-term assurance funds is analysed as follows:

	1998 £m	*1997* £m
Loans and advances to banks	145	162
Debt securities	766	959
Equity shares	893	717
Other assets	1,212	1,271
Prepayments and accrued income	24	24
Other liabilities	(362)	(644)
Long-term assurance net assets attributable to policyholders	2,678	2,489

21 Deposits by banks

	Midland		Bank	
	1998 £m	*1997* £m	1998 £m	*1997* £m
Repayable on demand	4,636	3,865	4,987	3,890
With agreed maturity dates or periods of notice by remaining maturity				
— 3 months or less but not repayable on demand	6,071	7,018	8,793	9,705
— 1 year or less but over 3 months	975	1,268	1,196	1,493
— 5 years or less but over 1 year	194	102	296	268
— over 5 years	6	14	117	281
	11,882	12,267	15,389	15,637
Amounts include:				
Due to subsidiary undertakings			3,671	3,549
Due to fellow subsidiary undertakings	1,561	1,101	1,560	1,098

Notes on the Accounts (continued)

22 Customer accounts

	Midland		Bank	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Repayable on demand	**35,818**	34,399	**32,233**	31,237
With agreed maturity dates or periods of notice by remaining maturity				
— 3 months or less but not repayable on demand	**19,854**	19,822	**19,505**	19,712
— 1 year or less but over 3 months	**2,208**	2,312	**2,188**	1,993
— 5 years or less but over 1 year	**1,782**	992	**1,794**	1,008
— over 5 years	**637**	377	**637**	288
	60,299	57,902	**56,357**	54,238
Amounts include:				
Due to associated undertakings	**2**	2	**2**	2
Due to subsidiary undertakings			**246**	866
Due to fellow subsidiary undertakings	**307**	458	**296**	456
Due to parent undertaking	**470**	1,714	**470**	1,711

23 Debt securities in issue

	Midland		Bank	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Bonds and medium-term notes, by remaining maturity				
— within 1 year	**162**	194	**132**	153
— between 1 and 2 years	**461**	—	**461**	—
— between 2 and 5 years	**1,562**	1,302	**1,562**	1,301
— over 5 years	**48**	59	**6**	18
	2,233	1,555	**2,161**	1,472
Other debt securities in issue, by remaining maturity				
— 3 months or less	**1,537**	2,311	**1,297**	2,171
— 1 year or less but over 3 months	**1,159**	820	**1,124**	820
— 5 years or less but over 1 year	**85**	51	**85**	51
	2,781	3,182	**2,506**	3,042
	5,014	4,737	**4,667**	4,514

24 Other liabilities

	Midland 1998 £m	Midland *1997* £m	Bank 1998 £m	Bank *1997* £m
Short positions in debt securities				
— government securities	**1,862**	2,819	**1,862**	1,853
— other public sector securities	**3**	15	**3**	15
— other debt securities	**136**	182	**136**	177
	2,001	3,016	**2,001**	2,045
Liabilities, including losses, resulting from off-balance-sheet interest rate, exchange rate and equities contracts which are marked-to-market	**8,650**	7,790	**8,654**	7,772
Current taxation	**447**	566	**331**	400
Obligations under finance leases	**169**	158	**39**	49
Dividend payable	**350**	350	**350**	350
Long-term assurance liabilities attributable to policyholders (Note 20)	**2,678**	2,489	**—**	—
Other liabilities	**2,050**	2,147	**1,251**	1,628
	16,345	16,516	**12,626**	12,244
Liabilities, including losses, resulting from off-balance-sheet interest rate, exchange rate and equities contracts which are marked-to-market include amounts due to:				
Subsidiary undertakings			**21**	34
Fellow subsidiary undertakings	**842**	815	**842**	779
Obligations under finance leases fall due as follows:				
— within 1 year	**14**	22	**23**	24
— between 1 to 5 years	**6**	41	**41**	54
— over 5 years	**369**	323	**—**	—
	389	386	**64**	78
— less future finance charges	**(220)**	(228)	**(25)**	(29)
	169	158	**39**	49

25 Provisions for liabilities and charges

a *Deferred taxation*

	Midland £m	Bank £m
At 1 January 1998	**394**	**(35)**
Charge to the profit and loss account (Note 6)	**57**	**(14)**
Exchange and other movements	**(22)**	**—**
At 31 December 1998	**429**	**(49)**

	Midland 1998 £m	Midland *1997* £m	Bank 1998 £m	Bank *1997* £m
Included in 'Provisions for liabilities and charges'	**429**	394	**—**	—
Included in 'Other assets' (Note 20)	**—**	—	**(49)**	(35)
	429	394	**(49)**	(35)

Notes on the Accounts (continued)

25 Provisions for liabilities and charges *(continued)*

a *Deferred taxation (continued)*

	Unprovided deferred tax/(relief)	*Provided in accounts*	*Unprovided deferred tax/(relief)*	*Provided in accounts*
	1998	**1998**	*1997*	*1997*
Midland	**£m**	**£m**	£m	£m
Short-term timing differences	**(13)**	**1**	(11)	(21)
Accelerated capital allowances	**(10)**	**—**	(7)	(1)
Leasing transactions	**14**	**485**	14	447
Provision for bad and doubtful debts	**(14)**	**(18)**	(17)	(14)
Other items	**(32)**	**(39)**	(39)	(17)
	(55)	**429**	(60)	394
Bank				
Short-term timing differences	**(12)**	**(9)**	(11)	(28)
Accelerated capital allowances	**(10)**	**—**	(7)	—
Provision for bad and doubtful debts	**(6)**	**(18)**	(9)	(15)
Other items	**(22)**	**(22)**	(29)	8
	(50)	**(49)**	(56)	(35)

It is not considered necessary to provide for taxation on capital gains which might arise on the disposal of subsidiary or associated undertakings at their balance sheet amounts, or for taxation on capital gains which might arise on the disposal of premises, as it is anticipated that any liability will be covered by capital losses or other reliefs; nor is it considered necessary to provide for any liability to UK taxation on overseas earnings which are not expected to be remitted.

b *Other provisions for liabilities and charges*

	Provisions for pensions and other post-retirement obligations	*Provisions for contingent liabilities and commitments*	*Premises-related provisions*	*Insurance and other provisions*	*Total*
	£m	**£m**	**£m**	**£m**	**£m**
Midland					
At 1 January 1998	**80**	**27**	**87**	**134**	**328**
Charge to the profit and loss account	**12**	**59**	**3**	**128**	**202**
Other changes to provisions	**—**	**—**	**76**	**—**	**76**
Disposal of subsidiary undertakings	**—**	**—**	**—**	**(73)**	**(73)**
Provisions utilised	**(9)**	**(12)**	**(24)**	**(84)**	**(129)**
Exchange and other movements	**1**	**1**	**—**	**—**	**2**
At 31 December 1998	**84**	**75**	**142**	**105**	**406**
Bank					
At 1 January 1998	77	25	80	14	196
Charge to the profit and loss account	10	59	4	—	73
Other changes to provisions	—	—	76	—	76
Provisions utilised	(9)	(11)	(23)	—	(43)
Exchange and other movements	—	—	—	1	1
At 31 December 1998	78	73	137	15	303

25 Provisions for liabilities and charges *(continued)*

b *Other provisions for liabilities and charges (continued)*

Other changes to premises-related provisions comprise provisions for the discounted future costs associated with certain short leasehold properties, which will become vacant as a consequence of the planned move of most of Midland's central London-based staff to Canary Wharf in 2002. The cost of these provisions has been charged to the profit and loss account of HSBC Holdings plc.

A review of the classification of insurance provisions has resulted in the reclassification of amounts previously included in 'Accruals and deferred income' to 'Other provisions for liabilities and charges'. The 1997 comparatives for Midland have been restated by £116 million accordingly (Bank: £ nil).

26 Subordinated liabilities

	Midland		Bank	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Undated subordinated loan capital	**1,235**	1,241	**1,235**	1,241
Dated subordinated loan capital	**2,145**	2,056	**2,144**	2,055
Total subordinated liabilities	**3,380**	3,297	**3,379**	3,296
Dated subordinated loan capital is repayable:				
— within 1 year	**316**	31	**315**	30
— between 1 to 2 years	**—**	297	**—**	297
— between 2 to 5 years	**250**	250	**250**	250
— over 5 years	**1,579**	1,478	**1,579**	1,478
	2,145	2,056	**2,144**	2,055

Undated subordinated loan capital

		1998	1997
		£m	£m
Bank			
US$750 million	Undated Floating Rate Primary Capital Notes	**452**	455
US$500 million	Undated Floating Rate Primary Capital Notes	**302**	304
US$300 million	Undated Floating Rate Primary Capital Notes (Series 3)	**181**	182
£150 million	9.25% Step-up Undated Subordinated Notes	**150**	150
£150 million	8.625% Step-up Undated Subordinated Notes	**150**	150
		1,235	1,241

Notes on the Accounts (continued)

26 Subordinated liabilities *(continued)*

Dated subordinated loan capital

		1998 £m	*1997 £m*
Bank			
Yen 6.3 billion	7.55% Guaranteed Loan 1998 *	—	30
Yen 3.0 billion	7.25% Guaranteed Loan 1999 *	**16**	14
Yen 10.0 billion	7.41% Guaranteed Loan 1999 *	**53**	47
US$200 million	Guaranteed Floating Rate Notes 1999 *	**121**	122
Yen 5.0 billion	7.75% Dual Currency Guaranteed Bonds 1999 *	**26**	23
DM 200 million	Guaranteed Floating Rate Notes 1989/1999 *	**72**	68
Yen 5.0 billion	6.99% Guaranteed Loan 1999 *	**27**	23
£250 million	Subordinated Floating Rate Notes 2001	**250**	250
US$150 million	12.75% Guaranteed Notes 2003 *	—	91
US$400 million	8.625% Subordinated Notes 2004	**240**	241
£200 million	9% Subordinated Notes 2005	**200**	200
US$500 million	7.625% Subordinated Notes 2006	**301**	304
£100 million	14% Subordinated Unsecured Loan Stock 2002/2007	**100**	100
US$50 million	Subordinated Step-up Coupon Callable Floating Rate Notes 2007	**30**	30
£150 million	Subordinated Step-up Coupon Floating Rate Notes 2007	**150**	149
US$300 million	6.95% Subordinated Notes 2011	**181**	182
£200 million	6.5% Subordinated Notes 2023†	**197**	—
US$300 million	7.65% Subordinated Notes 2025	**180**	181
		2,144	2,055
Subsidiary undertakings			
Guaranteed Floating Rate Unsecured Loan Stock/Notes 2001		**1**	1
		2,145	2,056

* *Issued by subsidiary undertakings under the Bank's subordinated guarantee and on-lent to the Bank on a subordinated basis.*

† *The proceeds of the issue of £200 million 6.5% Subordinated Notes 2023 were used to support the development of Midland and to strengthen further Midland's capital base.*

Interest rates on the floating rate loan capital are related to Interbank Offered Rates. On the remaining subordinated loan capital, interest is payable at fixed rates up to 14 per cent.

Generally, subordinated loan capital is repayable at par on maturity, but some is repayable prior to maturity at the option of the borrower, subject to the prior consent of the Financial Services Authority. The US$300 million 7.65% Subordinated Notes 2025 are repayable in May 2007 at par at the option of the holders.

The dated loan capital of the Bank represents unsecured obligations of the Bank which rank *pari passu* with the subordinated guarantees given by the Bank in respect of dated loan capital issued by subsidiary undertakings under the Bank's subordinated guarantee and on-lent to the Bank on a subordinated basis. Claims in respect of principal and interest on such debt are subordinated to the claims of all creditors of the Bank, other than claims of any creditors in respect of subordinated debt ranking *pari passu* or junior to claims in respect of dated loan capital.

The undated loan capital of the Bank has characteristics which renders it similar in certain circumstances to preference shares. These borrowings are unsecured obligations of the Bank. Claims in respect of principal and interest are subordinated to the claims of all creditors of the Bank, other than claims of any creditors in respect of subordinated indebtedness ranking *pari passu* or junior to claims in respect of undated loan capital.

27 Called up share capital

	Non-cumulative preference shares of £1 each	*Non-cumulative preference shares of US$0.01 each*	*Ordinary shares of £1 each*	*Total*
At 31 December 1996, 1997 and 1998	£m	£m	£m	£m
Authorised share capital	150	1	1,000	1,151
Issued, allotted and fully paid share capital	—	—	797	797

The issued, allotted and fully paid share capital of the Bank comprises 796,903,203 ordinary shares of nominal value £1 each, 20,000,000 Series A, 14,000,000 Series B, 16,000,000 Series C, and 16,000,000 Series D US$ non-cumulative preference shares of nominal value US$0.01 each, 4,000,000 Second US$ non-cumulative preference shares of nominal value US$0.01 each and one preferred ordinary share of nominal value £1.

In the event of a winding up, US$ preference shareholders would receive, in priority to the ordinary shareholders of the Bank, repayment of US$20 per share, in the case of the Series A1, Series B1, Series C1 and Series D1 preference shares and Series 1 Second preference shares, and US$5 per share, in the case of the Series A2, Series B2, Series C2 and Series D2 preference shares and Series 2 Second preference shares, plus an amount equal to any dividends declared but unpaid in respect of the previous dividend for the period and any accrued and unpaid dividends for the period to the date of the commencement of the winding up. With the exception of the above, the preference shares do not carry any right to participate in any surplus of assets on a winding up. The Second preference shares are subordinated, as regards payment of capital and dividends, to the other US$ preference shares.

Holders of the Series A1, Series A2, Series B1, Series B2, Series C1, Series C2, Series D1 and Series D2 preference shares and Series 1 and Series 2 Second preference shares are not entitled to vote at general meetings of the shareholders, except in certain limited circumstances, such as the variation of the rights attaching to those shares, or in the event of reduction of the preference share capital. In addition, the Series A1, Series B1, Series C1 and Series D1 preference shareholders and Series 1 Second preference shareholders are entitled to vote at general meetings of the shareholders if any resolution is proposed for a winding up or sale of the whole business of the Bank, or in the event of a failure to pay in full the dividend payable on the Series A1, Series B1, Series C1 or Series D1 preference shares or Series 1 Second preference shares for the most recent dividend period.

The Series A1 and A2 preference shares are redeemable at the option of the Bank at a redemption price of US$20 per Series A1 and US$5 per Series A2 preference share. A special dividend is payable for redemptions of Series A2 preference shares up to 4 October 2003. The dividend amounts to US$1.109 per Series A2 preference share until 4 October 1999, and thereafter decreases for share redemptions made up to 4 October 2003.

The Series B1 and B2 preference shares are redeemable at the option of the Bank, on or after 24 February 2000, at a redemption price of US$20 per Series B1 and US$5 per Series B2 preference share. A special dividend is payable for redemptions of Series B2 preference shares between 24 February 2000 and 23 February 2005 inclusive. The dividend amounts to US$1.281 per Series B2 preference share between 24 February 2000 and 23 February 2001, and thereafter decreases for share redemptions up to 23 February 2005.

The Series C1 and C2 preference shares are redeemable at the option of the Bank, on or after 27 October 2000, at a redemption price of US$20 per Series C1 and US$5 per Series C2 preference share. A special dividend is payable for redemptions of Series C2 preference shares between 27 October 2000 and 26 October 2005 inclusive. The dividend amounts to US$1.141 per Series C2 preference share between 27 October 2000 and 26 October 2001, and thereafter decreases for share redemptions up to 26 October 2005.

The Series D1 and D2 preference shares are redeemable at the option of the Bank, on or after 25 July 2001, at a redemption price of US$20 per Series D1 and US$5 per Series D2 preference share.

The Series 1 and 2 Second preference shares are redeemable at the option of the Bank, on or after 7 February 2002, at a redemption price of US$20 per Series 1 and US$5 per Series 2 Second preference share.

Notes on the Accounts (continued)

28 Reserves

	Midland			Bank		Associated undertakings	
	1998	*1997*	*1996*	**1998**	*1997*	**1998**	*1997*
	£m	£m	£m	**£m**	£m	**£m**	£m
Share premium account							
At 1 January	**1,976**	1,931	1,452	**1,976**	1,931	—	—
New share capital subscribed	—	30	524	—	30	—	—
Exchange movements	**(3)**	15	(45)	**(3)**	15	—	—
At 31 December	**1,973**	1,976	1,931	**1,973**	1,976	—	—
Revaluation reserves							
At 1 January	**65**	6	(31)	**107**	170	—	—
Realisation on disposal of properties	**(6)**	(4)	—	**(5)**	(4)	—	—
Unrealised (deficit)/surplus on revaluation of freehold and long leasehold properties	**(8)**	54	22	**7**	45	—	—
Transfer of permanent diminution in value of land and buildings to the profit and loss account	—	13	16	—	13	—	—
Net change in attributable net assets of subsidiary and associated undertakings	—	—	—	**42**	(117)	—	—
Realisation on disposal of subsidiary undertakings	—	(4)	—	**(2)**	—	—	—
Exchange and other movements	—	—	(1)	**4**	—	—	—
At 31 December	**51**	65	6	**153**	107	—	—
Profit and loss account							
At 1 January	**1,597**	1,226	1,021	**1,555**	1,062	**(5)**	14
Retained profit for the year	**349**	407	312	**291**	507	**(7)**	2
Goodwill written off on acquisitions	—	(7)	(5)	—	(6)	—	—
Goodwill written back on disposals	**1**	11	—	—	—	—	—
Transfer of permanent diminution in value of land and buildings from revaluation reserve	—	(13)	(16)	—	(13)	—	—
Realisation on disposal of properties	**6**	4	—	**5**	4	—	—
Realisation on disposal of subsidiary and associated undertakings	—	4	—	**2**	—	—	(21)
Exchange and other movements	**6**	(35)	(86)	**4**	1	**1**	—
At 31 December	**1,959**	1,597	1,226	**1,857**	1,555	**(11)**	(5)

Goodwill amounting to £86 million (1997: £86 million; 1996: £90 million) has been charged against reserves in prior years in respect of acquisitions.

The reserves of the Bank include distributable reserves of £1,845 million (1997: £1,546 million; 1996: £1,057 million).

Some of Midland's banking subsidiary undertakings operate under local regulatory jurisdictions which could potentially restrict the amount of reserves which can be remitted to the Bank in order to maintain local regulatory capital ratios.

29 Analysis of total assets and total liabilities

a *Assets and liabilities denominated in foreign currency*

	Midland		Bank	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Denominated in sterling	**73,822**	71,828	**69,373**	67,410
Denominated in currencies other than sterling	**31,024**	30,248	**30,435**	29,271
Total assets	**104,846**	102,076	**99,808**	96,681
Denominated in sterling	**74,680**	71,461	**69,859**	67,264
Denominated in currencies other than sterling	**30,166**	30,615	**29,949**	29,417
Total liabilities	**104,846**	102,076	**99,808**	96,681

b *Assets subject to sale and repurchase transactions*

	Midland		Bank	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Total assets subject to sale and repurchase transactions	**3,360**	2,952	**3,338**	2,946

c *Assets leased to customers*

Amounts relating to assets leased to customers are included under the following balance sheet headings:

	Midland	
	1998	*1997*
	£m	£m
Finance leases		
— loans and advances to banks	**13**	22
— loans and advances to customers	**1,682**	1,979
Hire purchase agreements		
— loans and advances to customers	**941**	1,039
Tangible fixed assets		
— equipment on operating leases	**1,696**	1,617
	4,332	4,657

The cost of assets acquired during 1998 for letting under finance leases and hire purchase contracts by Midland amounted to £512 million (1997: £475 million) and £505 million (1997: £797 million), respectively.

d *Assets charged as security for liabilities*

Midland has pledged assets as security for liabilities included under the following headings:

	Amount of liability secured	
	1998	1997
	£m	£m
Deposits by banks	**412**	210
Customer accounts	**109**	51
Debt securities in issue	**42**	41
	563	302

The amount of assets pledged to secure these amounts is £4,584 million (1997: £4,562 million), and is mainly made up of items included in 'Debt securities' £3,401 million (1997: 'Debt securities' £3,822 million).

Notes on the Accounts (continued)

30 Memorandum items and foreign exchange rate, interest rate and equities contracts

a *Contingent liabilities and commitments*

	1998			1997		
	Contract amount	*Credit equivalent amount*	*Risk-weighted amount*	*Contract amount*	*Credit equivalent amount*	*Risk-weighted amount*
Midland	**£m**	**£m**	**£m**	£m	£m	£m
Contingent liabilities						
Acceptances and endorsements	**1,234**	**1,193**	**1,189**	1,214	1,210	1,199
Guarantees and assets pledged as collateral security						
— guarantees and irrevocable letters of credit	**7,407**	**5,753**	**3,839**	6,344	5,004	3,323
Other contingent liabilities	**—**	**—**	**—**	17	17	4
	8,641	**6,946**	**5,028**	7,575	6,231	4,526
Commitments						
Documentary credits and short-term trade-related transactions	**1,048**	**493**	**214**	950	414	215
Forward asset purchases and forward deposits placed	**236**	**236**	**103**	429	429	236
Undrawn note issuance and revolving underwriting facilities	**9**	**4**	**4**	9	5	5
Undrawn formal standby facilities, credit lines and other commitments to lend						
— over 1 year	**9,063**	**4,532**	**4,071**	9,914	4,957	4,373
— 1 year or less	**23,386**	**—**	**—**	19,180	—	—
	33,742	**5,265**	**4,392**	30,482	5,805	4,829

	1998	*1997*
	£m	£m
Incurred on behalf of parent and fellow subsidiary undertakings (contract amount)		
— contingent liabilities	**114**	127
— commitments	**572**	992

30 Memorandum items and foreign exchange rate, interest rate and equities contracts *(continued)*

a *Contingent liabilities and commitments (continued)*

	1998			*1997*		
	Contract amount	*Credit equivalent amount*	*Risk-weighted amount*	*Contract amount*	*Credit equivalent amount*	*Risk-weighted amount*
Bank	**£m**	**£m**	**£m**	£m	£m	£m
Contingent liabilities						
Acceptances and endorsements	**1,221**	**1,183**	**1,183**	1,197	1,194	1,194
Guarantees and assets pledged as collateral security						
— guarantees and irrevocable letters of credit	**9,671**	**5,762**	**3,839**	8,554	5,041	3,342
Other contingent liabilities	**—**	**—**	**—**	17	17	4
	10,892	**6,945**	**5,022**	9,768	6,252	4,540
Commitments						
Documentary credits and short-term trade-related transactions	**1,034**	**492**	**210**	925	410	214
Forward asset purchases and forward deposits placed	**94**	**94**	**54**	29	29	29
Undrawn note issuance and revolving underwriting facilities	**9**	**4**	**4**	9	5	5
Undrawn formal standby facilities, credit lines and other commitments to lend						
— over 1 year	**9,063**	**4,532**	**4,071**	9,915	4,958	4,371
— 1 year or less	**23,053**	**—**	**—**	18,990	—	—
	33,253	**5,122**	**4,339**	29,868	5,402	4,619

	1998	*1997*
	£m	£m
Incurred on behalf of subsidiary undertakings (contract amount)		
— contingent liabilities	**2,256**	2,179
Incurred on behalf of parent and fellow subsidiary undertakings (contract amount)		
— contingent liabilities	**125**	132
— commitments	**572**	992

Notes on the Accounts (continued)

30 Memorandum items and foreign exchange rate, interest rate and equities contracts *(continued)*

a *Contingent liabilities and commitments (continued)*

The preceding tables give the nominal principal amounts, credit equivalent amounts and risk-weighted amounts of off-balance-sheet transactions. The credit equivalent amounts are calculated for the purposes of deriving the risk-weighted amounts. These are assessed in accordance with the Financial Services Authority's guidelines which implement the Basle agreement on capital adequacy and depend on the status of the counterparty and the maturity characteristics.

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

b *Exchange rate, interest rate and equities contracts*

	1998		*1997*	
	Contract amount	*Replacement cost*	*Contract amount*	*Replacement cost*
	£m	£m	£m	£m
Midland				
Exchange rate contracts	**348,541**	**3,731**	332,845	4,177
Interest rate contracts	**559,754**	**3,195**	455,039	2,221
Equities contracts	**14,154**	**1,237**	11,557	1,199
	922,449	**8,163**	799,441	7,597
Bank				
Exchange rate contracts	**348,259**	**3,714**	332,655	4,167
Interest rate contracts	**559,937**	**3,196**	454,500	2,208
Equities contracts	**14,154**	**1,237**	11,557	1,199
	922,350	**8,147**	798,712	7,574

Off-balance-sheet financial instruments arise from futures, forward, swap and option transactions undertaken by Midland in the foreign exchange, interest rate and equity markets.

Included in the above table there are £348,519 million (Midland) and £348,238 million (Bank) contract amount of exchange rate contracts, £553,886 million (Midland) and £555,033 million (Bank) contract amount of interest rate contracts and £14,154 million (Midland) and £14,154 million (Bank) contract amount of equities contracts which were made for trading purposes. The remaining exchange and interest rate contracts were made for non-trading purposes. In 1997, £332,791 million (Midland) and £332,568 million (Bank) contract amount of exchange rate contracts, £444,395 million (Midland) and £445,146 million (Bank) contract amount of interest rate contracts and £11,557 million (Midland) and £11,557 million (Bank) contract amount of equities contracts were made for trading purposes. The remaining exchange and interest rate contracts were made for non-trading purposes.

The notional or contractual amounts of these instruments indicate the volume of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

Replacement cost of contracts represents the mark-to-market assets on all contracts with a positive value. Replacement cost is therefore a close approximation of the credit risk for these contracts as at the balance sheet date. The actual credit risk is monitored internally and is the sum of the positive mark-to-market value and an estimate for the future fluctuation risk, using a future risk factor.

30 Memorandum items and foreign exchange rate, interest rate and equities contracts *(continued)*

c *Contingent liabilities and commitments – geographical analysis*

Midland has the following concentration of exposure to contingent liabilities and commitments, based on the location of the office recording the transaction:

	United Kingdom	*Continental Europe*	*Rest of the world*	*Total*
	£m	£m	£m	£m
Contingent liabilities				
1998	**7,364**	**1,124**	**153**	**8,641**
1997	6,577	892	106	7,575
Commitments				
1998	**32,247**	**1,143**	**352**	**33,742**
1997	29,306	938	238	30,482

31 Litigation

The Bank and certain subsidiary undertakings are named in, and are defending, legal actions in various jurisdictions arising from their normal business. No material adverse impact on Midland's financial position is expected to arise from these proceedings.

32 Capital commitments

	Midland		Bank	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Expenditure contracted for	**284**	10	**35**	10

33 Lease commitments

At 31 December 1998, Midland was committed to various non-cancellable operating leases for leasehold land and buildings, which require aggregate future rental payments as follows:

	£m
Payable within 1 year	**68**
1 to 2 years	**66**
2 to 3 years	**62**
3 to 4 years	**61**
4 to 5 years	**59**
over 5 years	**475**
	791

At the year-end, annual commitments under non-cancellable operating leases were:

	Midland		Bank	
	1998	*1997*	**1998**	*1997*
	£m	£m	**£m**	£m
Leasehold land and buildings				
Operating leases which expire				
— within 1 year	**1**	3	**1**	3
— 1 to 5 years	**11**	8	**11**	8
— over 5 years	**56**	57	**62**	64
	68	68	**74**	75

Notes on the Accounts (continued)

34 Segmental analysis

a *By geographic region*

In the analysis set out below, net assets include an appropriate amount of shareholders' funds, based on the proportion of risk-weighted assets in each segment. Geographical information has been classified by the location of the principal operations of the subsidiary undertaking, or in the case of the Bank, by the location of the branch responsible for reporting the results or for advancing the funds.

		International			
	Domestic	*United Kingdom*	*Continental Europe*	*Rest of the world*	*Total*
	£m	£m	£m	£m	£m
1998					
Gross income					
Interest receivable	5,829	167	254	231	6,481
Dividend income	2	—	—	—	2
Fees and commissions receivable	1,558	35	30	9	1,632
Dealing profits	98	6	9	11	124
Other operating income	397	—	7	—	404
Total gross income	7,884	208	300	251	8,643
Profit on ordinary activities before tax	1,262	164	44	52	1,522
Attributable profit	807	162	28	45	1,042
Net assets	4,419	32	165	164	4,780
Total assets	94,139	3,195	3,082	4,430	104,846

34 Segmental analysis *(continued)*

a *By geographic region (continued)*

	Domestic	International: United Kingdom	International: Continental Europe	International: United States	International: Rest of the world	Total
	£m	£m	£m	£m	£m	£m
1997						
Gross income						
Interest receivable	4,808	200	504	94	249	5,855
Dividend income	—	1	10	—	—	11
Fees and commissions receivable	1,459	34	174	4	11	1,682
Dealing profits	217	—	17	(1)	2	235
Other operating income	310	—	1	—	—	311
Total gross income	6,794	235	706	97	262	8,094
Profit on ordinary activities before tax	1,091	412	96	16	10	1,625
Attributable profit	592	399	46	13	1	1,051
Net assets	3,995	136	135	—	169	4,435
Total assets	92,921	2,224	2,356	25	4,550	102,076

	Domestic	International: United Kingdom	International: Continental Europe	International: United States	International: Rest of the world	Total
	£m	£m	£m	£m	£m	£m
1996						
Gross income						
Interest receivable	4,136	192	539	111	137	5,115
Dividend income	1	—	1	—	1	3
Fees and commissions receivable	1,196	33	144	14	4	1,391
Dealing profits	153	2	55	14	10	234
Other operating income	202	—	(8)	—	(1)	193
Total gross income	5,688	227	731	139	151	6,936
Profit on ordinary activities before tax	1,010	163	66	22	11	1,272
Attributable profit	652	146	17	25	9	849
Net assets	3,241	93	314	133	179	3,960
Total assets	77,656	2,674	9,646	2,222	4,023	96,221

34 Segmental analysis *(continued)*

b *By class of business*

	Banking	*Asset Finance*	*Total*
	£m	£m	£m
1998			
Profit on ordinary activities before tax	**1,374**	**148**	**1,522**
Net assets	**4,435**	**345**	**4,780**
Total assets	**98,439**	**6,407**	**104,846**
1997			
Profit on ordinary activities before tax	1,503	122	1,625
Net assets	4,116	319	4,435
Total assets	95,790	6,286	102,076
1996			
Profit on ordinary activities before tax	1,175	97	1,272
Net assets	3,616	344	3,960
Total assets	91,260	4,961	96,221

Included within 1997 profit on ordinary activities before tax and total assets for Asset Finance were £56 million and £1,180 million respectively in relation to Forward Trust Rail Services Limited and its subsidiary undertaking Forward Trust Rail Limited which were acquired during 1997.

As Midland is not required to disclose turnover, no segmental analysis of turnover is included.

35 Related party transactions

a *Transactions, arrangements and agreements involving Directors and others*

Particulars of transactions, arrangements and agreements entered into by subsidiary undertakings of the Bank with Directors and connected persons and companies controlled by them and with officers of the Bank disclosed pursuant to section 232 of the Companies Act 1985 are as follows:

	1998		*1997*	
	Number	*£'000*	*Number*	*£'000*
Directors and connected persons and companies controlled by them:				
Loans and credit card transactions (including £95,000 in credit card transactions (1997: £27,000))	**11**	**4,562**	10	790
Officers:				
Loans and credit card transactions (including £61,000 in credit card transactions (1997: £56,000))	**24**	**1,819**	16	1,296

b *Associated undertakings*

Information relating to associated undertakings can be found in the Notes on the Accounts where the following are disclosed:

- Note 12: amounts due from associated undertakings
- Note 17: interests in associated undertakings
- Note 22: amounts due to associated undertakings

c *Transactions with other related parties of Midland*

Pension Funds

At 31 December 1998, the Midland Bank Pension Scheme had deposits of £200 million with the Bank.

36 Notes to the statement of consolidated cash flows

a *Reconciliation of operating profit to net cash flow from operating activities*

	1998	*1997*	*1996*
	£m	£m	£m
Operating profit	**1,489**	1,583	1,159
Change in prepayments and accrued income	**(437)**	36	306
Change in accruals and deferred income	**33**	244	(306)
Interest on finance leases and similar hire purchase contracts	**14**	14	7
Interest on subordinated loan capital	**254**	250	224
Depreciation and amortisation	**291**	231	200
Provisions for bad and doubtful debts	**196**	129	172
Loans written off net of recoveries	**(300)**	(172)	(265)
Provisions for liabilities and charges	**202**	36	59
Provisions utilised	**(129)**	(43)	(24)
Amounts written off fixed asset investments	**1**	4	40
Net cash inflow from trading activities	**1,614**	2,312	1,572
Change in items in the course of collection from other banks	**9**	(89)	100
Change in treasury bills and other eligible bills	**412**	(1,325)	2,965
Change in loans and advances to banks	**494**	149	(289)
Change in loans and advances to customers	**(2,124)**	(6,905)	(2,668)
Change in other securities	**(231)**	(2,546)	(1,779)
Change in other assets	**(605)**	(909)	2,666
Change in deposits by banks	**(385)**	1,468	(2,751)
Change in customer accounts	**2,397**	6,827	4,300
Change in items in the course of transmission to other banks	**84**	(204)	179
Change in debt securities in issue	**277**	2,431	1,029
Change in other liabilities	**(52)**	754	(1,288)
Elimination of exchange differences and other non-cash movements	**(370)**	479	336
Net cash inflow from operating activities	**1,520**	2,442	4,372

b *Changes in cash during the year*

	1998	*1997*	*1996*
	£m	£m	£m
Balance at 1 January	**4,689**	5,590	3,220
Net cash (outflow)/inflow before the effect of foreign exchange and other movements	**(1,447)**	(769)	2,622
Effect of foreign exchange movements	**(9)**	(132)	(252)
Balance at 31 December	**3,233**	4,689	5,590

Notes on the Accounts (continued)

36 Notes to the statement of consolidated cash flows *(continued)*

c *Analysis of the balances of cash (revised FRS 1)*

	1998	*1997*	*1996*
	£m	£m	£m
Cash and balances at central banks	**533**	559	599
Loans and advances to banks	**2,700**	4,130	4,991
	3,233	4,689	5,590

d *Changes in financing during the year*

	Share capital (including share premium)			*Subordinated loan capital*		
	1998	*1997*	*1996*	**1998**	*1997*	*1996*
	£m	£m	£m	**£m**	£m	£m
Balance at 1 January	**2,773**	2,728	2,249	**3,297**	3,203	2,831
Issued during the year	**—**	30	524	**197**	330	620
Repaid during the year	**—**	—	—	**(121)**	(101)	—
Net cash inflow from financing	**—**	30	524	**76**	229	620
Exchange and other movements	**(3)**	15	(45)	**7**	(135)	(248)
Balance at 31 December	**2,770**	2,773	2,728	**3,380**	3,297	3,203

37 Differences between UK and US GAAP

The accounting policies under which the consolidated financial statements of Midland are prepared conform to UK Generally Accepted Accounting Principles ('GAAP') and differ in certain respects from US GAAP. A summary of the significant differences that could have an effect on consolidated profit attributable or shareholders' funds or on the presentation of the consolidated financial statements is set out below.

UK GAAP	US GAAP
Acceptances Acceptances outstanding and the matching customers' liabilities are not reflected in the consolidated balance sheet.	Acceptances are included in the consolidated balance sheet.
Debt swaps Debt securities and equity shares acquired in exchange for advances in order to achieve an orderly realisation continue to be reported as advances. The asset acquired is recorded at the carrying value of the advance disposed of at the date of the exchange, and provisions are based on any subsequent deterioration in its value.	Under Statement of Financial Accounting Standards ('SFAS') No.15 'Accounting by Debtors and Creditors for Troubled Debt Restructurings', debt securities and equity shares acquired in exchange for advances in order to achieve an orderly realisation are required to be accounted for at their fair value, usually their secondary market value, at the date of exchange. Under SFAS No. 115 'Accounting for Certain Investments in Debt and Equity Securities', certain of these debt swaps qualify as securities and accordingly are classified as available for sale.
Deferred taxation Deferred taxation is provided on timing differences, using the liability method, between the accounting and taxation treatment of income and expenditure. Provision is made for deferred tax only to the extent that it is probable that an actual liability will crystallise. Deferred tax assets are recognised when recovery is anticipated in the near future without replacement by equivalent assets.	Under SFAS No. 109 'Accounting for Income Taxes', deferred tax balances are calculated using the full provision liability method. In addition, a deferred tax asset may be recognised if management's judgement is that realisation of the deferred tax asset is more likely than not. A valuation allowance is raised against any deferred tax asset where it is more likely than not that the asset, or part thereof, will not be realised.
Goodwill In 1998, Midland has adopted Financial Reporting Standard ('FRS') 10 'Goodwill and Intangible Assets'. For acquisitions made on or after 1 January 1998, goodwill is included in the balance sheet and amortised over its estimated life on a straight-line basis. Midland has applied the transitional arrangements provided in FRS 10 and goodwill previously eliminated against reserves has not been reinstated. At the date of disposal of subsidiary or associated undertakings, any unamortised goodwill or goodwill charged directly against reserves is included in Midland's share of total net assets of the undertaking in the calculation of the profit on disposal of the undertaking. Prior to 1 January 1998, goodwill arising on the acquisition of subsidiary and associated undertakings was charged against reserves in the year of acquisition. At the date of disposal of subsidiary or associated undertakings, goodwill was reinstated in reserves and included in the calculation of the profit or loss on disposal.	Goodwill on acquisitions is capitalised and amortised over its estimated useful life and written off when judged to have no recoverable value. In the case of Midland, goodwill is being amortised over periods of up to 20 years.

Notes on the Accounts (continued)

37 Differences between UK and US GAAP *(continued)*

UK GAAP

Lease financing

Finance lease income is recognised so as to give a constant rate of return on the net cash investment in the lease, taking into account tax payments and receipts associated with the lease.

Operating leased assets are depreciated over their useful lives such that, for each asset, rentals less depreciation are recognised at a constant periodic rate of return on the net cash invested in that asset. Rentals receivable under operating leases are accounted for on a straight line basis over the lease term.

US GAAP

Unearned income on finance leases is taken to income at a rate calculated to give a constant rate of return on the investment in the lease, but no account is taken of the tax flows generated by the lease.

Operating leased assets are depreciated such that in each period the depreciation charge is at least equal to that which would have arisen on a straight line basis.

Loan impairment

UK GAAP: Midland's policy for measuring specific provisions for bad and doubtful debts takes into account the estimated realisable value of security, the likely period of repayment and the costs associated with obtaining repayment and realisation of the security.

US GAAP: SFAS No. 114 'Accounting by Creditors for Impairment of a Loan' as amended by SFAS No. 118 'Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosures' requires that an impaired loan which is within the scope of the Statement be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. A loan is considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement.

Long-term assurance business

UK GAAP: Midland determines the results of the operations of its subsidiary undertakings, Midland Life Limited and Midland Life International Limited, by including within the profit and loss account the surplus expected to emerge from long-term assurance funds and the increase in the net present value of policies in force.

US GAAP: The net present value inherent in long-term assurance funds is not recognised and an adjustment is made for the deferral and amortisation of acquisition costs and fees in accordance with the provisions of SFAS No. 60 'Accounting and Reporting by Insurance Enterprises', 97 'Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments' and 113 'Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts'.

Net unrealised gains/losses on debt and equity securities

UK GAAP: Debt securities and equity shares intended to be held on a continuing basis are disclosed as investment securities and are included in the balance sheet at cost less provision for any permanent diminution in value. Other participating interests are accounted for on the same basis. Where dated investment securities are purchased at a premium or discount, these premiums and discounts are amortised through the profit and loss account over the period from date of purchase to date of maturity. Any profit or loss on realisation of these securities is recognised in the profit and loss account as it arises and included in 'Gains on disposal of investments'.

US GAAP: Under SFAS No. 115 'Accounting for Certain Investments in Debt and Equity Securities' all debt securities and equity shares are classified and disclosed within one of the following three categories: held-to-maturity, available for sale or trading. Held-to-maturity debt securities are measured at amortised cost. Available for sale securities are measured at fair value with unrealised holding gains and losses excluded from earnings and reported net of applicable taxes and minority interests in a separate component of shareholders' funds. Trading securities are measured at fair value with unrealised holding gains and losses included in earnings.

37 Differences between UK and US GAAP *(continued)*

UK GAAP

Net unrealised gains/losses on debt and equity securities *(continued)*

Other debt securities, including treasury bills and other eligible bills, and equity shares are included in the balance sheet at market value; changes in the market value of such assets are recognised in the profit and loss account as 'Dealing profits' as they arise.

US GAAP

Ordinary dividends payable

UK GAAP: Ordinary dividends declared after the period end are recorded in the period to which they relate.

US GAAP: Dividends are recorded in the period in which they are declared.

Pension costs

UK GAAP: Pension costs, based on actuarial assumptions and methods, are charged to the Profit and Loss account so as to allocate the costs of providing benefits over the average remaining service life of the employees in a consistent manner.

US GAAP: Under SFAS No.87 'Employers' Accounting for Pensions' the method of actuarial valuation requires assets to be assessed at fair value and liabilities to be assessed at current settlement rates. Certain variations from regular cost are allocated in equal amounts over the average remaining service lives of current employees.

Repurchase agreements

UK GAAP: Repurchase agreements ('repos') and reverse repos are accounted for as if the collateral involved remains with the transferor. On the balance sheet, repos are included with 'Deposits by banks' and 'Customer accounts'; reverse repos are included with 'Loans and advances to banks' and 'Loans and advances to customers'.

US GAAP: Under SFAS No.125 'Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities' repos and reverse repos transacted under agreements that give the transferee the right to resell or repledge the securities are accounted for as if the collateral involved has been transferred by the transferor. For repos, the securities involved would be reclassified as collateralised within 'Debt securities'. For reverse repos, the securities transferred would be recognised within 'Debt securities' and a corresponding liability would be recognised.

Revaluation and depreciation of freehold and long leasehold premises

UK GAAP: Midland's freehold and long leasehold premises are revalued annually on an existing use basis or at open market value as appropriate. Impairment losses below depreciated historical cost and losses caused by the clear consumption of economic benefits are recognised in the profit and loss account. Other valuation differences are taken to the revaluation reserve.

US GAAP: Revaluations are only reflected in the financial statements to the extent that they represent permanent diminutions in value.

UK GAAP: When revalued properties are sold, any revaluation surplus or deficit recognised in the revaluation reserve is transferred to the profit and loss account reserve.

US GAAP: When revalued properties are sold, any revaluation surplus or temporary deficit thus realised would be reflected in income.

UK GAAP: Midland depreciates its freehold and long leasehold buildings based on cost or the revalued amounts.

US GAAP: Depreciation is provided based on the historical cost of such buildings.

Future developments

SFAS No.133 'Accounting for Derivative Instruments and Hedging Activities' was issued in June 1998. The Statement is effective for fiscal years beginning after 15 June 1999 and may not be retroactively applied to financial statements of prior periods. Initial application shall be at the beginning of an entity's fiscal year and on that date, hedging relationships shall be designated anew. At the date of initial application, an entity shall recognise all derivatives as either assets or liabilities in the statement of financial position and measure them at fair value. The entity also shall

37 Differences between UK and US GAAP *(continued)*

Future developments (continued)

recognise offsetting gains and losses on hedged assets, liabilities and firm commitments by adjusting their carrying amount at the balance sheet date. Transitional adjustments resulting from adopting this Statement shall be reported in net income or other comprehensive income, as appropriate based on the hedging relationship, if any, that had existed for that derivative. Midland is currently reviewing the likely impact of this Statement.

Statement Of Position ('SOP') 98-1 'Accounting for the costs of computer software developed or obtained for internal use', was issued in March 1998. It requires that internal and external costs incurred in developing internal-use computer software are capitalised from the application development stage through to the point at which the project is substantially complete. The SOP is effective for fiscal years beginning after 15 December 1998 and retroactive application is not permitted. Midland is currently reviewing the likely impact of this Statement.

Deferred taxation

Under SFAS No. 109, Midland's total deferred tax assets were £251 million at 31 December 1998 (1997: £249 million). Midland's deferred tax liabilities at 31 December 1998 amounted to £523 million (1997: £482 million).

Realisation of the total deferred tax assets of £251 million is considered more likely than not, as the temporary timing differences are expected to reverse in the foreseeable future.

In connection with an HSBC Group-wide initiative in 1998, all relevant subsidiaries of HSBC have conformed to a common application of the more-likely-than-not test in SFAS No. 109 for recognition of deferred tax assets for US GAAP purposes. For Midland, this resulted in recognition on a retroactive basis of greater deferred tax asset amounts in connection with provisions for loan losses. Management does not consider the effect of this restatement to be material.

Fees and commissions receivable

In 1993, Midland adopted the Statement of Recommended Practice ('SORP') on Advances, which requires that a fee which amounts in substance to an additional interest charge should be spread on a level yield basis, or, to the extent that a fee represents costs of providing a continuing service to the borrower, spread over the life of the advance on the basis of work done.

SFAS No. 91 'Accounting for Non-refundable Fees and Costs Associated with Originating or Acquiring Loans', requires all loan origination fees, net of related direct costs, to be deferred and recognised over the life of the loan as an adjustment of yield.

As a result of the adoption of the SORP on Advances, the difference between UK GAAP and US GAAP is not material in relation to fees received from 1 January 1993. Consequently, the adjustment to shareholders' funds at 31 December 1992, which related to the effect of the difference between UK GAAP and US GAAP for fees received prior to 1 January 1993, has now been amortised over the remaining average life of the loans concerned. As at 31 December 1998 there was no residual unamortised amount.

Goodwill

Under US GAAP, at 31 December 1998 the cost of goodwill relating to acquisitions made prior to 1 January 1998 amounted to £107 million (1997: £108 million) and the accumulated amount of goodwill amortised amounted to £49 million (1997: £45 million).

Lease financing

Leasing balances are stated in the balance sheet after deducting £230 million (1997: £473 million) unearned charges and interest.

Loan impairment

Having compared the carrying value of the loan portfolio calculated in accordance with SFAS No. 114 with the carrying value under UK GAAP, Midland has determined that there is no material effect on attributable profit or shareholders' funds.

Net unrealised gains/losses on debt and equity securities

Under SFAS No. 115 Midland's investment securities are categorised as available for sale, and securities held for purposes other than investment are designated as trading securities. Midland's other participating interests are categorised as available for sale. Debt securities and equity shares that were acquired in exchange for advances in order to achieve an orderly realisation are categorised as available for sale.

37 Differences between UK and US GAAP *(continued)*

Net unrealised gains/losses on debt and equity securities (continued)

The book value and market value of these debt securities and equity shares are analysed as follows:

	1998		*1997*	
	Book value £m	**Market value £m**	Book value £m	Market value £m
Available for sale	**7,969**	**8,036**	6,917	7,012
Trading	**13,572**	**13,572**	13,753	13,753

In addition, under US GAAP, debt securities and equity shares acquired in exchange for advances in order to achieve an orderly realisation are required to be accounted for at their fair value at the date of exchange. Under SFAS No. 115, certain of these debt swaps qualify as securities and accordingly have been classified as available for sale above. The adjustment to shareholders' funds to reflect the US GAAP treatment of debt swaps included write downs of £30 million at 31 December 1998 (1997: £36 million; 1996: £54 million) which related to securities. The adjustments required under SFAS No. 115 have been calculated based on balances which already incorporate the adjustments made for debt swaps.

Debt securities and equity shares categorised as available for sale under US GAAP give rise to an adjustment in the reconciliation of shareholders' funds under UK and US GAAP as they are carried at amortised cost less any permanent diminution in value under UK GAAP, but are required to be measured at fair value under SFAS No. 115. The net unrealised holding gains as at 31 December 1998 amounted to £97 million before tax (1997: £131 million) and £67 million (1997: £91 million) after tax.

Pension costs

For the reconciliation below, Midland has adopted the provisions of SFAS No. 87, as amended by SFAS No. 132 'Employers' Disclosures about Pensions and Other Postretirement Benefits', in respect of the Principal Scheme, a funded defined benefit plan within the Midland Bank Pension Scheme. Estimated pension costs for this plan computed under SFAS No. 87 are as follows:

	1998 £m	*1997* £m	*1996* £m
Service cost	**145**	135	117
Interest cost	**333**	352	319
Expected return on plan assets	**(349)**	(359)	(333)
Net amortisation and deferral	**(3)**	(3)	(1)
Pension costs	**126**	125	102

The estimated funded status of the Principal Scheme under SFAS No. 87 was as follows:

	1998 £m	*1997* £m
Projected benefit obligation		
Benefit obligation at 1 January	**5,231**	4,409
Service cost	**145**	135
Interest cost	**333**	352
Benefits paid	**(215)**	(201)
Actuarial loss	**863**	536
Benefit obligation at 31 December	**6,357**	5,231
Plan assets at fair value		
Assets at 1 January	**5,420**	4,393
Actual return	**(155)**	940
Employer contribution	**97**	288
Benefits paid	**(215)**	(201)
Assets at 31 December	**5,147**	5,420

Notes on the Accounts (continued)

37 Differences between UK and US GAAP *(continued)*

Pension costs (continued)

	1998 £m	*1997* £m
Plan assets (deficient to)/in excess of projected benefit obligation	**(1,210)**	189
Amounts available to be applied as an increase (reduction) to future pension cost		
Balance of initial transition amount	**(20)**	(25)
Net unrecognised loss/(gain)	**1,079**	(288)
Unrecognised prior service cost	**18**	20
Accrued pension cost	**(133)**	(104)
Additional minimum liability	**(223)**	—
Unfunded accumulated benefit obligation	**(356)**	(104)
Additional minimum liability	**(223)**	—
Intangible asset	**18**	—
Accumulated other comprehensive income	**(205)**	—
Taxation	**64**	—
Net accumulated other comprehensive income	**(141)**	—

The valuations of plan assets were conducted on 30 September 1998 and 1997.

Under SFAS No. 87, the excess of plan assets over the projected benefit obligation at the transition date (1 January 1988) is recognised as a reduction to pension expense on a prospective basis over 15 years.

The financial assumptions used to calculate the projected benefit obligation at 31 December 1998 and 1997 are as follows:

	1998 %	*1997* %
Discount rate	**5.5**	6.5
Rate of pay escalation	**4.5**	4.5
Rate of pension increase	**3.0**	3.0
Rate of return on assets	**5.5**	6.5

The assets of the Principal Scheme are invested primarily in equities and fixed interest securities.

The scheme's retirement benefits are generally based on the final year's pensionable salary and the number of years' pensionable service with the Bank at retirement.

The £126 million US GAAP pension cost (1997: £125 million; 1996: £102 million) compares with £97 million (1997: £101 million; 1996: £113 million) under UK GAAP. The difference, net of UK corporation tax at 31 per cent in 1998, 31.5 per cent in 1997 and 33 per cent in 1996, results in an additional charge to attributable profit of £20 million (1997: £16 million; 1996: £7 million credit) under US GAAP.

Post-retirement benefits other than pensions

US GAAP requires the cost of post-retirement benefits other than pensions to be accrued over the service lives of employees from the date of full eligibility for all of the benefits expected to be received. The statement permits companies to account for the unfunded and previously unrecognised accumulated benefit obligation either by a full charge to income in the year of adoption or by amortisation over the average remaining service period of active scheme participants, or 20 years, if greater.

The UK Urgent Issues Task Force issued Abstract 6 ('UITF 6') 'Accounting for post-retirement benefits other than pensions' in November 1992. Its requirements are similar to those of SFAS No. 106. Midland adopted UITF 6 with effect from 1 January 1993.

37 Differences between UK and US GAAP *(continued)*

Post-retirement benefits other than pensions (continued)

Approximately 3,700 (1997: 3,600) pensioners are covered by Midland's post-retirement health-care scheme and approximately 1,200 (1997: 1,300) staff members may become eligible if they remain with Midland until retirement.

The charge relating to post-retirement health care benefits was made up as follows:

	1998	*1997*	*1996*
	£m	£m	£m
Interest cost	**8**	11	11
Amortisation of actuarial gain	**(3)**	—	—
Amortisation of transition obligation	**6**	6	6
	11	17	17

Repurchase agreements

SFAS No. 127 'Deferral of the Effective Date of Certain Provisions of FASB Statement No. 125', which was issued in December 1996, delayed by one year the effective date of the provisions of SFAS No.125 that deal with secured borrowings and collateral, repurchase agreements and securities lending.

Midland has reviewed the requirements of SFAS No. 125 which are now effective and has determined that the impact on the balance sheet as at 31 December 1998 has been to increase total assets and liabilities by £2,562 million relating to reverse repos.

Restructuring costs

Midland's provisions for redundancy costs under US GAAP that did not meet the specific EITF Abstracts Issue 94-3 criteria were not material as at 31 December 1998, 31 December 1997 and 31 December 1996.

Share option plans

SFAS No.123 'Accounting for Stock Based Compensation' while introducing a fair value based method of accounting for stock based compensation plans, does permit entities to continue with the Accounting Practices Board ('APB') Opinion No.25 'intrinsic' value method (where compensation cost is based on the market value of the stock). Midland continues to value its stock compensation plans under the provisions of APB Opinion No.25.

Statement of consolidated cash flows

Midland complies with the requirements of FRS 1 'Cash Flow Statements' which was revised in October 1996.

FRS 1 is similar to SFAS No. 95 'Statement of Cash Flows', as amended by SFAS No. 104 'Statement of Cash Flows – Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows from Hedging Transactions'.

In the Statement of Consolidated Cash Flows, 'cash' is defined as cash in hand and deposits repayable on demand with any qualifying financial institution, less overdrafts from any qualifying financial institution repayable on demand. Under US GAAP, 'cash equivalents' are defined as short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of interest rate changes.

Other principal differences between UK GAAP and US GAAP are in respect of classification. Under UK GAAP, Midland presents its cash flows for (a) operating activities; (b) dividends received from associated undertakings; (c) returns on investments and servicing of finance; (d) taxation; (e) capital expenditure and financial investment; (f) acquisitions and disposals; (g) equity dividends paid; and (h) financing activities. US GAAP requires only three categories of cash flow activity which are (a) operating; (b) investing; and (c) financing.

Cash flows arising from taxation and returns on investments and servicing of finance under UK GAAP would, with the exception of dividends paid, be included as operating activities under US GAAP; dividend payments would be included as a financing activity under US GAAP. Cash flows arising from capital expenditure and financial investments, as well as cash flows arising from transfers of subsidiaries and other associated interests under UK GAAP, would be classified as investing activities under US GAAP.

Notes on the Accounts (continued)

37 Differences between UK and US GAAP *(continued)*

Statement of consolidated cash flows (continued)

Net changes in loans and advances to customers, including lease financing receivables, would be reclassified from operating activities under UK GAAP, to investing activities under US GAAP. Net changes in deposits, dealing securities, and other short-term funding not included in cash, would be reclassified from operating activities to financing activities.

Under FRS 1, transactions designated as hedges are reported under the same heading as the related assets or liabilities. Set out below is a summary combined statement of cash flows under US GAAP.

	1998	*1997*	*1996*
	£m	£m	£m
Cash flows from operating activities	**(35)**	1,670	3,189
Cash flows from investing activities	**(3,985)**	(8,636)	(1,516)
Cash flows from financing activities	**1,848**	8,135	4,014
Effect of exchange rate changes on cash and cash equivalents	**50**	(223)	(389)
Net movement in cash and cash equivalents under US GAAP	**(2,122)**	946	5,298
Cash and cash equivalents at beginning of year	**13,540**	12,594	7,296
Cash and cash equivalents at end of year	**11,418**	13,540	12,594

Profit and loss account presentation

Provisions for contingent liabilities and commitments

Under US GAAP, 'Provisions for contingent liabilities and commitments' of £59 million, £3 million and £3 million for 1998, 1997 and 1996 respectively would be classified as 'Operating expenses'.

Amounts written off fixed asset investments

Under US GAAP, 'Amounts written off fixed asset investments' of £1 million, £4 million and £40 million for 1998, 1997 and 1996 respectively would be classified as 'Other operating income'.

Gains on disposal of investments and tangible fixed assets

Under US GAAP, 'Gains on disposal of investments and tangible fixed assets' of £34 million, £33 million and £92 million for 1998, 1997 and 1996 respectively would be classified as 'Other operating income'.

37 Differences between UK GAAP and US GAAP *(continued)*

The estimated effect of the adjustments to attributable profit and shareholders' funds, which would be required if US GAAP had been applied instead of UK GAAP, is summarised below:

Attributable profit		**1998**		*1997*		*1996*
		£m		£m		£m
Attributable profit as reported in the consolidated profit and loss account		**1,042**		1,051		849
Estimated adjustments regarding						
Debt swaps	**6**		20		1	
Deferred taxation	**(4)**		55		13	
Fees and commissions receivable	**—**		—		1	
Goodwill	**(5)**		—		(4)	
Lease financing	**(64)**		(43)		(2)	
Change in surplus retained in long-term assurance funds and net present value of policies in force	**(19)**		—		(44)	
Pension costs	**(29)**		(24)		11	
Restructuring costs	**—**		—		(12)	
Revaluation and depreciation of freehold and long leasehold properties	**14**		(14)		(15)	
Tax on reconciling items	**47**		26		14	
		(54)		20		(37)
Estimated attributable profit adjusted to accord with US GAAP		**988**		1,071		812
Of which:						
Banking		**932**		1,027		763
Asset Finance		**56**		44		49
Estimated attributable profit		**988**		1,071		812
		pence		pence		pence
Per ordinary share		**118.6**		129.0		97.2

Notes on the Accounts (continued)

37 Differences between UK GAAP and US GAAP *(continued)*

Shareholders' funds

		1998 £m		*1997* £m
Shareholders' funds as reported in the consolidated balance sheet		4,780		4,435
Estimated adjustments regarding				
Debt swaps	(40)		(46)	
Deferred taxation	157		161	
Goodwill	58		63	
Lease financing	(99)		(35)	
Surplus retained in long-term assurance funds and net present value of policies in force	(302)		(283)	
Ordinary dividends payable	350		350	
Pension costs	(133)		(104)	
Unfunded accumulated benefit obligation	(141)		—	
Revaluation and depreciation of freehold and long leasehold premises	(254)		(286)	
Tax on reconciling items	178		131	
Fair value adjustment for securities available for sale	67		91	
		(159)		42
Estimated shareholders' funds adjusted to accord with US GAAP		4,621		4,477
Of which:				
Banking		4,314		4,150
Asset Finance		307		327
Estimated shareholders' funds		4,621		4,477

Cumulative other comprehensive income

	Unfunded accumulated benefit obligation £m	*Foreign currency* £m	*Unrealised gains on securities* £m	*Total* £m
Balance at 1 January 1998	—	(102)	91	(11)
Current period movement	(141)	3	(24)	(162)
Balance at 31 December 1998	(141)	(99)	67	(173)

37 Differences between UK GAAP and US GAAP *(continued)*

Reconciliation of movements in shareholders' funds adjusted to accord with US GAAP

	1998	*1997*	*1996*
	£m	£m	£m
Estimated attributable profit adjusted to accord with US GAAP	**988**	1,071	812
Dividends	**(693)**	(594)	(387)
	295	477	425
Other recognised gains and losses for the year	**14**	(19)	(128)
New share capital subscribed	**—**	30	524
Unfunded accumulated benefit obligation	**(141)**	—	—
Change in fair value of securities available for sale	**(24)**	(36)	(1)
Net addition to shareholders' funds	**144**	452	820
Balance at 1 January	**4,477**	4,025	3,205
Balance at 31 December	**4,621**	4,477	4,025

38 Approval of the accounts

These accounts were approved by the Board of Directors on 22 February 1999.

39 Ultimate parent company

The ultimate parent company of Midland Bank plc is HSBC Holdings plc, which is incorporated and registered in England.

HSBC Holdings plc is the only undertaking for which consolidated accounts which include the consolidated accounts of Midland are drawn up.

HSBC Holdings plc is Midland's direct and ultimate controlling party as defined under Financial Reporting Standard 8 'Related Party Disclosures'.

Copies of HSBC Holdings plc's 1998 *Annual Report and Accounts* can be obtained from its registered office at 10 Lower Thames Street, London EC3R 6AE.

Five-Year Summary

Summary Consolidated Profit and Loss Account

Amounts in accordance with UK GAAP

	1998 £m	*1997* £m	*1996* £m	*1995* £m	*1994* £m
Interest receivable	6,481	5,855	5,115	4,974	4,280
Interest payable	(4,244)	(3,652)	(3,064)	(3,067)	(2,452)
Net interest income	2,237	2,203	2,051	1,907	1,828
Other income	1,805	1,839	1,587	1,465	1,217
Operating income	4,042	4,042	3,638	3,372	3,045
Operating expenses	(2,297)	(2,323)	(2,264)	(2,251)	(2,120)
Operating profit before provisions	1,745	1,719	1,374	1,121	925
Provisions					
— provisions for bad and doubtful debts	(196)	(129)	(172)	(198)	(98)
— provisions for contingent liabilities and commitments	(59)	(3)	(3)	—	(37)
Amounts written off fixed asset investments	(1)	(4)	(40)	(1)	(5)
Operating profit	1,489	1,583	1,159	922	785
Share of operating (loss)/profit in associated undertakings	(1)	9	21	22	34
Gains on disposal of					
— investments	28	24	91	50	84
— tangible fixed assets	6	9	1	4	2
Profit on ordinary activities before tax	1,522	1,625	1,272	998	905
Tax on profit on ordinary activities	(479)	(559)	(408)	(361)	(289)
Profit on ordinary activities after tax	1,043	1,066	864	637	616
Minority interests	(1)	(15)	(15)	(27)	(21)
Profit for the financial year attributable to shareholders	1,042	1,051	849	610	595
Dividends (including amounts attributable to non-equity shareholders)	(693)	(644)	(537)	(472)	(413)
Retained profit for the year	349	407	312	138	182
	pence	pence	pence	pence	pence
Earnings per ordinary share (basic and diluted)	125.3	126.3	101.9	73.8	73.1
Dividends per ordinary share	81.6	75.3	62.7	56.5	50.2
Dividend payout ratio	65.1%	59.6%	61.6%	76.5%	68.7%
Ratio of earnings to combined fixed charges and preference share dividend *(i)*					
Excluding interest on deposits	5.4	5.7	4.5	4.4	4.8
Including interest on deposits	1.3	1.4	1.4	1.3	1.4

(i) For the purpose of calculating the ratios of earnings to combined fixed charges and preference share dividends, earnings consist of profit before tax and minority interests, less the unremitted income of associated undertakings, plus fixed charges. Fixed charges consist of total net interest expense, including or excluding interest on deposits, as appropriate and the proportion of rental expense deemed representative of the interest factor.

Summary Consolidated Balance Sheet

Amounts in accordance with UK GAAP

	1998	*1997*	*1996*	*1995*	*1994*
	£m	£m	£m	£m	£m
Assets					
Treasury bills and other eligible bills	**2,562**	2,974	1,649	4,614	2,474
Loans and advances to banks	**11,516**	13,379	14,944	12,381	12,933
Loans and advances to customers	**52,371**	50,143	45,352	42,548	37,780
Debt securities	**18,734**	17,418	16,851	13,586	12,430
Other assets	**19,663**	18,162	17,425	20,498	14,758
Total assets	**104,846**	102,076	96,221	93,627	80,375
Liabilities					
Deposits by banks	**11,882**	12,267	12,401	15,152	13,668
Customer accounts	**60,299**	57,902	53,917	49,617	44,557
Debt securities in issue	**5,014**	4,737	3,065	2,036	2,375
Other liabilities	**19,488**	19,436	19,520	20,571	14,238
Subordinated liabilities					
— undated loan capital	**1,235**	1,241	1,061	999	992
— dated loan capital	**2,145**	2,056	2,142	1,832	1,490
Minority interests	**3**	2	155	181	197
Shareholders' funds (including non-equity interests)	**4,780**	4,435	3,960	3,239	2,858
Total liabilities	**104,846**	102,076	96,221	93,627	80,375
Attributable profit as a percentage of:					
Average shareholders' funds (equity)	**23.4%**	26.0%	24.5%	20.0%	21.2%
Average total assets	**1.0%**	1.0%	0.9%	0.7%	0.8%
Undated and dated subordinated loan capital, minority interests and shareholders' funds (equity) as a percentage of average total assets	**7.5%**	7.6%	7.3%	6.7%	7.0%
Shareholders' funds (equity) as a percentage of average total assets	**3.9%**	3.7%	3.4%	3.3%	3.6%

Five-Year Summary (continued)

Summary Consolidated US GAAP Information

Amounts in accordance with US GAAP

	1998	*1997*	*1996*	*1995*	*1994*
	£m	£m	£m	£m	£m
Profit for the financial year attributable to shareholders from continuing operations	**988**	1,071	812	488	546
Total assets	**108,196**	100,442	94,777	92,570	79,234
Shareholders' funds (including non-equity interests)	**4,621**	4,477	4,025	3,205	2,850
	pence	pence	pence	pence	pence
Earnings per ordinary share	**118.6**	129.0	97.2	58.5	66.9
Dividends per ordinary share	**81.6**	69.0	43.9	62.7	50.2
Dividend payout ratio	**68.8%**	53.6%	45.2%	107.3%	75.0%
Attributable profit as a percentage of:					
Average shareholders' funds (equity)	**22.4%**	26.2%	23.2%	16.0%	19.4%
Average total assets	**0.9%**	1.1%	0.9%	0.6%	0.7%
Undated and dated subordinated loan capital, minority interest and shareholders' funds (equity) as a percentage of average total assets	**7.2%**	7.7%	7.4%	6.8%	7.1%
Shareholders' funds (equity) as a percentage of average total assets	**3.7%**	3.8%	3.5%	3.3%	3.6%
Ratio of earnings to combined fixed charges and preference share dividend *(i)*					
Excluding interest on deposits	**5.1**	5.7	4.3	3.9	4.2
Including interest on deposits	**1.3**	1.4	1.4	1.3	1.3

(i) For the purpose of calculating the ratios of earnings to combined fixed charges and preference share dividends, earnings consist of profit before tax and minority interests, less the unremitted income of associated undertakings, plus fixed charges. Fixed charges consist of total net interest expense, including or excluding interest on deposits, as appropriate and the proportion of rental expense deemed representative of the interest factor.

Shareholder Information

Control of Registrant

The whole of the ordinary share capital and the one preferred ordinary share of Midland Bank plc are 100 per cent owned by HSBC Holdings plc.

None of the Directors or executive officers owned any ordinary shares in Midland Bank plc at 31 December 1998.

Nature of Trading Market

The authorised and issued, allotted and fully paid share capital of the Bank is as set out in Note 27 of the Notes on the Accounts.

In October 1993, the Bank issued 20,000,000 non-cumulative dollar-denominated preference shares represented by 10,000,000 Series A American Depositary Share ('ADS') units, each consisting of one Series A1 ADS and one Series A2 ADS. The Series A ADS units are evidenced by units of Series A1 American Depositary Receipts ('ADR') and Series A2 ADRs. The Series A1 ADSs and Series A2 ADSs represent one non-cumulative dollar-denominated preference share, Series A1 ('Series A1 dollar preference share') and one non-cumulative dollar-denominated preference share, Series A2 ('Series A2 dollar preference share'), respectively.

In February 1995, the Bank issued 14,000,000 non-cumulative dollar-denominated preference shares represented by 7,000,000 Series B ADS units, each consisting of one Series B1 ADS and one Series B2 ADS. The Series B ADS units are evidenced by units of Series B1 ADRs and Series B2 ADRs. The Series B1 ADSs and Series B2 ADSs represent one non-cumulative dollar-denominated preference share, Series B1 ('Series B1 dollar preference share') and one non-cumulative dollar-denominated preference share, Series B2 ('Series B2 dollar preference share'), respectively.

In October 1995, the Bank issued 16,000,000 non-cumulative dollar-denominated preference shares represented by 8,000,000 Series C ADS units, each consisting of one Series C1 ADS and one Series C2 ADS. The Series C ADS units are evidenced by units of Series C1 ADRs and Series C2 ADRs. The Series C1 ADSs and Series C2 ADSs represent one non-cumulative dollar-denominated preference share, Series C1 ('Series C1 dollar preference share') and one non-cumulative dollar-denominated preference share, Series C2 ('Series C2 dollar preference share'), respectively.

In July 1996, the Bank issued 16,000,000 non-cumulative dollar-denominated preference shares represented by 8,000,000 Series D ADS units, each consisting of one Series D1 ADS and one Series D2 ADS. The Series D ADS units are evidenced by units of Series D1 ADRs and Series D2 ADRs. The Series D1 ADSs and Series D2 ADSs represent one non-cumulative dollar-denominated preference share, Series D1 ('Series D1 dollar preference share') and one non-cumulative dollar-denominated preference share, Series D2 ('Series D2 dollar preference share'), respectively.

In February 1997, the Bank issued 2,000,000 non-cumulative second dollar-denominated preference share units, each consisting of one non-cumulative second dollar-denominated preference share, Series 1 and one non-cumulative second dollar-denominated preference share, Series 2. These securities have not been and will not be registered under the US Securities Act of 1933 and there is no established public trading market for these securities.

The ADR depositary is HSBC Bank USA (formerly Marine Midland Bank) and these ADSs are listed and traded on the New York Stock Exchange. Series A and B dollar preference shares are listed on the London Stock Exchange, although no trading takes place. The Series A1, A2, B1, B2, C1, C2, D1 and D2 ADSs are not separately transferable. The Series A1, A2, B1, B2, C1, C2, D1 and D2 dollar preference shares can be transferred separately if they are withdrawn from deposit.

Shareholder Information (continued)

Nature of Trading Market *(continued)*

The following table shows the number of ADS record holders, the number of ADS record holders with US addresses and the number of units held by those with US addresses as at 31 December 1998.

	Number of record holders	*Number of record holders with US addresses*	*Those with US addresses hold the following number of units*
Series A	660	652	9,994,150
Series B	504	503	6,999,000
Series C	324	319	7,996,800
Series D	230	229	7,999,300

The following table shows the high and low sales prices for the Series A ADS units, the Series B ADS units, the Series C ADS units and the Series D ADS units during the periods indicated, as reported by the New York Stock Exchange.

	Series A ADS units		*Series B ADS units*		*Series C ADS units*		*Series D ADS units*	
	High	*Low*	*High*	*Low*	*High*	*Low*	*High*	*Low*
	US$	US$	US$	US$	US$	US$	US$	US$
1998								
Fourth quarter	**25.81**	**24.81**	**27.06**	**26.00**	**26.63**	**25.38**	**26.75**	**25.69**
Third quarter	**26.25**	**24.81**	**27.75**	**26.19**	**27.31**	**25.38**	**27.13**	**25.25**
Second quarter	**26.38**	**25.31**	**27.75**	**27.00**	**26.88**	**26.05**	**26.69**	**26.06**
First quarter	**26.25**	**24.88**	**27.75**	**26.88**	**26.94**	**26.00**	**26.75**	**25.88**
1997								
Fourth quarter	26.06	25.31	27.94	27.38	26.75	25.88	26.75	25.88
Third quarter	25.94	24.63	27.75	26.88	26.75	25.31	26.75	25.56
Second quarter	25.13	24.13	27.34	26.13	25.63	24.75	25.91	25.13
First quarter	25.63	24.38	27.75	25.88	25.88	24.75	26.75	24.75

Exchange Controls and Other Limitations Affecting Security Holders

There are no UK exchange controls that would affect payments to holders of the Bank's securities who are US citizens or residents.

Taxation

The following is a summary of certain US federal and UK tax considerations relevant to the acquisition, ownership and disposition of dollar-denominated preference shares, ADRs and debt securities (issued by the Bank) by a holder that qualifies as a resident of the United States for the purposes of, and is fully entitled to benefits under, the income tax treaty between the United States and the United Kingdom (an 'Eligible US Holder'). Holders should consult their own advisers regarding their entitlement to treaty benefits and other matters relevant to their particular circumstances.

This summary deals only with original purchasers who hold dollar-denominated preference shares, ADRs or debt securities as capital assets, and does not address tax considerations applicable to investors who may be subject to special tax rules. The summary does not address the tax treatment for persons or entities who hold dollar-denominated preference shares, ADRs or debt securities in connection with the conduct of business in the United Kingdom. Special considerations applicable to certain classes of debt securities are discussed in the relevant prospectus supplement.

UK taxation

Dividends

Up to 5 April 1999 an Eligible US Holder generally has been entitled to receive, in respect of a cash dividend from the Bank, an additional payment (a 'treaty payment') equal to the associated UK tax credit to which an individual resident in the United Kingdom would have been entitled, reduced by a UK withholding tax not exceeding 15 per cent of the sum of the cash dividend and the associated UK tax credit. As a result, an Eligible US Holder receiving a dividend of US$80 from the Bank has been entitled to receive a treaty payment of US$5, (i.e. an associated UK tax credit of US$20, less UK withholding tax of US$15), for a total receipt after UK taxes but before US taxes of US$85. The Bank entered into arrangements with the UK Inland Revenue under which the Bank made treaty payments directly to certain Eligible US Holders of ADRs at the same time, and together with, the related cash dividend. Eligible US holders who have not qualified for these expedited payment procedures may claim treaty payments by following procedures prescribed by the US and UK tax authorities.

Following the Finance (No. 2) Act 1997 the tax treatment outlined above will change with effect from 6 April 1999. The amount of the tax credit will fall from 20 per cent to 10 per cent of the aggregate of the dividend and the tax credit. So, for example, on a dividend of US$80, the tax credit will be US$8.89 (i.e. 10 per cent of US$80 plus US$8.89). An effect of the Finance (No. 2) Act 1997 changes will be to reduce the treaty payment to zero for dividends paid after 5 April 1999.

Under the terms of issue prospectus in respect of each dollar-denominated preference share, the Bank has guaranteed a fixed tax credit inclusive return to the shareholders. Therefore, in the above example, for dividends paid after 5 April 1999 the tax credit inclusive return will be maintained by the Bank increasing the cash dividend to US$90.

Interest

Payments of interest on debt securities will be exempt from UK withholding tax so long as the Global Security (debt securities are issued as a Global Security in bearer form) remains in its current form and continues to be quoted on the New York or London Stock Exchange, and payments are not made by or through a paying agent in the United Kingdom.

Shareholder Information (continued)

UK taxation *(continued)*

Disposal

An Eligible US Holder who is not resident (nor, in the case of an individual, ordinarily resident) in the United Kingdom normally will not be liable for UK taxation on any capital gain realised on the sale or redemption of a dollar preference share, ADR or debt security.

Stamp duty

No UK stamp duty will be payable on the transfer of, or agreement to transfer, an ADR, or beneficial ownership of an ADR, provided that the ADR and any separate instrument of transfer or written agreement to transfer is executed and remains at all times outside the United Kingdom. In the event that the dollar-denominated preference shares are not held as ADRs, UK stamp duty or stamp duty reserve tax normally will be payable on or in respect of transfers of dollar-denominated preference shares. Prospective purchasers of dollar-denominated preference shares should consult their own advisers regarding this issue. No UK stamp duty will be payable on the acquisition or transfer, or agreement to transfer, of a beneficial interest in the Global Security, provided that the Global Security remains in its current form and that any instrument of transfer or agreement to transfer is not executed in the United Kingdom and remains at all times outside the United Kingdom

US taxation

Dividends

The gross amount of dividends received by an Eligible US Holder (including amounts in respect of the associated UK tax credit and UK withholding tax) will be treated as foreign source dividend income for US tax purposes, and will not be eligible for the dividends received deduction allowed to corporations. UK taxes withheld from dividend distributions (in effect 15 per cent up to 5 April 1999, 10 per cent thereafter) are eligible for credit against an Eligible US Holder's US federal income tax liability, subject to generally applicable limitations. If the Bank declares and pays a special dividend in connection with the redemption of dollar-denominated preference shares of any series, that special dividend, although no authority directly addresses the issue, should be treated for US tax purposes in the same manner as any other dividend paid by the Bank.

Interest

Payments of interest on a debt security should be included in an Eligible US Holder's income at the time that such payments accrue or are received, in accordance with the Eligible US Holder's method of tax accounting.

Disposal

Upon the sale, exchange or redemption of a dollar-denominated preference share or ADR, a US holder generally will recognise a gain or loss for US federal income tax purposes in an amount equal to the difference between the amount realised (including, in the case of a redemption, any related associated UK tax credit, but excluding amounts treated as dividends for US tax purposes) and the holder's tax basis in the dollar-denominated preference share or ADR. Upon the sale, exchange or retirement of a debt security, a US holder generally will recognise a gain or loss equal to the difference between the amount realised on the sale, exchange or retirement (less any accrued interest, which will be taxable as such) and the holder's tax basis in the debt security.

SEC 20-F Cross Reference Sheet and Other Information

Cross reference sheet

SEC 20-F Cross Reference Sheet and Other Information (continued)

Glossary of terms

Term used	US equivalent or brief description
Accounts	Financial statements
Advance Corporation Tax	Tax paid on company distributions offsettable against UK taxes due on income (repealed with effect 6 April 1999)
Allotted	Issued
Attributable profit	Net income
Balance sheet	Statement of financial position
Bills	Notes
Called-up share capital	Ordinary shares, issued and fully paid
Capital allowances	Tax depreciation allowances
Class of business	Industry segment
Creditors	Payables
Dealing	Trading
Debtors	Receivables
Deferred tax	Deferred income tax
Depreciation	Amortisation
Fees and commissions payable	Fees and commissions expense
Fees and commissions receivable	Fees and commissions income
Finance lease	Capital lease
Financial Review	Management's Discussion and Analysis
Freehold	Ownership with absolute rights in perpetuity
Interest payable	Interest expense
Interest receivable	Interest income
Loans and advances	Lendings
Loan capital	Long-term debt
Net asset value	Book value
Nominal value	Par value
Ordinary shares	Common stock
Overdraft	A line of credit, contractually repayable on demand unless a fixed term has been agreed, established through a customer's current account.
Preference shares	Preferred stock
Premises	Real estate
Profit and loss account	Income statement
Profit and loss account reserve	Retained earnings
Provisions	Allowances
Revaluation reserve	Increase or temporary decrease in the valuation of certain assets as compared with historical cost
Share capital	Ordinary shares or common stock issued and fully paid
Shareholders' funds	Stockholders' equity
Share premium account	Additional paid-in capital
Shares in issue	Shares outstanding
Tangible fixed assets	Property and equipment
Write-offs	Charge-offs

Published by Midland Bank plc, 27-32 Poultry,
London EC2P 2BX

Midland Bank plc is regulated by the Personal Investment Authority, the Investment Management Regulatory Organisation and The Securities and Futures Authority.

Designed by Group Corporate Affairs,
HSBC Holdings plc, London

Printed by Garden House Press, Perivale, London

Stock no. 91273-6

Midland Bank plc
27-32 Poultry, London EC2P 2BX, United Kingdom