HSBC Bank Middle East Limited

Annual Report and Accounts 2010

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Presentation of Information

This document comprises the *Annual Report and Accounts 2010* for HSBC Bank Middle East Limited ('the bank') and its subsidiary undertakings (together 'the group'). It contains the Directors' Report and Accounts, together with the Auditor's report, as required by the Companies (Jersey) Law 1991. References to 'HSBC' or 'the HSBC Group' within this document mean HSBC Holdings plc together with its subsidiaries.

Report of the Directors

Board of Directors

S N Cooper, Chief Executive Officer & Deputy Chairman
A S M El Anwar
R B Gray
M M Hussain
C J M Keirle
A D R Monro-Davies
A H M H B Mostafawi
A M Sharaf
T L Slattery
N G Winsor
A P Zeller

Changes in Directors

- **S T Gulliver** *was appointed as a Director and Chairman of the Board on 15 February 2010 and resigned as a Director and Chairman of the Board on 31 December 2010;*
- **R B Gray** *was appointed as a Director on 15 February 2010;*
- **Y A Nasr** *resigned as a Director on 14 March 2010;*
- **R W L Groves** *resigned as a Director on 10 May 2010;*
- **A D R Monro-Davies** *was appointed as a Director on 12 July 2010;*
- **N G Winsor** *was appointed as a Director on 6 December 2010;*
- **A H M H B Mostafawi** *was appointed as a Director on 9 December 2010;*
- **J C Perry** *resigned as a Director on 17 December 2010;*
- **C M Meares** *resigned as a Director on 31 December 2010;*
- **A P Zeller** *was appointed as a Director on 14 February 2011; and*
- **A M Sharaf** *was appointed as a Director on 3 March 2011.*

The Directors who held office during the year and up to the date the Annual Report and Accounts were approved are listed above.

Principal activities

The group, through its branch network and subsidiary undertakings, provides a range of banking and related financial services in the Middle East. There has been no significant change in this activity.

Disposal of interest in associates

On 29 October 2010, the bank sold its 48.9 per cent shareholding in British Arab Commercial Bank plc for US$90,301 thousand resulting in a loss of US$41,556 thousand.

Profit/loss and dividends

The profit attributable to the shareholders amounted to US$462,152 thousand (2009: loss US$6,718 thousand) as set out in the consolidated income statement on page 5.

During the year there were no dividends declared or paid (2009: US$150,000 thousand declared and paid).

Registered office

HSBC House, Esplande, St Helier, Jersey, JE4 8UB, Channel Islands.
The bank is incorporated in Jersey, Channel Islands - number 85600.

Auditors

The shareholders of the bank having agreed to dispense with the requirement to hold annual general meetings, the auditors, KPMG Channel Islands Limited are deemed to be re-appointed, and continue in office at fees to be agreed by the Directors.

On behalf of the Board
J A Tothill, *Secretary*
20 March 2011

Statement of Directors' Responsibilities in Relation to the Directors' Report and the Financial Statements

The following statement, which should be read in conjunction with the Auditor's statement of their responsibilities set out in their report on page 3, is made with a view to distinguishing for shareholders the respective responsibilities of the Directors and of the Auditors in relation to the financial statements.

The Directors are responsible for preparing the financial statements in accordance with applicable law and International Financial Reporting Standards as endorsed by the EU.

Company law requires the Directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the group and of the profit or loss of the group for that period. In preparing these financial statements, the Directors are required to:

- select suitable accounting policies and apply them consistently;
- make judgments and estimates which are reasonable and prudent;
- state whether they have been prepared in accordance with International Financial Reporting Standards as endorsed by the EU;
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the group will continue in business.

The Directors are responsible for keeping proper accounting records that disclose with reasonable accuracy at any time the financial position of the group and enable them to ensure that the financial statements comply with the Companies (Jersey) Law 1991, the Banking Business (Jersey) Law 1991, the Financial Services (Trust Company and Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2007, the Financial Services (Fund Services Business (Accounts, Audits and Reports) (Jersey)) Order 2007 and the Financial Services (General Insurance Mediation Business (Accounts, Audits, Reports and Solvency)) (Jersey) Order 2005. They are also responsible for safeguarding the assets of the group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

On behalf of the Board

S N Cooper, Chief Executive Officer & Deputy Chairman

Independent Auditor's Report to the Member of HSBC Bank Middle East Limited

We have audited the consolidated financial statements of HSBC Bank Middle East Limited for the year ended 31 December 2010 which comprise the consolidated income statement, the consolidated statement of comprehensive income, the consolidated statement of financial position, the consolidated statement of cash flows, the consolidated statement of changes in equity and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards as adopted by the EU.

This report is made solely to the bank's member, as a body, in accordance with Article 113A of the Companies (Jersey) Law 1991. Our audit work has been undertaken so that we might state to the bank's member those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the bank and the bank's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of directors and auditors

As explained more fully in the Statement of Directors' Responsibilities set out on page 2, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies (Jersey) Law 1991, the Banking Business (Jersey) Law 1991, the Financial Services (Trust Company and Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2007, the Financial Services (Fund Services Business (Accounts, Audits and Reports) (Jersey)) Order 2007 and the Financial Services (General Insurance Mediation Business (Accounts, Audits, Reports and Solvency)) (Jersey) Order 2005.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the group's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements. In addition, we read all the financial and non-financial information in the Annual Report and Accounts to identify material inconsistencies with the audited financial statements. If we become aware of any apparent material misstatements or inconsistencies we consider the implications for our report.

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the group's affairs as at 31 December 2010 and of its profit for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards as adopted by the EU; and
- have been prepared in accordance with the requirements of the Companies (Jersey) Law 1991, the Banking Business (Jersey) Law 1991, the Financial Services (Trust Company and Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2007, the Financial Services (Fund Services Business (Accounts, Audits and Reports) (Jersey)) Order 2007 and the Financial Services (General Insurance Mediation Business (Accounts, Audits, Reports and Solvency)) (Jersey) Order 2005.

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies (Jersey) Law 1991 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept by the company; or
- returns adequate for our audit have not been received from branches not visited by us; or

Independent Auditor's Report to the Member of HSBC Bank Middle East Limited (continued)

- the financial statements are not in agreement with the accounting records and returns; or
- we have not received all the information and explanations we require for our audit.

Laurence Catterson
for and on behalf of KPMG Channel Islands Limited
Chartered Accountants and Recognized Auditor
21 March 2011

Notes:

- The maintenance and integrity of the HSBC Bank Middle East Limited and/ or other HSBC Group websites is the responsibility of the directors; the work carried out by auditors does not involve consideration of these matters and accordingly, KPMG Channel Islands Limited accepts no responsibility for any changes that may have occurred to the financial statements or our audit report since 21 March 2011. KPMG Channel Islands Limited has carried out no procedures of any nature subsequent to 21 March 2011 which in any way extends this date.
- Legislation in Jersey governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions. The directors shall remain responsible for establishing and controlling the process for doing so, and for ensuring that the financial statements are complete and unaltered in any way.

Financial Statements

Consolidated income statement for the year ended 31 December 2010

	Notes	2010 US$000	2009 US$000
Interest income		**1,536,116**	1,808,997
Interest expense		**(416,042)**	(571,334)
Net interest income		**1,120,074**	1,237,663
Fee income		**635,694**	602,129
Fee expense		**(54,094)**	(48,987)
Net fee income		**581,600**	553,142
Trading income excluding net interest income		**287,452**	316,496
Net interest income on trading activities		**11,474**	19,121
Net trading income		**298,926**	335,617
Gains less losses from financial investments		**(2,237)**	9,113
Dividend income		**6,157**	3,275
Other operating income		**(8,653)**	76,165
Net operating income before loan impairment charges and other credit risk provisions		**1,995,867**	2,214,975
Loan impairment charges and other credit risk provisions		**(533,742)**	(1,272,868)
Net operating income	*4*	**1,462,125**	942,107
Employee compensation and benefits	*5*	**(502,610)**	(473,014)
General and administrative expenses		**(374,351)**	(373,360)
Depreciation and impairment of property, plant and equipment	*17*	**(28,722)**	(20,484)
Amortisation of intangible assets	*16*	**(6,610)**	(6,505)
Total operating expenses		**(912,293)**	(873,363)
Operating profit		**549,832**	68,744
Share of profit in associates		**8,813**	4,253
Profit before tax		**558,645**	72,997
Tax expense	*8*	**(93,832)**	(62,825)
Profit for the year		**464,813**	10,172
Profit/(loss) attributable to shareholders of the parent company		**462,152**	(6,718)
Profit attributable to non-controlling interests		**2,661**	16,890

The accompanying notes on pages 11 to 93 form an integral part of these financial statements.

Financial Statements (continued)

Consolidated statement of comprehensive income for the year ended 31 December 2010

	2010	2009
	US$000	US$000
Profit for the year	**464,813**	10,172
Other comprehensive income/(expense)		
Available-for-sale investments:	**(649)**	(1,716)
– fair value (losses)/gains	**(2,232)**	19,760
– fair value losses transferred to income statement on disposal	**(3)**	(18,922)
– amounts transferred to the income statement in respect of impairment losses	**1,338**	2,722
– income taxes	**248**	(5,276)
Cash flow hedges	**(9,928)**	7,760
– fair value (losses)/gains	**(8,906)**	21,414
– fair value losses transferred to income statement	**(3,503)**	(11,713)
– income taxes	**2,481**	(1,941)
Actuarial (losses)/gains on defined benefit plans	**(4,958)**	6,784
– before income taxes	**(6,851)**	8,236
– income taxes	**1,893**	(1,452)
Exchange differences	**(11,621)**	9,109
Other comprehensive (expense)/income for the year, net of tax	**(27,156)**	21,937
Total comprehensive income for the year	**437,657**	32,109
Total comprehensive income for the year attributable to:		
– shareholders of the parent company	**435,002**	15,219
– non-controlling interests	**2,655**	16,890
	437,657	32,109

The accompanying notes on pages 11 to 93 form an integral part of these financial statements.

Consolidated statement of financial position at 31 December 2010

	Notes	**2010 US$000**	2009 US$000
ASSETS			
Cash and balances at central banks		**719,363**	432,386
Items in the course of collection from other banks		**61,085**	49,259
Trading assets	*12*	**718,676**	453,349
Derivatives	*13*	**826,578**	662,301
Loans and advances to banks	*23*	**8,229,772**	8,106,050
Loans and advances to customers	*23*	**20,586,712**	19,883,399
Financial investments	*14*	**8,667,721**	7,873,086
Other assets	*19*	**1,269,993**	1,007,690
Current tax assets		**183**	9,287
Prepayments and accrued income		**173,903**	197,547
Interests in associates	*15*	**29,337**	170,284
Intangible assets	*16*	**13,293**	9,639
Property, plant and equipment	*17*	**123,821**	137,667
Deferred tax assets	*8*	**173,986**	174,208
Total assets		**41,594,423**	39,166,152
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	*23*	**1,547,700**	1,674,632
Customer accounts	*23*	**26,343,980**	26,524,487
Items in the course of transmission to other banks		**766,308**	65,703
Trading liabilities	*24*	**121,733**	12,874
Derivatives	*13*	**834,806**	647,895
Debt securities in issue	*20*	**5,688,545**	5,090,208
Other liabilities	*21*	**1,924,724**	1,198,844
Current tax liabilities		**142,668**	211,193
Accruals and deferred income		**209,389**	215,666
Provisions	*22*	**15,372**	11,089
Deferred tax liabilities	*8*	**6,715**	4,471
Retirement benefit liabilities	*5*	**63,885**	53,759
Total liabilities		**37,665,825**	35,710,821
Equity			
Called up share capital	*28*	**931,055**	931,055
Other reserves		**24,241**	38,692
Retained earnings		**2,708,619**	2,267,418
Total equity attributable to shareholders of the parent company		**3,663,915**	3,237,165
Non-controlling interests		**264,683**	218,166
Total equity		**3,928,598**	3,455,331
Total equity and liabilities		**41,594,423**	39,166,152

The accompanying notes on pages 11 to 93 form an integral part of these financial statements.

S N Cooper, *Chief Executive Officer and Deputy Chairman*

Financial Statements (continued)

Consolidated statement of cash flows for the year ended 31 December 2010

	Notes	2010 US$000	2009 US$000
Cash flows from operating activities			
Profit before tax		**558,645**	72,997
Adjustments for:			
– non-cash items included in profit before tax	*29*	**625,856**	1,346,019
– change in operating assets	*29*	**(1,492,094)**	2,566,192
– change in operating liabilities	*29*	**1,001,139**	(1,971,369)
– elimination of exchange differences[1]		**(44,279)**	(57,595)
– net loss/(gain) from investing activities		**41,991**	(18,757)
– share of profits in associates		**(8,813)**	(4,253)
– distributions from associates		**1,987**	6,267
– contributions paid for defined benefit plans		**(248)**	(291)
– tax paid		**(145,211)**	(226,282)
Net cash generated from operating activities		**538,973**	1,712,928
Cash flows from investing activities			
Purchase of financial investments		**(2,793,004)**	(1,236,463)
Proceeds from the sale of financial investments		**1,736,858**	735,350
Purchase of property, plant and equipment		**(25,675)**	(48,476)
Proceeds from the sale of property, plant and equipment		**2,187**	6,743
Purchase of intangible assets		**(5,812)**	(7,286)
Proceeds from the sale of intangible assets		**–**	41
Net cash outflow from acquisition of and increase in stake of associates		**(50)**	(811)
Proceeds from disposal of associates		**90,301**	–
Net cash outflow from acquisition of Algeria branch network		**–**	(15,352)
Net cash used in investing activities		**(995,195)**	(566,254)
Cash flows from financing activities			
Issue of ordinary share capital		**–**	300,000
Non equity preference share capital issued		**–**	225,000
Non equity preference share capital redeemed		**–**	(225,000)
Dividends paid to shareholders of the parent company		**–**	(150,000)
Dividends paid to non-controlling interests		**(3,367)**	(2,342)
Net cash (used in)/generated from financing activities		**(3,367)**	147,658
Net (decrease)/increase in cash and cash equivalents		**(459,589)**	1,294,332
Cash and cash equivalents at 1 January		**11,371,131**	10,066,255
Effect of exchange rate changes on cash and cash equivalents		**71,501**	10,544
Cash and cash equivalents at 31 December	*29*	**10,983,043**	11,371,131

1 *Adjustment to bring changes between opening and closing balance sheet amounts to average rates. This is not done on a line-by-line basis, as details cannot be determined without unreasonable expense.*

The accompanying notes on pages 11 to 93 form an integral part of these financial statements.

Consolidated statement of changes in equity for the year ended 31 December 2010

	2010									
			Other reserves							
	Called up share capital US$000	*Retained earnings* US$000	*Available-for-sale fair value reserve* US$000	*Cash flow hedging reserve* US$000	*Foreign exchange reserve* US$000	*Other reserve* US$000	*Merger reserve* US$000	*Total share-holders' equity* US$000	*Non-controlling interests* US$000	*Total equity* US$000
At 1 January	**931,055**	**2,267,418**	**48,592**	**(3,701)**	**(2,929)**	**12,082**	**(15,352)**	**3,237,165**	**218,166**	**3,455,331**
Profit for the year	–	**462,152**	–	–	–	–	–	**462,152**	**2,661**	**464,813**
Other comprehensive income (net of tax)	–	**(15,822)**	**(642)**	**(9,927)**	**(755)**	**(4)**	–	**(27,150)**	**(6)**	**(27,156)**
Available-for-sale investments	–	–	**(649)**	–	–	–	–	**(649)**	–	**(649)**
Cash flow hedges	–	–	–	**(9,928)**	–	–	–	**(9,928)**	–	**(9,928)**
Actuarial losses on defined benefit plans	–	**(4,958)**	–	–	–	–	–	**(4,958)**	–	**(4,958)**
Exchange differences and other	–	**(10,864)**	**7**	**1**	**(755)**	**(4)**	–	**(11,615)**	**(6)**	**(11,621)**
Total comprehensive income for the year	–	**446,330**	**(642)**	**(9,927)**	**(755)**	**(4)**	–	**435,002**	**2,655**	**437,657**
Dividends to shareholders	–	–	–	–	–	–	–	–	**(3,367)**	**(3,367)**
Shares issued in lieu of dividends and amounts arising thereon	–	–	–	–	–	**(107)**	–	**(107)**	–	**(107)**
Exercise and lapse of share options and vesting of share awards	–	–	–	–	–	**(316)**	–	**(316)**	–	**(316)**
Cost of share-based payment arrangements	–	–	–	–	–	**805**	–	**805**	–	**805**
Other movements	–	**(5,129)**	**674**	–	–	**(4,179)**	–	**(8,634)**	–	**(8,634)**
Changes in ownership interests in subsidiaries	–	–	–	–	–	–	–	–	**47,229**	**47,229**
At 31 December	**931,055**	**2,708,619**	**48,624**	**(13,628)**	**(3,684)**	**8,281**	**(15,352)**	**3,663,915**	**264,683**	**3,928,598**

The accompanying notes on pages 11 to 93 form an integral part of these financial statements.

Financial Statements (continued)

	2009									
			Other reserves							
	Called up share capital US$000	*Retained earnings* US$000	*Available-for-sale fair value reserve* US$000	*Cash flow hedging reserve* US$000	*Foreign exchange reserve* US$000	*Other reserve* US$000	*Merger reserve* US$000	*Total share-holders' equity* US$000	*Non-controlling interests* US$000	*Total equity* US$000
At 1 January	631,055	2,401,324	49,952	(11,461)	322	8,078	–	3,079,270	251,985	3,331,255
Profit/(loss) for the year	–	(6,718)	–	–	–	–	–	(6,718)	16,890	10,172
Other comprehensive income (net of tax)		19,156	(1,712)	7,760	(3,251)	(16)	–	21,937	–	21,937
Available-for-sale investments	–	–	(1,716)	–	–	–	–	(1,716)	–	(1,716)
Cash flow hedges	–	–	–	7,760	–	–	–	7,760	–	7,760
Actuarial gains on defined benefit plans	–	6,784	–	–	–	–	–	6,784	–	6,784
Exchange differences and other	–	12,372	4	–	(3,251)	(16)	–	9,109	–	9,109
Total comprehensive income for the year	–	12,438	(1,712)	7,760	(3,251)	(16)	–	15,219	16,890	32,109
Share capital issued	300,000	–	–	–	–	–	–	300,000	–	300,000
Dividends to shareholders	–	(150,000)	–	–	–	–	–	(150,000)	(900)	(150,900)
Realisation on disposal of property taken directly to Equity	–	–	–	–	–	–	–	–	–	–
Shares issued in lieu of dividends and amounts arising thereon	–	–	–	–	–	(319)	–	(319)	–	(319)
Exercise and lapse of share options and vesting of share awards	–	–	–	–	–	(317)	–	(317)	–	(317)
Cost of share-based payment arrangements	–	–	–	–	–	4,625	–	4,625	–	4,625
Excess of consideration over net asset value	–	–	–	–	–	–	(15,352)	(15,352)	–	(15,352)
Other movements	–	3,656	352	–	–	31	–	4,039	(4,315)	(276)
Changes in ownership interests in subsidiaries	–	–	–	–	–	–	–	–	(45,494)	(45,494)
At 31 December	931,055	2,267,418	48,592	(3,701)	(2,929)	12,082	(15,352)	3,237,165	218,166	3,455,331

The accompanying notes on pages 11 to 93 form an integral part of these financial statements.

Notes on the Financial Statements

1 Basis of preparation

a *Compliance with International Financial Reporting Standards*

The consolidated financial statements of the group have been prepared in accordance with International Financial Reporting Standards ('IFRSs') as issued by the International Accounting Standards Board ('IASB') and as endorsed by the EU. EU-endorsed IFRSs may differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2010, there were no unendorsed standards effective for the year ended 31 December 2010 affecting these consolidated financial statements, and there was no difference between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to the group. Accordingly, the group's financial statements for the year ended 31 December 2010 are prepared in accordance with IFRSs as issued by the IASB.

IFRSs comprise accounting standards issued by the IASB and its predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee ('IFRIC') and its predecessor body.

During 2010, the group adopted the following standards and amendments to standards:

The group adopted the revised IFRS 3 'Business Combinations' and amendments to IAS 27 'Consolidated and Separate Financial Statements'. The main changes under the standards are that:

– acquisition-related costs are recognised as an expense in the income statement in the period in which they are incurred;

– all consideration transferred, including contingent consideration, is recognised and measured at fair value at the acquisition date;

– equity interests held prior to control being obtained are remeasured to fair value at the date of obtaining control, and any gain or loss is recognised in the income statement;

– an option is available, on a transaction-by-transaction basis, to measure any non-controlling (previously referred to as minority) interests in the entity acquired either at fair value, or at the non-controlling interests' proportionate share of the net identifiable assets of the entity acquired; and

– changes in a parent's ownership interest in a subsidiary that do not result in a change of control are treated as transactions between equity holders and are reported in equity.

In terms of their application to the group, the revised IFRS 3 and the amendments to IAS 27 apply prospectively to acquisitions and transactions taking place on or after 1 January 2010, and have no significant effect on these consolidated financial statements.

During 2010, in addition to the above, the group adopted a number of standards, interpretations and amendments thereto which had an insignificant effect on the consolidated financial statements of the group.

b *Presentation of information*

Capital disclosures under IAS 1 'Presentation of Financial Statements' have been included in note 30.

The functional currency of the bank is US dollars, which is also the presentation currency of the consolidated financial statements of the group.

c *Consolidation*

The consolidated financial statements of the group comprise the financial statements of HSBC Bank Middle East Limited and its subsidiaries made up to 31 December.

Subsidiaries are consolidated from the date that the group gains control. The purchase method of accounting is used to account for the acquisition of subsidiaries by the group. The cost of an acquisition is measured at the fair value of the consideration, including contingent consideration, given at the date of exchange. Acquisition-related costs are recognised as an expense in the income statement in the period in which they are incurred. The acquired identifiable assets, liabilities and contingent liabilities are measured at their fair values at the date of acquisition. Goodwill is measured as the excess of the aggregation of the consideration transferred, the amount of non-controlling interest and the fair value of the acquirer's previously held equity interest, if any, over the net of the amounts of the identifiable

Notes on the Financial Statements (continued)

1 Basis of preparation *(continued)*

assets acquired and the liabilities assumed. The amount of non-controlling interest is measured either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets. In a business combination achieved in stages, the previously held equity interest is remeasured at the acquisition-date fair value with resulting gain or loss recognised in the income statement or other comprehensive income as appropriate. In the event of that the fair value of net assets acquired is in excess of the aggregation of the consideration transferred, the amount of non-controlling interest and the fair value of the previously held equity interest, the difference is recognised immediately in the income statement.

The group has adopted the policy of 'predecessor accounting' for the transfer of business combinations under common control within the HSBC Group. Under IFRS where both HSBC Group entities adopt the same method for accounting for common control transactions the excess of the cost of the purchased group entity over the carrying value is recorded as a merger reserve on consolidation.

Entities that are controlled by the group are consolidated until the date that control ceases.

In the context of Special Purpose Entities ('SPEs'), the following circumstances may indicate a relationship in which, in substance, the group controls and, consequently, consolidates an SPE:

- the activities of the SPE are being conducted on behalf of the group according to its specific business needs so that the group obtains benefits from the SPE's operation;
- the group has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an 'autopilot' mechanism, the group has delegated these decision-making powers;
- the group has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
- the group retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

The group performs a re-assessment of consolidation whenever there is a change in the substance of the relationship between the group and an SPE. All intra-group transactions are eliminated on consolidation.

The consolidated financial statements of the group also include the attributable share of the results and reserves of associates. These are based on financial statements made up to 31 December.

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d *Future accounting developments*

At 31 December 2010, a number of standards and interpretations, and amendments thereto, had been issued by the IASB, which are not effective for the group's consolidated financial statements as at 31 December 2010. Those which are expected to have a significant effect on the group's consolidated financial statements are discussed below.

Standards and Interpretations issued by the IASB but not endorsed by the EU

In November 2009, the IASB issued IFRS 9 'Financial Instruments' ('IFRS 9'). This introduced new requirements for the classification and measurement of financial assets. In October 2010, the IASB issued additions to IFRS 9 dealing with financial liabilities. These represent the first instalments in the IASB's planned phased replacement of IAS 39 'Financial Instruments: Recognition and Measurement' ('IAS 39') with a less complex and improved standard for financial instruments.

The standard is effective for annual periods beginning on or after 1 January 2013 with early adoption permitted. IFRS 9 is required to be applied retrospectively. If the standard is adopted prior to 1 January 2012, an entity will be exempt from the requirement to restate prior period comparative information. IFRS 9 is subject to EU endorsement, the timing of which is uncertain. Accordingly, HSBC is unable to provide a date by which it plans to apply IFRS 9.

The main changes to the requirements of IAS 39 are summarised below.

- All financial assets that are currently in the scope of IAS 39 will be classified as either amortised cost or fair value. The available-for-sale held-to-maturity and loans and receivables categories will no longer exist.
- Classification is based on an entity's business model for managing the financial assets and the contractual

1 Basis of preparation *(continued)*

cash flow characteristics of the financial assets. Reclassifications between the two categories are prohibited unless there is a change in the entity's business model.

- A financial asset is measured at amortised cost if two criteria are met: i) the objective of the business model is to hold the financial asset for the collection of the contractual cash flows; and ii) the contractual cash flows of the instrument are solely payments of principal and interest on the principal outstanding. All other financial assets are measured at fair value. Movements in the fair value of financial assets classified at fair value are recognised in profit or loss, except for equity investments where an entity takes the option to designate an equity instrument that is not held for trading at fair value through other comprehensive income. If this option is taken, all subsequent changes in fair value are recognised in other comprehensive income with no recycling of gains or losses to the income statement. Dividend income would continue to be recognised in the income statement.

- An entity is only permitted to designate a financial asset otherwise meeting the amortised cost criteria at fair value through profit or loss if doing so significantly reduces or eliminates an accounting mismatch. This designation is made on initial recognition and is irrevocable.

- Financial assets which contain embedded derivatives are to be classified in their entirety either at fair value or amortised cost depending on whether the contracts as a whole meet the relevant criteria under IFRS 9.

- Most of IAS 39's requirements for financial liabilities are retained, including amortised cost accounting for most financial liabilities with bifurcation of embedded derivatives. However, fair value changes attributable to changes in own credit risk for financial liabilities designated under the fair value option other than loan commitments and financial guarantee contracts are to be presented in the statement of other comprehensive income. These amounts are not subsequently reclassified to the income statement but may be transferred within equity.

The next steps in the IASB's project will address the impairment of financial assets measured at amortised cost and hedge accounting. The IASB has indicated that it aims to finalise the replacement of IAS 39 by June 2011. In addition, the IASB is working with the US Financial Accounting Standards Board to reduce inconsistencies between US GAAP and IFRS in accounting for financial instruments. The impact of IFRS 9 may change as a consequence of further developments resulting from the IASB's financial instruments project. As a result, it is impracticable to quantify the impact of IFRS 9 as at the date of publication of these financial statements.

2 Summary of significant accounting policies

a *Interest income and expense*

Interest income and expense for all financial instruments except for those classified as held-for-trading or designated at fair value (other than debt securities issued by the group and derivatives managed in conjunction with such debt securities issued) are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest method. The effective interest method is a way of calculating the amortised cost of a financial asset or a financial liability (or groups of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments through the expected life of the financial instrument or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the group estimates cash flows considering all contractual terms of the financial instrument but not future credit losses. The calculation includes all amounts paid or received by the group that are an integral part of the effective interest rate of a financial instrument, including transaction costs and all other premiums or discounts.

Interest on impaired financial assets is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

b *Non interest income*

Fee income is earned from a diverse range of services provided by the group to its customers. Fee income is accounted for as follows:

Notes on the Financial Statements (continued)

2 Summary of significant accounting policies *(continued)*

- income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as an arrangement for the acquisition of shares or other securities);
- income earned from the provision of services is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
- income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, certain loan commitment fees) and recorded in 'Interest income' (Note 2(a)).

Net trading income comprises all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with related interest income, expense and dividends.

Net expense/income from financial instruments designated at fair value includes all gains and losses from changes in the fair value of financial assets and financial liabilities designated at fair value through profit or loss. Interest income and expense and dividend income arising on these financial instruments are also included in 'Net income from financial instruments at fair value', except for interest arising from debt securities issued, and derivatives managed in conjunction with those debt securities, which is recognised in 'Interest expense'.

Dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for listed equity securities, and usually the date when shareholders have approved the dividend for unlisted equity securities.

c *Operating segments*

The group's operating segments are organised into geographical regions comprising UAE, Qatar, and Rest of Middle East. The Rest of Middle East covers Algeria, Bahrain, Jordan, Kuwait, Lebanon, Oman, Pakistan and the Palestine Autonomous Area. Due to the nature of the group, the Board (chief operating decision maker) regularly reviews operating activity on a number of bases, including by geography and by customer group. Although the Board reviews information on a number of bases, capital resources are allocated and performance assessed primarily by geographical region and the segmental analysis is presented on that basis. In addition, the economic conditions of each geographical region are highly influential in determining performance across the different types of business activity carried out in each region. Therefore, provision of segment information on a geographical basis provides the most meaningful information with which to understand the performance of the business.

Information provided to the Board to make decisions about allocating resources and assessing performance of operating segments is measured in accordance with IFRSs. Due to the nature of the HSBC Group's structure, the analysis of profits shown in note 10 includes intra-group items between geographical regions with the elimination shown in a separate column. Such transactions are conducted on an arm's length basis. Shared costs are included in segments on the basis of the actual recharges made.

d *Determination of fair value*

All financial instruments are recognised initially at fair value. In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (that is, the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, the group recognises a trading gain or loss on inception of the financial instrument. When unobservable market data has a significant impact on the valuation of financial instruments, the entire initial difference in fair value indicated by the valuation model from the transaction price is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis, or when the inputs become observable, or the transaction matures or is closed out, or when the group enters into an offsetting transaction.

Subsequent to initial recognition, the fair values of financial instruments measured at fair value are determined as described in note 23.

2 Summary of significant accounting policies *(continued)*

e *Reclassification of financial assets*

Non-derivative financial assets (other than those designated at fair value through profit or loss upon initial recognition) may be reclassified out of the fair value through profit or loss category in the following circumstances:

- financial assets that would have met the definition of loans and receivables at initial recognition (if the financial asset had not been required to be classified as held for trading) may be reclassified out of the fair value through profit or loss category if there is the intention and ability to hold the financial asset for the foreseeable future or until maturity; and
- financial assets (except financial assets that would have met the definition of loans and receivables at initial recognition) may be reclassified out of the fair value through profit or loss category and into another category in rare circumstances.

When a financial asset is reclassified as described in the above circumstances, the financial asset is reclassified at its fair value on the date of reclassification. Any gain or loss already recognised in the income statement is not reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortised cost, as applicable.

f *Loans and advances to banks and customers*

Loans and advances to banks and customers include loans and advances originated by the group which are not classified either as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to a borrower. They are derecognised when either the borrower repays their obligations, or the loans are sold or written off, or substantially all the risks and rewards of ownership are transferred. They are initially recorded at fair value plus any directly attributable transaction costs and are subsequently measured at amortised cost using the effective interest method, less impairment losses. Where exposures are hedged by derivatives designated and qualifying as fair value hedges, the carrying value of the loans and advances so hedged includes a fair value adjustment for the hedged risk only.

The group may commit to underwrite loans on fixed contractual terms for specified periods of time, where the drawdown of the loan is contingent upon certain future events outside the control of the group. Where the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a trading derivative and measured at fair value through profit and loss. On drawdown, the loan is classified as held for trading and measured at fair value through profit and loss. Where it is not the group's intention to trade the loan, a provision on the loan commitment is only recorded where it is probable that the group will incur a loss. This may occur, for example, where a loss of principal is probable or the interest rate charged on the loan is lower than the cost of funding. On inception of the loan, the hold portion is recorded at its fair value and subsequently measured at amortised cost using the effective interest method. However, where the initial fair value is lower than the cash amount advanced (for example, due to the rate of interest charged on the loan being below the market rate of interest), the write down is charged to the income statement. The write down will be recovered over the life of the loan, through the recognition of interest income using the effective interest method, unless the loan becomes impaired. The write down is recorded as a reduction to other operating income.

Financial assets which have been reclassified out of the fair value through profit and loss category into the loans and receivables category are initially recorded at the fair value at the date of reclassification. The reclassified assets are subsequently measured at amortised cost, using the effective interest rate determined at the date of reclassification.

g *Impairment of loans and advances*

Losses for impaired loans are recognised promptly when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment losses are calculated on individual loans and on groups of loans assessed collectively. Impairment losses are recorded as charges to the income statement. The carrying amount of impaired loans on the balance sheet is reduced through the use of impairment allowance accounts. Losses expected from future events are not recognised.

Individually assessed loans and advances

For all loans that are considered individually significant, the group assesses on a case-by-case basis at each balance

Notes on the Financial Statements (continued)

2 Summary of significant accounting policies *(continued)*

sheet date whether there is any objective evidence that a loan is impaired. The criteria used by the group to determine that there is such objective evidence include:

- known cash flow difficulties experienced by the borrower;
- past due contractual payments of either principal or interest;
- breach of loan covenants or conditions;
- the probability that the borrower will enter bankruptcy or other financial realisation; and
- a significant downgrading in credit rating by an external credit rating agency.

For those loans where objective evidence of impairment exists, impairment losses are determined by considering the following factors:

- the group's aggregate exposure to the customer;
- the viability of the customer's business model and its capability to trade successfully out of financial difficulties and generate sufficient cash flow to service its debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, the group and the likelihood of other creditors continuing to support the company;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency; and
- when available, the secondary market price of the debt.

Impairment losses are calculated by discounting the expected future cash flows of a loan at its original effective interest rate, and comparing the resultant present value with the loan's current carrying amount. The impairment allowances on individually significant accounts are reviewed at least semi-annually, and more regularly when circumstances require. This normally encompasses re-assessment of the enforceability of any collateral held and of actual and anticipated receipts. Individually assessed impairment allowances are only released when there is reasonable and objective evidence of a reduction in the established loss estimate.

Collectively assessed loans and advances

Impairment is assessed on a collective basis in two circumstances:

- to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment; and
- for homogeneous groups of loans that are not considered individually significant.

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of loss has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for the purpose of calculating an estimated collective loss. This reflects impairment losses that the group has incurred as a result of events occurring before the balance sheet date, which the group is not able to identify on an individual loan basis, and that can be reliably estimated.

2 Summary of significant accounting policies *(continued)*

These losses will only be individually identified in the future. As soon as information becomes available which identifies losses on individual loans within the group, those loans are removed from the group and assessed on an individual basis for impairment.

The collective impairment allowance is determined after taking into account:

- historical loss experience in portfolios of similar credit risk characteristics (for example, by industry sector, loan grade or product);
- the estimated period between impairment occurring and the loss being identified and evidenced by the establishment of an appropriate allowance against the individual loan; and
- management's experienced judgement as to whether current economic and credit conditions are such that the actual level of inherent losses at the balance sheet date is likely to be greater or less than that suggested by historical experience.

The period between a loss occurring and its identification is estimated by local management for each identified portfolio.

Homogeneous groups of loans and advances

Statistical methods are used to determine impairment losses on a collective basis for homogeneous groups of loans that are not considered individually significant, because individual loan assessment is impracticable. Losses in these groups of loans are recorded on an individual basis when individual loans are written off, at which point they are removed from the group. Two alternative methods are used to calculate allowances on a collective basis:

- When appropriate empirical information is available, the group uses roll-rate methodology. This methodology employs statistical analyses of historical data and experience of delinquency and default to estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date which the group is not able to identify on an individual loan basis, and that can be reliably estimated. Under this methodology, loans are grouped into ranges according to the number of days past due, and statistical analysis is used to estimate the likelihood that loans in each range will progress through the various stages of delinquency and ultimately prove irrecoverable. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss.
- When the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, the group adopts a basic formulaic approach based on historical loss rate experience.

In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio. In certain circumstances, historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, where there have been changes in economic, regulatory or behavioural conditions, such that the most recent trends in the portfolio risk factors are not fully reflected in the statistical models.

These additional portfolio risk factors may include recent loan portfolio growth and product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features (such as the ability of borrowers to repay adjustable-rate loans where reset interest rates give rise to increases in interest charges), economic conditions such as national and local trends in housing markets and interest rates, portfolio seasoning, account management policies and practices, current levels of write-offs, changes in laws and regulations and other items which can affect customer payment patterns on outstanding loans, such as natural disasters. These risk factors, where relevant, are taken into account when calculating the appropriate level of impairment allowances by adjusting the impairment allowances derived solely from historical loss experience.

Roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

Notes on the Financial Statements (continued)

2 Summary of significant accounting policies *(continued)*

Write-off of loans and advances

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery. Where loans are secured, this is generally after receipt of any proceeds from the realisation of security. In circumstances where the net realisable value of any collateral has been determined and there is no reasonable expectation of further recovery, write off may be earlier.

Reversals of impairment

If the amount of an impairment loss decreases in a subsequent period, and the decrease can be related objectively to an event occurring after the impairment was recognised, the excess is written back by reducing the loan impairment allowance account accordingly. The write-back is recognised in the income statement.

Reclassified loans and advances

Where financial assets have been reclassified out of the fair value through profit or loss category to the loans and receivables category, the effective interest rate determined at the date of reclassification is used to calculate any impairment losses.

Following reclassification, where there is a subsequent increase in the estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase is recognised as an adjustment to the effective interest rate from the date of change in the estimate rather than as an adjustment to the carrying amount of the asset at the date of change in the estimate.

Assets acquired in exchange for loans

Non-financial assets acquired in exchange for loans as part of an orderly realisation are recorded as assets held for sale and reported in 'Other assets'. The asset acquired is recorded at the lower of its fair value (less costs to sell) and the carrying amount of the loan (net of impairment allowance) at the date of exchange. No depreciation is charged in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recognised in the income statement, in 'Other operating income'. Any subsequent increase in the fair value less costs to sell, to the extent this does not exceed the cumulative write down, is also recognised in 'Other operating income', together with any realised gains or losses on disposal.

Renegotiated loans

Loans subject to collective impairment assessment whose terms have been renegotiated are no longer considered past due, but are treated as new loans for measurement purposes once the minimum numbers of payments required under the new arrangements have been received. These renegotiated loans are segregated from other parts of the loan portfolio for the purpose of collective impairment assessment, to reflect their risk profile. Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or should be considered past due. The carrying amount of loans that have been classified as renegotiated retain this classification until maturity or derecognition.

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h *Trading assets and trading liabilities*

Treasury bills, debt securities, equity shares, loans, deposits, debt securities in issue, and short positions in securities are classified as held for trading if they have been acquired principally for the purpose of selling or repurchasing in the near term, or they form part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking. These financial assets or financial liabilities are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase or sell the financial instruments, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently their fair values are remeasured, and gains and losses from changes therein are recognised in the income statement in 'Net trading income'.

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i *Financial instruments designated at fair value*

Financial instruments, other than those held for trading, are classified in this category if they meet one or more of the criteria set out below, and are so designated by management. The group may designate financial instruments at fair value when the designation:

2 Summary of significant accounting policies *(continued)*

- eliminates or significantly reduces measurement or recognition inconsistencies that would otherwise arise from measuring financial assets or financial liabilities, or recognising gains and losses on them, on different bases;
- applies to groups of financial assets, financial liabilities or combinations thereof that are managed, and their performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, and where information about the groups of financial instruments is reported to management on that basis; and
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, including certain debt issues and debt securities held.

The fair value designation, once made, is irrevocable. Designated financial assets and financial liabilities are recognised when the group enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and are normally derecognised when sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken directly to the income statement. Subsequently, the fair values are remeasured, and gains and losses from changes therein are recognised in 'Net income from financial instruments designated at fair value'.

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j *Financial investments*

Treasury bills, debt securities and equity shares intended to be held on a continuing basis, other than those designated at fair value, are classified as available-for-sale or held-to-maturity. Financial investments are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase securities, and are normally derecognised when either the securities are sold or the borrowers repay their obligations.

(i) Available-for-sale financial assets are initially measured at fair value plus direct and incremental transaction costs. They are subsequently remeasured at fair value, and changes therein are recognised in other comprehensive income in 'Available-for-sale investments – fair value gains/ (losses)' until the financial assets are either sold or become impaired. When available-for-sale financial assets are sold, cumulative gains or losses previously recognised in other comprehensive income are recognised in the income statement as 'Gains less losses from financial investments'.

Interest income is recognised on available-for-sale debt securities using the effective interest rate, calculated over the asset's expected life. Premiums and/or discounts arising on the purchase of dated investment securities are included in the calculation of their effective interest rates. Dividends are recognised in the income statement when the right to receive payment has been established.

At each balance sheet date an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset. Impairment losses are recognised if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the financial asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset that can be reliably estimated.

If the available-for-sale financial asset is impaired, the difference between the financial asset's acquisition cost (net of any principal repayments and amortisation) and the current fair value, less any previous impairment loss recognised in the income statement, is removed from other comprehensive income and recognised in the income statement.

Impairment losses for available-for-sale debt securities are recognised within 'Loan impairment charges and other credit risk provisions' in the income statement and impairment losses for available-for-sale equity securities are recognised within 'Gains less losses from financial investments' in the income statement. The impairment methodologies for available-for-sale financial assets are set out in more detail below:

- Available-for-sale debt securities: When assessing available-for-sale debt securities for objective evidence of impairment at the reporting date, the group considers all available evidence, including observable data or information about events specifically relating to the securities which may result in a shortfall in recovery of future cash flows. These events may include a significant financial difficulty of the issuer, a breach of contract such as a default, bankruptcy or other financial reorganisation, or the disappearance of an active market for the debt security because of financial difficulties relating to the issuer. These types of specific event and other factors such as information about the issuers' liquidity, business and financial risk exposures, levels of and

Notes on the Financial Statements (continued)

2 Summary of significant accounting policies *(continued)*

trends in default for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees may be considered individually, or in combination, to determine if there is objective evidence of impairment of a debt security.

– Available-for-sale equity securities: Objective evidence of impairment for available-for sale equity securities may include specific information about the issuer as detailed above, but may also include information about significant changes in technology, markets, economics or the law that provides evidence that the cost of the equity securities may not be recovered. A significant or prolonged decline in the fair value of the asset below its cost is also objective evidence of impairment. In assessing whether it is significant, the decline in fair value is evaluated against the original cost of the asset at initial recognition. In assessing whether it is prolonged, the decline is evaluated against the period in which the fair value of the asset has been below its original cost at initial recognition.

Once an impairment loss has been recognised on an available-for-sale financial asset, the subsequent accounting treatment for changes in the fair value of that asset differs depending on the nature of the available-for-sale financial asset concerned:

– For an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement when there is further objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in fair value of the financial asset is recognised in other comprehensive income. If the fair value of the debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement to the extent of the increase in fair value.

– For an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised directly in other comprehensive income. Impairment losses recognised on the equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available-for-sale equity security are recognised in the income statement, to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost of the equity security.

(ii) Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the group positively intends, and is able, to hold until maturity. Held-to-maturity investments are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest method, less any impairment losses.

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k *Sale and repurchase agreements (including stock lending and borrowing)*

When securities are sold subject to a commitment to repurchase them at a predetermined price (‘repos’), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to sell (‘reverse repos’) are not recognised on the balance sheet and the consideration paid is recorded in ‘Loans and advances to banks’ or ‘Loans and advances to customers’ as appropriate. The difference between the sale and repurchase price is treated as interest and recognised over the life of the agreement.

Securities lending and borrowing transactions are generally secured, with collateral taking the form of securities or cash advanced or received. The transfer of securities to counterparties under these agreements is not normally reflected on the balance sheet. Cash collateral advanced or received is recorded as an asset or a liability respectively.

Securities borrowed are not recognised on the balance sheet. If they are sold on to third parties, an obligation to return the securities is recorded as a trading liability and measured at fair value, and any gains or losses are included in ‘Net trading income’.

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l *Derivatives and hedge accounting*

Derivatives are recognised initially, and are subsequently remeasured, at fair value. Fair values of exchange-traded derivatives are obtained from quoted market prices. Fair values of over-the-counter derivatives are obtained using valuation techniques, including discounted cash flow models and option pricing models.

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are treated as separate derivatives when their economic characteristics and

2 Summary of significant accounting policies *(continued)*

risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative would meet the definition of a stand-alone derivative if they were contained in a separate contract, and the combined contract is not held for trading nor designated at fair value. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

Derivatives are classified as assets when their fair value is positive, or as liabilities when their fair value is negative. Derivative assets and liabilities arising from different transactions are offset only if the transactions are with the same counterparty, a legal right of offset exists, and the parties intend to settle the cash flows on a net basis.

The method of recognising fair value gains or losses depends on whether derivatives are held for trading or are designated as hedging instruments, and if the latter, the nature of the risks being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. When derivatives are designated as hedges, the group classifies them as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedges'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedges'); or (iii) a hedge of net investments in a foreign operation ('net investment hedges'). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value, cash flow or net investment hedge provided certain criteria are met.

Hedge accounting

At the inception of a hedging relationship, the group documents the relationship between the hedging instruments and hedged items, its risk management objective and its strategy for undertaking the hedge. The group also requires a documented assessment, both at hedge inception and on an ongoing basis, of whether or not the hedging instruments, primarily derivatives, that are used in hedging transactions are highly effective in offsetting the changes attributable to the hedged risks in the fair values or cash flows of the hedged items. Interest on designated qualifying hedges is included in 'Net interest income'.

Fair value hedge

Changes in the fair value of derivatives that are designated and qualify as fair value hedging instruments are recorded in the income statement, along with changes in the fair value of the hedged assets, liabilities or group thereof that are attributable to the hedged risk.

If a hedging relationship no longer meets the criteria for hedge accounting, the cumulative adjustment to the carrying amount of the hedged item is amortised to the income statement based on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognised, in which case it is released to the income statement immediately.

Cash flow hedge

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income within the 'Cash flow hedging reserve'. Any gain or loss in fair value relating to an ineffective portion is recognised immediately in the income statement.

The accumulated gains and losses recognised in other comprehensive income are reclassified to the income statement in the periods in which the hedged item will affect profit or loss. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously recognised in other comprehensive income are removed from equity and included in the initial measurement of the cost of the asset or liability.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in other comprehensive income at that time remains separately in equity until the forecast transaction is eventually recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in other comprehensive income is immediately reclassified to the income statement.

Net investment hedge

Hedges of net investments in foreign operations are accounted for in a similar way to cash flow hedges. A gain or loss on the effective portion of the hedging instrument is recognised in other comprehensive income; a gain

Notes on the Financial Statements (continued)

2 Summary of significant accounting policies *(continued)*

or loss on the ineffective portion is recognised immediately in the income statement. Gains and losses previously recognised in other comprehensive income are reclassified to the income statement on the disposal of the foreign operation.

Hedge effectiveness testing

To qualify for hedge accounting, the group requires that at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness) and demonstrate actual effectiveness (retrospective effectiveness) on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method adopted by an entity to assess hedge effectiveness will depend on its risk management strategy.

For prospective effectiveness the hedging instrument must be expected to be highly effective in offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. For actual effectiveness to be achieved, the changes in fair value or cash flows must offset each other in the range of 80 per cent to 125 per cent.

Hedge ineffectiveness is recognised in the income statement in 'Net trading income'.

Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in 'Net trading income', except where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives managed in conjunction with debt securities issued by the group), in which case gains and losses are reported in 'Net income from financial instruments designated at fair value'. The interest on derivatives managed in conjunction with debt securities issued by the group which are designated at fair value is recognised in 'Interest expense'. All other gains and losses on these derivatives are reported in 'Net income from financial instruments designated at fair value'.

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m *Derecognition of financial assets and liabilities*

Financial assets are derecognised when the contractual right to receive cash flows from the assets has expired; or when the group has transferred its contractual right to receive the cash flows of the financial assets, and either:

- substantially all the risks and rewards of ownership have been transferred; or
- the group has neither retained nor transferred substantially all the risks and rewards, but has not retained control.

Financial liabilities are derecognised when they are extinguished, that is when the obligation is discharged, cancelled or expires.

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n *Offsetting financial assets and financial liabilities*

Financial assets and financial liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

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o *Subsidiaries and associates*

The group classifies investments in entities which it controls as subsidiaries. The group classifies investments in entities over which it has significant influence, and that are not subsidiaries, as associates. For the purpose of determining this classification, control is considered to be the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Investments in associates are recognised using the equity method. Under this method, such investments are initially stated at cost, including attributable goodwill, and are adjusted thereafter for the post-acquisition change in the group's share of net assets.

2 Summary of significant accounting policies *(continued)*

Profits on transactions between the group and its associates are eliminated to the extent of the group's interest in the respective associates. Losses are also eliminated to the extent of the group's interest in the associates unless the transaction provides evidence of an impairment of the asset transferred.

p *Intangible assets*

Intangible assets includes computer software. Intangible assets are subject to impairment review if there are events or changes in circumstances that indicate that the carrying amount may not be recoverable.

- Intangible assets that have a finite useful life are stated at cost less amortisation and accumulated impairment losses and are amortised over their estimated useful lives. Estimated useful life is the lower of legal duration and expected useful life.

Intangible assets with finite useful lives are amortised, generally on a straight-line basis, over their useful lives as follows:

Internally generated software	between 3 and 5 years
Purchased software	between 3 and 5 years

q *Property, plant and equipment*

Land and buildings are stated at historical cost, or fair value at the date of transition to IFRSs ('deemed cost'), less any impairment losses and depreciation calculated to write off the assets over their estimated useful lives as follows:

- freehold land is not depreciated;
- freehold buildings are depreciated at the greater of two per cent per annum on a straight-line basis or over their remaining useful lives; and
- leasehold buildings are depreciated over the unexpired terms of the leases, or over their remaining useful lives.

Equipment, fixtures and fittings (including equipment on operating leases where the group is the lessor) are stated at cost less any impairment losses and depreciation calculated on a straight-line basis to write off the assets over their useful lives, which run to a maximum of 35 years but are generally between 5 years and 20 years.

Property, plant and equipment is subject to an impairment review if there are events or changes in circumstances which indicate that the carrying amount may not be recoverable.

r *Finance and operating leases*

Agreements which transfer to counterparties substantially all the risks and rewards incidental to the ownership of assets, but not necessarily legal title, are classified as finance leases. When the group is a lessor under finance leases the amounts due under the leases, after deduction of unearned charges, are included in 'Loans and advances to banks' or 'Loans and advances to customers', as appropriate. The finance income receivable is recognised in 'Net interest income' over the periods of the leases so as to give a constant rate of return on the net investment in the leases.

When the group is a lessee under finance leases, the leased assets are capitalised and included in 'Property, plant and equipment' and the corresponding liability to the lessor is included in 'Other liabilities'. A finance lease and its corresponding liability are recognised initially at the fair value of the asset or, if lower, the present value of the minimum lease payments. Finance charges payable are recognised in 'Net interest income' over the period of the lease based on the interest rate implicit in the lease so as to give a constant rate of interest on the remaining balance of the liability.

All other leases are classified as operating leases. When acting as lessor, the group includes the assets subject to operating leases in 'Property, plant and equipment' and accounts for them accordingly. Impairment losses are recognised to the extent that residual values are not fully recoverable and the carrying value of the assets is thereby impaired. When the group is the lessee, leased assets are not recognised on the balance sheet. Rentals payable and receivable under operating leases are accounted for on a straight-line basis over the periods of the leases and are included in 'General and administrative expenses' and 'Other operating income' respectively.

Notes on the Financial Statements (continued)

2 Summary of significant accounting policies *(continued)*

s *Income tax*

Income tax comprises current tax and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised in other comprehensive income or directly in equity, in which case it is recognised in the same statement in which the related item appears.

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantively enacted by the balance sheet date, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are offset when the group intends to settle on a net basis and the legal right to offset exists.

Deferred tax is recognised on temporary differences between the carrying amounts of assets and liabilities in the balance sheet and the amounts attributed to such assets and liabilities for tax purposes. Deferred tax liabilities are generally recognised for all taxable temporary differences and deferred tax assets are recognised to the extent that it is probable that future taxable profits will be available against which deductible temporary differences can be utilised.

Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled based on tax rates and laws enacted, or substantively enacted, by the balance sheet date. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when the group has a legal right to offset.

Deferred tax relating to actuarial gains and losses on post-employment benefits is recognised directly in other comprehensive income. Deferred tax relating to share-based payment transaction is recognised directly in equity to the extent that the amount of the estimated future tax deduction exceeds the amount of the related cumulative remuneration expense. Deferred tax relating to fair value re-measurement of available-for-sale investments and cash flow hedging instruments which are charged or credited directly to other comprehensive income, is also credited or charged directly to other comprehensive income and is subsequently recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

t *Pension and other post-employment benefits*

The group contributes to the Government pension and social security schemes in the countries in which it operates, as per local regulations. Where the group's obligations under the plans are equivalent to a defined contribution plan the payments made are charged as an expense as they fall due. End of service benefits are calculated and paid in accordance with local law. The group's net obligation in respect of such end of service benefits is the amount of future benefits that employees have earned in return for their service in current and prior periods.

The defined benefit pension costs and the present value of defined benefit obligations are calculated at the reporting date by the scheme's actuaries using the Projected Unit Credit Method. The net charge to the income statement mainly comprises the current service cost, plus the unwinding of the discount rate on plan liabilities, less the expected return on plan assets, and is presented in operating expenses. Past service costs are charged immediately to the income statement to the extent that the benefits have vested, and are otherwise recognised on a straight-line basis over the average period until the benefits vest. Actuarial gains and losses comprise experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred), as well as the effects of changes in actuarial assumptions. Actuarial gains and losses are recognised in other comprehensive income in the period in which they arise.

The defined benefit liability recognised in the balance sheet represents the present value of defined benefit obligations adjusted for unrecognised past service costs and reduced by the fair value of plan assets. Any net defined benefit surplus is limited to unrecognised past service costs plus the present value of available refunds and reductions in future contributions to the plan.

The group also makes contributions to the HSBC International Staff Retirement Benefit Scheme in respect of a small number of International Managers being seconded to the group by the HSBC Group. The group accounts for contributions to this scheme as if it is a defined contribution scheme on the basis that any actuarial gains and losses would not be material.

2 Summary of significant accounting policies *(continued)*

u *Share-based payments*

Shares in HSBC Holdings plc awarded to an employee on joining the group that are made available immediately, with no vesting period attached to the award, are expensed immediately. When an inducement is awarded to an employee on commencement of employment with the group, and the employee must complete a specified period of service before the inducement vests, the expense is recognised on a straight-line basis over the period to vesting.

Fair value is determined by using appropriate valuation models, taking into account the terms and conditions upon which the equity instruments were granted. Vesting conditions include service conditions and performance conditions. Market performance conditions are taken into account when estimating the fair value of equity instruments at the date of grant, so that an award is treated as vesting irrespective of whether the market performance condition or non-vesting condition is satisfied, provided all other conditions are satisfied.

Vesting conditions, other than market performance conditions, are not taken into account in the initial estimate of the fair value at the grant date. They are taken into account by adjusting the number of equity instruments included in the measurement of the transaction, so that the amount recognised for services received as consideration for the equity instruments granted shall be based on the number of equity instruments that eventually vest. On a cumulative basis, no expense is recognised for equity instruments that do not vest because of a failure to satisfy non-market performance or service conditions.

Where an award has been modified, as a minimum the expense of the original award continues to be recognised as if it had not been modified. Where the effect of a modification is to increase the fair value of an award or increase the number of equity instruments, the incremental fair value of the award or incremental fair value of the extra equity instruments is recognised in addition to the expense of the original grant, measured at the date of modification, over the modified vesting period.

A cancellation that occurs during the vesting period is treated as an acceleration of vesting, and recognised immediately for the amount that would otherwise have been recognised for services over the vesting period.

v *Foreign currencies*

Items included in the financial statements of each of the group's entities are measured using the currency of the primary economic environment in which the entity operates ('the functional currency'). The consolidated financial statements of HSBC Bank Middle East Limited are presented in US dollars, which is also the group's functional currency.

Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured at historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined. Any exchange component of a gain or loss on a non-monetary item is recognised in other comprehensive income if the gain or loss on the non-monetary item is recognised in other comprehensive income. Any exchange component of a gain or loss on a non-monetary item is recognised in the income statement.

The assets, including related goodwill where applicable, and liabilities of branches, subsidiaries and associates whose functional currency is not US dollars, are translated into the group's presentational currency at the rate of exchange ruling at the balance sheet date. The results of branches, subsidiaries and associates whose function currency is not US dollar are translated into US dollars at the average rates of exchange for the reporting period. Exchange differences arising from the retranslation of opening foreign currency net investments, and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period end, are recognised in other comprehensive income. In consolidated financial statements, exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in other comprehensive income. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in other comprehensive income are recognised in the income statement.

Notes on the Financial Statements (continued)

2 Summary of significant accounting policies *(continued)*

w *Provisions*

Provisions are recognised when it is probable that an outflow of economic benefits will be required to settle a current legal or constructive obligation, which has arisen as a result of past events, and for which a reliable estimate can be made of the amount of the obligation.

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security, are possible obligations that arise from past events whose existence will be confirmed only by the occurrence, or non-occurrence, of one or more uncertain future events not wholly within the control of the group; or are present obligations that have arisen from past events but are not recognised because it not probable that settlement will require outflow of economic benefits, or because the amount of the obligations cannot be reliably measured. Contingent liabilities are not recognised in the financial statements but are disclosed unless the probability of settlement is remote.

x *Financial guarantee contracts*

Liabilities under financial guarantee contracts not classified as insurance contracts are recorded initially at their fair value, which is generally the fee received or receivable. Subsequently, the financial guarantee liabilities are measured at the higher of the initial fair value, less cumulative amortisation, and the best estimate of the expenditure required to settle the obligations.

The bank may issue financial guarantees to other group entities. Where it has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the group may elect to account for guarantees as insurance contracts. This election is made on a contract by contract basis, but the election for each contract is irrevocable. Where these guarantees have been classified as insurance contracts, they are measured and recognised as insurance liabilities.

y *Debt securities issued, non-equity preference share capital and deposits by customers and banks*

Financial liabilities are recognised when the group enters into the contractual provisions of the arrangements with counterparties, which is generally on trade date, and initially measured at fair value, which is normally the proceeds received net of directly attributable transaction costs incurred. Subsequent measurement of financial liabilities, other than those measured at fair value through profit or loss and financial guarantees, is at amortised cost, using the effective interest rate method to amortise the difference between proceeds received, net of directly attributable transaction costs incurred, and the redemption amount over the expected life of the instrument.

z *Share capital*

Shares are classified as equity when there is no contractual obligation to transfer cash or other financial assets. Incremental costs directly attributable to the issue of equity instruments are shown in equity as a deduction from the proceeds, net of tax.

aa *Cash and cash equivalents*

For the purpose of the statement of cash flows, cash and cash equivalents include highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value. Such investments are normally those with less than three months' maturity from the date of acquisition, and include cash and balances at central banks, treasury bills and other eligible bills, loans and advances to banks, items in the course of collection from or in transmission to other banks and certificates of deposit.

3 Use of assumptions, estimates and judgement

The results of the group are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its consolidated financial statements. The accounting policies used in the preparation of the consolidated financial statements are described in detail in Note 2.

When preparing the financial statements, it is the Directors' responsibility to select suitable accounting policies and to make judgements and estimates that are reasonable and prudent.

The accounting policies that are deemed critical to the group's results and financial position, in terms of the materiality

3 Use of assumptions, estimates and judgement *(continued)*

of the items to which the policy is applied, or which involve a high degree of judgement including the use of assumptions and estimation, are disclosed below:

Impairment of loans and advances

The group's accounting policy for losses arising from the impairment of customer loans and advances is described in Note 2(g). Further information can be found in Note 30 'Risk Management'. Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at balance sheet date.

Management is required to exercise judgement in making assumptions and estimations when calculating loan impairment allowances on both individually and collectively assessed loans and advances. The most significant judgemental area is the calculation of collective impairment allowances.

The group uses two alternative methods to calculate collective impairment allowances on homogeneous groups of loans that are not considered individually significant:

- When appropriate empirical information is available, the group uses roll-rate methodology. This methodology employs statistical analysis of historical data and experience of delinquency and default to estimate the likelihood that loans will progress through the various stages of delinquency and ultimately prove irrecoverable. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio; and
- In other cases, when the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, the group adopts a formulaic approach which allocates progressively higher percentage loss rates the longer a customer's loan is overdue. Loss rates are based on historical experience.

Both methodologies are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis because of the large number of individually insignificant loans in the portfolio.

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

This key area of judgement is subject to uncertainty and is highly sensitive to factors such as loan portfolio growth, product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features, economic conditions such as national and local trends in housing markets, the level of interest rates, portfolio seasoning, account management policies and practices, changes in laws and regulations, and other factors that can affect customer payment patterns. Different factors are applied in different regions and countries to reflect different economic conditions and laws and regulations. The assumptions underlying this judgement are highly subjective. The methodology and the assumptions used in calculating impairment losses are reviewed regularly in the light of differences between loss estimates and actual loss experience. For example, roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

The total amount of the group's impairment allowances on homogeneous groups of loans is inherently uncertain because it is highly sensitive to changes in economic and credit conditions across a large number of geographical areas. Economic and credit conditions within geographical areas are influenced by many factors with a high degree of interdependency so that there is no one single factor to which the group's loan impairment allowances as a whole are particularly sensitive. It is possible that the outcomes within the next financial year could be different from the assumptions built into the models, resulting in a material adjustment to the carrying amount of loans and advances.

Valuation of financial instruments

The best evidence of fair value is a quoted price in an actively traded market. In the event that the market for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable

Notes on the Financial Statements (continued)

3 Use of assumptions, estimates and judgement *(continued)*

market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable. Valuation techniques that rely to a greater extent on unobservable inputs require a higher level of management judgement to calculate a fair value than those based wholly on observable inputs.

Valuation techniques used to calculate fair values include comparisons with similar financial instruments for which market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants. Valuation techniques incorporate assumptions that other market participants would use in their valuations, including assumptions about interest rate yield curves, exchange rates, volatilities, and prepayment and default rates. When valuing instruments by reference to comparable instruments, management takes into account the maturity, structure and rating of the instrument with which the position held is being compared.

The main assumptions and estimates which management considers when applying a model with valuation techniques are:

- the likelihood and expected timing of future cash flows on the instrument. These cash flows are usually governed by the terms of the instrument, although management judgement may be required when the ability of the counterparty to service the instrument in accordance with the contractual terms is in doubt. Future cash flows may be sensitive to changes in market rates;
- selecting an appropriate discount rate for the instrument. Management bases the determination of this rate on its assessment of what a market participant would regard as the appropriate spread of the rate for the instrument over the appropriate risk-free rate; and
- judgement to determine what model to use to calculate fair value in areas where the choice of valuation model is particularly subjective, for example, when valuing complex derivative products.

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

Given the uncertainty and subjective nature of valuing financial instruments at fair value, it is possible that the outcomes within the next financial year could differ from the assumptions used, and this would result in a material adjustment to the carrying amount of financial instruments measured at fair value.

Impairment of available-for-sale financial assets

The group's accounting policy for impairment on available-for-sale financial assets is described in Note 2(j).

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

The objective evidence required to determine whether an available-for-sale debt security is impaired comprises evidence of the occurrence of a loss event, and evidence that the loss event results in a decrease in estimated future cash flows. Where cash flows are readily determinable, a low level of judgement may be involved. Where determination of estimated future cash flows requires consideration of a number of variables, some of which may be unobservable in current market conditions, more significant judgement is required.

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

3 Use of assumptions, estimates and judgement *(continued)*

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

It is reasonably possible that outcomes in the next financial year could be different from the assumptions and estimates used in identifying impairment on available-for-sale debt securities, as a result of which, evidence of impairment may be identified in available-for-sale debt securities which had previously been determined not to be impaired. It is possible that this could result in the recognition of material impairment losses in the next financial year.

Pensions

The assumptions used are disclosed in Note 5 'Employee compensation and benefits'.

Share-based payments

The assumptions used are disclosed in Note 7 'Share-based payments'.

Notes on the Financial Statements (continued)

4 Net operating income

Net operating income is stated after the following items of income, expense, gains and losses:

	2010 US$000	2009 US$000
Income		
Interest recognised on impaired financial assets	**20,309**	14,595
Fees earned on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	**486,485**	486,069
Fees earned on trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	**14,293**	15,789
Income from listed investments	**37,069**	44,422
Income from unlisted investments	**97,516**	86,574
Expense		
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	**(415,018)**	(569,808)
Fees payable on financial assets or liabilities not held for trading nor designated at fair value, other than fees included in effective interest rate calculations on these types of assets and liabilities	**(27,652)**	(28,359)
Gains/(losses)		
Impairment of available-for-sale equity shares	**(4,501)**	(3,920)
Loss on disposal or settlement of loans and advances	**–**	(1,432)
(Loss)/gains on disposal of property, plant and equipment, intangible assets and non-financial investments	**(1,661)**	537
Loan impairment charge and other credit risk provisions	**(533,742)**	(1,272,868)
Net impairment charge on loans and advances	**(530,195)**	(1,273,907)
Net impairment of available-for-sale debt securities	**–**	1,198
Net impairment in respect of other credit risk provisions	**(3,547)**	(159)

5 Employee compensation and benefits

	2010 US$000	2009 US$000
Wages and salaries	**480,879**	448,829
Social security costs	**7,543**	5,600
Post-employment benefits	**14,188**	18,585
	502,610	473,014

The average number of persons employed by the group during the year was as follows:

	2010	2009
UAE	**2,943**	3,366
Qatar	**534**	603
Rest of Middle East	**2,092**	2,183
Total	**5,569**	6,152

5 Employee compensation and benefits ((continued)

Post-employment benefit plans

Income statement charge

	2010	2009
	US$000	US$000
Defined benefit pension plans	**12,246**	14,805
Defined contribution pension plans	**1,942**	3,780
	14,188	18,585

Net liabilities recognised on balance sheet in respect of defined benefit plans

	2010	2009
	US$000	US$000
Defined benefit pension plans	**63,885**	53,759

Total cumulative actuarial gains/(losses) recognised in other comprehensive income

	2010	2009
	US$000	US$000
Defined benefit pension plans	**(9,920)**	(3,069)

Defined benefit pension plans

Arrangements for staff retirement benefits in overseas locations vary from country to country and are made in accordance with local regulations and custom. The majority of branches operate staff indemnity schemes for local staff which take the form of gratuity schemes.

The schemes are reviewed at least annually or in accordance with local practice and regulations by qualified actuaries. The actuarial assumptions used to calculate the scheme obligations vary according to the economic conditions of the countries in which they are situated.

Net liability under defined benefit pension plans

	2010	2009
Fair value of plan assets	**US$000**	US$000
At 1 January	**1,579**	1,254
Expected return on plan assets	**209**	201
Contributions by the group	**248**	291
Contributions by employees	–	13
Experience gains/(losses)	–	(43)
Benefits paid	–	(33)
Exchange differences	**(108)**	(104)
At 31 December	**1,928**	1,579
Present value of defined benefit obligations		
At 1 January	**(55,338)**	(59,529)
Current service cost	**(10,115)**	(13,699)
Interest cost	**(2,340)**	(1,307)
Contributions by employees	**(8)**	(13)
Actuarial (losses)/gains	**(6,851)**	8,236
Benefits paid	**8,630**	5,342
Reduction in liabilities resulting from curtailments	**612**	3,728
Liabilities extinguished on settlements	**9**	1,840
Exchange differences	**(412)**	64
At 31 December	**(65,813)**	(55,338)
Funded	**(1,848)**	(1,484)
Unfunded	**(63,965)**	(53,854)
Net liability	**(63,885)**	(53,759)

Notes on the Financial Statements (continued)

5 Employee compensation and benefits *(continued)*

The actual return on plan assets for the year ended 31 December 2010 was a positive return US$209 thousand (2009: US$158 thousand). The group expects to make US$9,496 thousand of contributions to defined benefit pension plans during 2011.

Total expense recognised in the income statement in 'Employee compensation and benefits'

	2010	2009
	US$000	US$000
Current service cost	**10,115**	13,699
Interest cost	**2,340**	1,307
Expected return on plan assets	**(209)**	(201)
Total expense	**12,246**	14,805

Post-employment defined benefit plans' principal actuarial assumptions

The principal actuarial financial assumptions used to calculate the group's obligations under its defined benefit pension plans at 31 December each period, and used as the basis for measuring periodic costs under the plans in the following periods, were as follows:

Principal actuarial assumptions

	Discount rate	**Rate of pay increase**	**Rate of resignation**	**Rate of employment termination**
	%	**%**	**%**	**%**
At 31 December 2010				
United Arab Emirates	**4.26**	**4.00**	**15.00**	**5.00**
At 31 December 2009				
United Arab Emirates	4.80	4.00	10.60	1.20

The group determines discount rates to be applied to its obligations in consultation with the plans' local actuaries, on the basis of current average yields of long term, high quality corporate bonds or Central Bank certificate of deposits or longer dated swap rates of approximately 7 years as a proxy for a government bond yield of suitable term and currency to the liabilities of the scheme, where appropriate.

Actuarial assumption sensitivities

The discount rate is sensitive to changes in market conditions arising during the reporting period. The mortality rates used are sensitive to experience from the plan member profile. The following table shows the effect of changes in these and the other key assumptions on the principal plan:

	United Arab Emirates	
	2010	2009
	US$000	US$000
Discount rate		
Change in scheme obligation at year end from a 25bps increase	**(48,051)**	(41,624)
Change in scheme obligation at year end from a 25bps decrease	**49,005**	42,935
Change in following year scheme cost from a 25bps increase	**(9,522)**	(8,971)
Change in following year scheme cost from a 25bps decrease	**9,468**	9,123
Rate of pay increase		
Change in scheme obligation at year end from a 25bps increase	**(49,087)**	(42,939)
Change in scheme obligation at year end from a 25bps decrease	**47,963**	41,618
Change in following year scheme cost from a 25bps increase	**(9,628)**	(9,241)
Change in following year scheme cost from a 25bps decrease	**9,423**	8,857

6 Auditors' remuneration

Auditors' remuneration in relation to the statutory audit amounted to US$942 thousand (2009: US$835 thousand).

The following fees were payable by the group to the group's principal auditor, KPMG Channel Islands Limited and its associates (together 'KPMG'):

	2010	2009
	US$000	US$000
Audit fees for HSBC Bank Middle East Limited statutory audit:		
– fees relating to current year	**942**	835
– fees relating to prior year	**-**	85
	942	920
Fees payable to KPMG for other services provided to the group		
– other services pursuant to legislation	**205**	472
– tax services	**59**	88
– local regulatory	**-**	16
– group reporting – current year	**232**	260
– group reporting – prior year	**(41)**	93
– all other services	**343**	260
	798	1,189
Total fees payable	**1,740**	2,109

The following is a description of the type of services included within the categories listed above:

- Audit fees are in respect of fees payable to KPMG Channel Islands Limited and their associates for the statutory audit of the consolidated financial statements of the group.
- Other services pursuant to legislation include services for assurance and other services that are in relation to statutory and regulatory filings, including comfort letters and interim reviews.
- Tax services include tax compliance services and tax advisory services.
- All other services include other assurance and advisory services such as translation services, ad-hoc accounting advice and reviews of financial models.

7 Share-based payments

During 2010, US$16,457 thousand was charged to the income statement in respect of share-based payment transactions settled in equity (2009: US$15,589 thousand). This expense, which was computed from the fair values of the share-based payment transactions when contracted, arose under employee share awards made in accordance with the HSBC Group's reward structures.

Calculation of fair values

Fair values of share options/awards, measured at the date of grant of the option/award are calculated using a binomial lattice model methodology that is based on the underlying assumptions of the Black-Scholes model. When modelling options/share awards with vesting dependent on the HSBC Group's Total Shareholder Return ('TSR') over a period, the TSR performance targets are incorporated into the model using Monte-Carlo simulation. The expected life of options depends on the behaviour of option holders, which is incorporated into the option model on the basis of historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

Notes on the Financial Statements (continued)

7 Share-based payments *(continued)*

Significant weighted average assumptions used to estimate the fair value of the options granted:

2010	1-year Savings-Related Share Option Plans	3-year Savings-Related Share Option Plans	5-year Savings-Related Share Option Plans
Risk-free interest rate[1] (%)	**0.7**	**1.9**	**2.9**
Expected life[2] (years)	**1**	**3**	**5**
Expected volatility[3] (%)	**30**	**30**	**30**
Share price at grant date (£)	**6.82**	**6.82**	**6.82**
2009			
Risk-free interest rate[1] (%)	0.7	2.1	2.4
Expected life[2] (years)	1	3	5
Expected volatility[3] (%)	50	35	30
Share price at grant date (£)	4.65	4.65	4.65

1 *The risk-free rate was determined from the UK gilts yield curve for the UK Savings-Related Share Option Plans. A similar yield curve was used for the Overseas Savings-Related Share Option Schemes.*
2 *Expected life is not a single input parameter but a function of various behavioural assumptions.*
3 *Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options.*

The expected US dollar denominated dividend yield was determined to be 4.5% per annum in line with consensus analyst forecasts (2009: 4.5%). Prior to 2009, HSBC adopted a dividend growth model and incorporated expected dividends into the valuation model for share options and awards.

The HSBC Share Plan

The HSBC Share Plan was adopted by the Group in 2005. Under this plan, Performance Share awards, restricted share awards and share option awards may be made. The aim of the HSBC Share Plan is to align the interests of executives with the creation of shareholder value and recognise individual performance and potential. Awards are also made under this plan for recruitment and retention purposes.

Performance Share awards

Performance Share awards are awarded to executive Directors and other senior executives after taking into account individual performance in the previous year. For awards made prior to 2008, each award is divided into two equal parts for testing attainment against pre-determined benchmarks. One half of the reward is subject to a TSR measure, based on HSBC's ranking against a comparator group of 28 major banks; the other half of the award is subject to an earnings per share target. For each element of the award, shares are released to the employee on a sliding scale from 30 to 100% of the award, depending on the scale of achievement against the benchmarks, providing that the minimum criteria for each performance measure have been met.

Movement in Performance Share awards under the HSBC Share Plan

	2010 Number (000's)	2009 Number (000's)
Outstanding at 1 January	**279**	330
Additions during the year[1]	**8**	9
Adjustment for rights issue[2]	**–**	49
Released and forfeited in the year	**(114)**	(109)
Outstanding at 31 December	**173**	279

1 *Additions in 2010 comprised reinvested dividend equivalents.*
2 *In April 2009, HSBC Holdings plc completed a rights issue. The terms of the share plans have been adjusted accordingly to maintain the value of the awards.*

No Performance Shares were awarded by HSBC in 2010 (2009: nil).

7 Share-based payments *(continued)*

Restricted Share awards

Awards of Restricted Shares are made to employees on the basis of their performance, potential and retention requirements, to aid recruitment or as a part-deferral of annual bonuses. Shares are awarded without corporate performance conditions and generally vest between one and three years from the date of award, providing the employees have remained continually employed by HSBC for this period.

Movement in Restricted Share awards under the HSBC Share Plan

	2010 Number (000's)	2009 Number (000's)
Outstanding at 1 January	**2,677**	761
Additions during the year	**2,863**	2,265
Adjustment for rights issue[1]	**–**	368
Released and forfeited in the year	**(1,539)**	(364)
Transferred in the year	**3,215**	(353)
Outstanding at 31 December	**7,216**	2,677

1 *In April 2009, HSBC Holdings plc completed a rights issue. The terms of the share plans have been adjusted accordingly to maintain the value of the awards.*

The weighted average fair value of Restricted Share awards in 2010 was £7.14 (2009: £4.00).

Savings-related share option plans

Savings-related share option plans invite eligible employees to enter into savings contracts to save up to £250 per month (or its equivalent in US dollars, Hong Kong dollars or euros), with the option to use the savings to acquire shares. The aim of the plans is to align the interests of all employees with the creation of shareholder value. The options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or the fifth anniversary of the commencement of three-year or five-year contracts, respectively. The exercise price is set at 20% (2009: 20%) discount to the market value immediately preceding the date of invitation.

Movement in savings-related share options

	2010		2009	
	Number (000's)	**Weighted average exercise price £**	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	**2,749**	**5.24**	1,646	6.94
Granted in the year	**425**	**5.33**	2,148	3.30
Adjustment for rights issue[1]	**–**	**–**	195	6.05
Exercised in the year	**(352)**	**4.01**	(55)	5.49
Transferred in the year	**(130)**	**5.57**	(4)	6.25
Forfeited and expired in the year	**(111)**	**4.62**	(1,181)	6.33
Outstanding at 31 December	**2,581**	**4.09**	2,749	5.24

1 *In April 2009, HSBC Holdings plc completed a rights issue. The terms of the share plans have been adjusted accordingly to maintain the value of the awards.*

The weighted average fair value of options granted during the year was £1.59 (2009: £1.37). The weighted average share price at the dates the share options were exercised was £6.65 (2009: £5.86). The exercise price range and weighted average remaining contractual life for options outstanding at the balance sheet date were as follows:

	2010	2009
Exercise price range (£)	**£3.14-£8.14**	£5.34-£9.77
Weighted average remaining contractual life (years)		
of which exercisable:	**2.05**	3.10
– number (000's)	**2,581**	2,749
– weighted average exercise price (£)	**6.56**	6.23

Notes on the Financial Statements (continued)

7 Share-based payments *(continued)*

HSBC Holdings Restricted Share Plan 2000

Restricted share awards made under the HSBC Holdings Restricted Share Plan 2000

Awards of Restricted Shares under the Restricted Share Plan were made to eligible employees from 2000 to 2005, after taking into account the employees' performance in the previous year, their potential and retention requirements. Restricted shares were also awarded as part-deferral of annual bonuses or for recruitment purposes. Shares are awarded without corporate performance conditions and generally vest between one and three years from the date of award, providing the employees have remained continuously employed by the group for the period.

	2010 Number (000's)	2009 Number (000's)
Outstanding at 1 January	**746**	747
Additions during the year[1]	–	5
Adjustment for rights issue[2]	–	99
Released and forfeited in the year	–	(249)
Transferred in the year	**(746)**	144
Outstanding at 31 December	–	746

1 *Additions during the year comprised reinvested dividend equivalents.*
2 *In April 2009, HSBC Holdings plc completed a rights issue. The terms of the share plans have been adjusted accordingly to maintain the value of the awards.*

No shares were awarded by the group for the HSBC Holdings Restricted Share Plan 2000 in 2010 or 2009.

The weighted average remaining vesting period as at 31 December 2010 was nil (2009: 0.3 years).

The HSBC Holdings Group Share Option Plan

The HSBC Holdings Group Share Option Plan was a long-term incentive plan under which certain HSBC employees between 2000 and 2005 were awarded share options. The aim of the plan was to align the interests of those higher-performing employees with the creation of shareholder value. This was achieved by setting certain TSR targets which would normally have to be attained in order for the awards to vest. Options were granted at market value and are normally exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions. Options granted after May 2005 are made under the HSBC Share Plan.

	2010		2009	
	Number (000's)	**Weighted average exercise price £**	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	**1,507**	**6.85**	1,405	7.87
Adjustment for rights issue	–	–	198	7.86
Exercised in the year	**(11)**	**6.02**	(15)	6.26
Transferred in the year	**299**	**6.89**	(10)	7.94
Forfeited and expired in the year	**(26)**	**6.93**	(71)	7.34
Outstanding at 31 December	**1,769**	**7.07**	1,507	6.85

The weighted average share price at the date the share options were exercised was £7.07 (2009: £6.85). No share options were awarded by the group for the Group Share Option Plan in 2010 (2009: nil). The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	2010		2009	
Exercise price range (£)	**£6.00-£7.00**	**£7.26-£8.50**	£6.00-£7.00	£8.01-£8.50
Number (000's)	**345**	**1,424**	311	1,196
Weighted average exercise price (£)	**6.02**	**7.32**	6.02	7.23
of which exercisable:				
– number (000's)	**345**	**1,424**	311	1,196
– weighted average exercise price (£)	**6.02**	**7.32**	6.02	7.23

7 Share-based payments *(continued)*

HSBC Holdings Executive Share Option Scheme

The HSBC Holdings Executive Share Option Scheme was a long-term incentive scheme under which certain senior employees were awarded share options before the adoption of the HSBC Holdings Group Share Option Plan in 2000. The aim of the plan was to align the interests of those higher performing senior employees to the creation of shareholder value. This was achieved by setting certain Total Shareholder Return targets to be attained in order for the awards to vest. Options were granted at market value and were exercisable between the third and tenth anniversaries of the date of grant, subject to vesting conditions. No awards have been made under this plan since 2000 and the remaining unexercised options are summarised below:

	2010		2009	
	Number (000's)	**Weighted average exercise price £**	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	**80**	**6.50**	165	6.92
Adjustment for rights issue	**–**	**–**	21	6.04
Exercised in the year	**(62)**	**6.50**	(8)	6.39
Transferred in the year	**23**	**6.50**	3	6.50
Forfeited and expired in the year	**(41)**	**6.50**	(101)	5.61
Outstanding at 31 December	**–**	**–**	80	6.50

No share options were awarded by the group for the Group Executive Share Option Plan in 2010 (2009: nil).

The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	2010	2009
Exercise price range (£)	**–**	£5.50-£7.00
Number (000's)	**–**	80
Weighted average exercise price (£)		
of which exercisable:		
– number (000's)	**–**	80
– weighted average exercise price (£)	**–**	6.50

8 Tax expense

	2010 US$000	2009 US$000
Current tax		
Tax – on current year profit	**73,830**	200,200
Tax – adjustments in respect of prior years	**21,471**	802
	95,301	201,002
Deferred tax		
Origination and reversal of temporary differences	**17,332**	(138,177)
Adjustment in respect of prior years	**(18,801)**	–
	(1,469)	(138,177)
Tax expense	**93,832**	62,825

Notes on the Financial Statements (continued)

8 Tax expense *(continued)*

The group provides for taxation at the appropriate rates in the countries in which its operates.

Analysis of tax expense

	2010		2009	
		Percentage of profit before tax		Percentage of profit before tax
	US$000	**%**	US$000	%
Taxation at UAE corporate tax rate of 20% (2009: 20 %)	**109,966**	**19.7**	13,749	18.8
Effect of taxing overseas profit in principal locations at different rates[1]	**(11,888)**	**(2.1)**	47,426	65.0
Income not subject to tax	**(7,839)**	**(1.4)**	(30,685)	(42.0)
Expenses not deductible for tax purposes	**3,423**	**0.6**	5,844	8.0
Adjustment in respect of prior period liabilities	**15,127**	**2.7**	(556)	(0.8)
Disallowance of loan impairment charges	**(16,479)**	**(2.9)**	23,358	32.0
Other items	**1,522**	**0.2**	3,689	5.1
Overall tax expense	**93,832**	**16.8**	62,825	86.1

1 *Overseas profits taxed at different rates to that which applies in the UAE contributed to a decrease in the effective tax rate of 69% (2009 increase of 68%). The decrease in the effective tax rate is due to a decrease in the proportion of losses arising in tax free jurisdictions.*

In addition to the amount charged to the income statement the aggregate amount of deferred taxation, relating to items that are taken directly to equity, was a US$4.6 million increase in equity (2009: US$8.7 million decrease in equity).

The group is subject to income taxes in many jurisdictions and significant judgement is required in estimating the group's provision for income taxes. There are many transactions and interpretations of tax law for which the final outcome will not be established until some time later. The group recognises liabilities for taxation based on estimates of whether additional taxes will be payable. The estimation process includes seeking expert advice where appropriate. Where the final liability for taxation is different from the amounts that were initially recorded, these differences will affect the income tax and deferred taxation provisions in the period in which the estimate is revised or the final liability is established.

8 Tax expense *(continued)*

Deferred taxation

The following table shows the gross deferred tax assets and liabilities recognised in the balance sheet and the related movements recognised in the income statement, other comprehensive income and directly in equity:

Movement of net deferred tax assets before offsetting balances within countries

	Retirement benefits	Loan impairment allowances	Unused tax losses	Accelerated capital allowances	Available-for-sale investments	Cash flow hedges	Share-based payments	Revaluation of property	Relief for unused tax credits	Other	Total
	US$000	US$000	US$000	US$000	US$000	US$000	US$000	US$000	US$000	US$000	US$000
Assets	–	166,384	–	(363)	(3,773)	925	111	–	–	10,924	174,208
Liabilities	218	–	–	–	(2,126)	–	(86)	(2,477)	–	–	(4,471)
At 1 January 2010	218	166,384	–	(363)	(5,899)	925	25	(2,477)	–	10,924	169,737
Acquisition and disposals	–	–	–	–	–	–	–	–	–	–	–
Income statement	–	(157)	–	373	46	–	–	571	(3,153)	3,789	1,469
Other comprehensive income:											
– available-for-sale investment	–	–	–	–	248	–	–	–	–	–	248
– cash flow hedges	–	–	–	–	–	2,481	–	–	–	–	2,481
– actuarial losses	1,893	–	–	–	–	–	–	–	–	–	1,893
Equity:											
– share based payments	–	–	–	–	–	–	170	–	–	–	170
Foreign exchange and other adjustments	–	(12,901)	3,111	6	(299)	1	(1,263)	–	(40)	2,658	(8,727)
	2,111	153,326	3,111	16	(5,904)	3,407	(1,068)	(1,906)	(3,193)	17,371	167,271
Assets	–	153,326	3,111	16	(3,139)	3,407	(564)	–	–	17,829	173,986
Liabilities	2,111	–	–	–	(2,765)	–	(504)	(1,906)	(3,193)	(458)	(6,715)
At 31 December 2010	2,111	153,326	3,111	16	(5,904)	3,407	(1,068)	(1,906)	(3,193)	17,371	167,271
Assets	–	22,634	–	–	764	2,865	(662)	–	–	14,116	39,717
Liabilities	1,671	858	–	(1,388)	(1,631)	–	(23)	(2,532)	–	–	(3,045)
At 1 January 2009	1,671	23,492	–	(1,388)	(867)	2,865	(685)	(2,532)	–	14,116	36,672
Acquisition and disposals											
Income statement	–	144,973	–	874	–	–	–	–	–	(7,670)	138,177
Other comprehensive income:											
– available-for-sale investment	–	–	–	–	(5,276)	–	–	–	–	–	(5,276)
– cash flow hedges	–	–	–	–	–	(1,941)	–	–	–	–	(1,941)
– actuarial losses	(1,452)	–	–	–	–	–	–	–	–	–	(1,452)
Equity:											
– share based payments	–	–	–	–	–	–	–	–	–	–	–
Foreign exchange and other adjustments	(1)	(2,081)	–	151	244	1	710	55	–	4,478	3,557
	218	166,384	–	(363)	(5,899)	925	25	(2,477)	–	10,924	169,737
Assets	–	166,384	–	(363)	(3,773)	925	111	–	–	10,924	174,208
Liabilities	218	–	–	–	(2,126)	–	(86)	(2,477)	–	–	(4,471)
At 31 December 2009	218	166,384	–	(363)	(5,899)	925	25	(2,477)	–	10,924	169,737

Notes on the Financial Statements (continued)

8 Tax expense *(continued)*

Analysis of deferred tax assets by country

	2010	2009
	US$000	US$000
UAE	**163,853**	162,425
Qatar	**–**	–
Rest of Middle East	**10,133**	11,783
	173,986	174,208

9 Dividends

Dividends to shareholders of the parent company were as follows:

	2010		2009	
	US$ per share	**Total US$000**	US$ per share	Total US$000
Dividends declared on ordinary shares	**–**	**–**	0.238	150,000

10 Segment analysis

The factors used to identify the group's reporting segment are discussed in the 'Summary of significant accounting policies' in Note 2(c).

Products and services

The group provides a comprehensive range of banking and related financial services to its customers in its geographical regions. The products and services offered to customers are organised by customer group and global business.

- Personal Financial Services offers a broad range of products and services to meet the personal banking, consumer finance and wealth management needs of individual customers. Personal banking products typically include current and savings accounts, mortgages and personal loans, credit cards, insurance, wealth management and local and international payment services.

- Commercial Banking product offerings include the provision of financing services, payments and cash management, international trade finance, treasury and capital markets, commercial cards, insurance, wealth management and investment banking services.

- Global Banking and Markets provide tailored financial solutions to government, corporate and institutional clients. The client focused business lines deliver a full range of banking capabilities including investment banking and financing solutions; a markets business that provides services in credit, rates, foreign exchange, money markets and securities services; global asset management and principle investment activities.

- Private Banking provides a range of services to meet the banking, investment and wealth advisory needs of high net worth individuals.

10 Segment analysis *(continued)*

Financial information

Profit/(loss) for the year

	Year ended 31 December 2010				
	UAE	Qatar	Rest of Middle East	Intra-group items	Total
	US$000	US$000	US$000	US$000	US$000
Net interest income	**710,022**	**149,565**	**260,487**	**–**	**1,120,074**
Net fee income	**391,486**	**70,712**	**119,402**	**–**	**581,600**
Net trading income	**202,631**	**31,076**	**65,219**	**–**	**298,926**
Gains less losses from financial investments[1]	**(2,353)**	**–**	**116**	**–**	**(2,237)**
Dividend income	**6,149**	**–**	**8**	**–**	**6,157**
Other operating income	**48,392**	**644**	**3,467**	**(61,156)**	**(8,653)**
Net operating income before loan impairment charges and other credit risk provisions	**1,356,327**	**251,997**	**448,699**	**(61,156)**	**1,995,867**
Loan impairment charges and other credit risk provisions[1]	**(384,888)**	**(25,449)**	**(123,405)**	**–**	**(533,742)**
Net operating income	**971,439**	**226,548**	**325,294**	**(61,156)**	**1,462,125**
Employee compensation and benefits	**(364,030)**	**(44,528)**	**(94,052)**	**–**	**(502,610)**
General and administrative expenses	**(277,939)**	**(41,693)**	**(115,875)**	**61,156**	**(374,351)**
Depreciation and impairment of property, plant and equipment[1]	**(19,846)**	**(2,541)**	**(6,335)**	**–**	**(28,722)**
Amortisation and impairment of intangible assets[1]	**(6,446)**	**(51)**	**(113)**	**–**	**(6,610)**
Total operating expenses	**(668,261)**	**(88,813)**	**(216,375)**	**61,156**	**(912,293)**
Operating profit	**303,178**	**137,735**	**108,919**	**–**	**549,832**
Share of profit in associates	**8,813**	**–**	**–**	**–**	**8,813**
Profit before tax	**311,991**	**137,735**	**108,919**	**–**	**558,645**
Tax expense	**(57,297)**	**(12,090)**	**(24,445)**	**–**	**(93,832)**
Profit for the year	**254,694**	**125,645**	**84,474**	**–**	**464,813**

1 *Significant non-cash item.*

Notes on the Financial Statements (continued)

10 Segment analysis *(continued)*

Profit/(loss) for the year (continued)

	Year ended 31 December 2009				
	UAE	Qatar	Rest of Middle East	Intra-group items	Total
	US$000	US$000	US$000	US$000	US$000
Net interest income	829,759	156,246	251,658	–	1,237,663
Net fee income	387,109	66,271	99,762	–	553,142
Net trading income	253,711	33,635	48,271	–	335,617
Gains less losses from financial investments[1]	10,377	(300)	(964)	–	9,113
Dividend income	3,268	-	7	–	3,275
Other operating income	142,149	(48)	3,626	(69,562)	76,165
Net operating income before loan impairment charges and other credit risk provisions	1,626,373	255,804	402,360	(69,562)	2,214,975
Loan impairment charges and other credit risk provisions[1]	(993,590)	(28,217)	(251,061)	–	(1,272,868)
Net operating income	632,783	227,587	151,299	(69,562)	942,107
Employee compensation and benefits	(338,251)	(48,702)	(86,061)	–	(473,014)
General and administrative expenses	(292,014)	(42,460)	(108,448)	69,562	(373,360)
Depreciation and impairment of property, plant and equipment[1]	(13,017)	(1,315)	(6,152)	–	(20,484)
Amortisation and impairment of intangible assets[1]	(6,363)	(35)	(107)	–	(6,505)
Total operating expenses	(649,645)	(92,512)	(200,768)	69,562	(873,363)
Operating profit	(16,862)	135,075	(49,469)	–	68,744
Share of profit in associates	4,253	–	–	–	4,253
Profit before tax	(12,609)	135,075	(49,469)	–	72,997
Tax expense	587	(44,917)	(18,495)	–	(62,825)
Profit for the year	(12,022)	90,158	(67,964)	–	10,172

1 *Significant non-cash item.*

10 Segment analysis *(continued)*

Performance ratios

	UAE	Qatar	Rest of Middle East	Total
	%	%	%	%
Year ended 31 December 2010				
Share of the group's profit before tax	**55.8**	**24.7**	**19.5**	**100.0**
Cost efficiency ratio	**49.3**	**35.2**	**48.2**	**45.7**
Year ended 31 December 2009				
Share of the group's profit before tax	(17.3)	185.0	(67.7)	100.0
Cost efficiency ratio	39.9	36.2	49.9	39.4

Balance sheet information

	UAE	Qatar	Rest of Middle East	Intra-group items	Total
	US$000	US$000	US$000	US$000	US$000
Year ended 31 December 2010					
Loans and advances to customers (net)	**13,982,792**	**1,716,331**	**4,887,589**	**–**	**20,586,712**
Interest in associates	**29,337**	**–**	**–**	**–**	**29,337**
Total assets	**28,440,704**	**5,509,230**	**10,601,050**	**(2,956,561)**	**41,594,423**
Customer accounts	**16,376,930**	**3,068,743**	**6,898,307**	**–**	**26,343,980**
Total liabilities	**24,521,133**	**5,504,587**	**10,596,666**	**(2,956,561)**	**37,665,825**
Capital expenditure incurred[1]	**21,846**	**5,405**	**4,236**	**–**	**31,487**
Year ended 31 December 2009					
Loans and advances to customers (net)	13,724,340	1,811,217	4,347,842	–	19,883,399
Interest in associates	170,284	–	–	–	170,284
Total assets	28,797,009	4,258,320	9,867,141	(3,756,318)	39,166,152
Customer accounts	17,559,029	2,698,045	6,267,413	–	26,524,487
Total liabilities	25,350,999	4,256,221	9,859,919	(3,756,318)	35,710,821
Capital expenditure incurred[1]	38,714	11,330	5,718	–	55,762

1 *Expenditure incurred on property, plant and equipment and other intangible assets. Excludes assets acquired as part of business combination and goodwill, if any.*

Other financial information

Net operating income by customer group and global business

	Personal Financial Services	Commercial Banking	Global Banking and Markets	Private Banking	Other	Inter Segment	Total
	US$000	US$000	US$000	US$000	US$000	US$000	US$000
Year ended 31 December 2010							
Net operating income:	**487,176**	**553,935**	**417,351**	**27,197**	**37,622**	**(61,156)**	**1,462,125**
External	**347,056**	**651,191**	**517,871**	**18,883**	**(72,876)**	**–**	**1,462,125**
Inter-segment	**140,120**	**(97,256)**	**(100,520)**	**8,314**	**110,498**	**(61,156)**	**–**
Year ended 31 December 2009							
Net operating income:	259,224	191,988	519,970	9,184	31,303	(69,562)	942,107
External	140,997	356,079	570,525	(3,116)	(122,378)	–	942,107
Inter-segment	118,227	(164,091)	(50,555)	12,300	153,681	(69,562)	–

Notes on the Financial Statements (continued)

10 Segment analysis *(continued)*

Information by country

	31 December 2010		31 December 2009	
	External net operating income[1]	**Non-current assets[2]**	External net operating income[1]	Non-current assets[2]
	US$000	**US$000**	US$000	US$000
UAE	**965,305**	**110,952**	617,235	261,729
Qatar	**213,753**	**14,598**	213,883	12,234
Rest of Middle East	**283,067**	**40,901**	110,989	43,627
TOTAL	**1,462,125**	**166,451**	942,107	317,590

1 *External net operating income is attributed to countries on the basis of the location of the branch responsible for reporting the results or advancing the funds.*
2 *Non current assets consist of property, plant and equipment, goodwill, other intangible assets and certain other assets expected to be recovered more than twelve months after the reporting period.*

11 Analysis of financial assets and liabilities by measurement basis

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The summary of significant accounting policies in Note 2 (d) describes how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the carrying amounts of the financial assets and liabilities by category as defined in IAS 39 and by balance sheet heading.

11 Analysis of financial assets and liabilities by measurement basis *(continued)*

	At 31 December 2010					
	Held for trading US$000	**Loans and receivables US$000**	**Available-for-sale securities US$000**	**Financial assets and liabilities at amortised cost US$000**	**Derivatives designated as cash flow hedging instruments US$000**	**Total US$000**
Financial assets						
Cash and balances at central banks	–	–	–	719,363	–	719,363
Items in the course of collection from other banks	–	–	–	61,085	–	61,085
Trading assets	718,676	–	–	–	–	718,676
Derivatives	826,578	–	–	–	–	826,578
Loans and advances to banks	–	8,229,772	–	–	–	8,229,772
Loans and advances to customers	–	20,586,712	–	–	–	20,586,712
Financial investments	–	–	8,667,721	–	–	8,667,721
Other assets	–	–	–	1,266,916	–	1,266,916
Accrued income	–	–	–	173,903	–	173,903
Total financial assets	1,545,254	28,816,484	8,667,721	2,221,267	–	41,250,726
Total non-financial assets						343,697
Total assets						41,594,423
Financial liabilities						
Deposits by banks	–	–	–	1,547,700	–	1,547,700
Customer accounts	–	–	–	26,343,980	–	26,343,980
Items in the course of transmission to other banks	–	–	–	766,308	–	766,308
Trading liabilities	121,733	–	–	-	–	121,733
Derivatives	818,880	–	–	-	15,926	834,806
Debt securities in issue	–	–	–	5,688,545	–	5,688,545
Other liabilities	–	–	–	1,924,724	–	1,924,724
Accruals	–	–	–	104,692	–	104,692
Total financial liabilities	940,613	–	–	36,375,949	15,926	37,332,488
Total non-financial liabilities						333,337
Total liabilities						37,665,825

Notes on the Financial Statements (continued)

11 Analysis of financial assets and liabilities by measurement basis *(continued)*

	At 31 December 2009					
	Held for trading US$000	Loans and receivables US$000	Available-for-sale securities US$000	Financial assets and liabilities at amortised cost US$000	Derivatives designated as cash flow hedging instruments US$000	Total US$000
Financial assets						
Cash and balances at central banks	–	–	–	432,386	–	432,386
Items in the course of collection from other banks	–	–	–	49,259	–	49,259
Trading assets	453,349	–	–	–	–	453,349
Derivatives	662,301	–	–	–	–	662,301
Loans and advances to banks	–	8,106,050	–	–	–	8,106,050
Loans and advances to customers	–	19,883,399	–	–	–	19,883,399
Financial investments	–	–	7,873,086	–	–	7,873,086
Other assets	–	–	–	1,006,225	–	1,006,225
Accrued income	–	–	–	197,547	–	197,547
Total financial assets	1,115,650	27,989,449	7,873,086	1,685,417	–	38,663,602
Total non-financial assets						502,550
Total assets						39,166,152
Financial liabilities						
Deposits by banks	–	–	–	1,674,632	–	1,674,632
Customer accounts	–	–	–	26,524,487	–	26,524,487
Items in the course of transmission to other banks	–	–	–	65,703	–	65,703
Trading liabilities	12,874	–	–	–	–	12,874
Derivatives	641,157	–	–	–	6,738	647,895
Debt securities in issue	–	–	–	5,090,208	–	5,090,208
Other liabilities	–	–	–	1,198,844	–	1,198,844
Accruals	–	–	–	123,438	–	123,438
Total financial liabilities	654,031	–	–	34,677,312	6,738	35,338,081
Total non-financial liabilities						372,740
Total liabilities						35,710,821

12 Trading assets

	2010	2009
	US$000	US$000
Trading assets:		
– not subject to repledge or resale by counterparties	**718,676**	453,349
	718,676	453,349
Debt securities	**452,016**	235,750
Equity securities	**207,161**	210,344
Treasury and other eligible bills	**45,494**	–
Loans and advances to customers	**14,005**	7,255
	718,676	453,349

13 Derivatives

Fair values of derivatives by product contract type held by the group

	Assets			**Liabilities**		
	Trading	**Hedging**	**Total**	**Trading**	**Hedging**	**Total**
At 31 December 2010	**US$000**	**US$000**	**US$000**	**US$000**	**US$000**	**US$000**
Foreign exchange	**354,311**	**–**	**354,311**	**335,134**	**–**	**335,134**
Interest rate	**408,464**	**–**	**408,464**	**429,146**	**15,926**	**445,072**
Equity	**17,416**	**–**	**17,416**	**17,416**	**–**	**17,416**
Credit	**40,317**	**–**	**40,317**	**35,344**	**–**	**35,344**
Commodity and other	**6,070**	**–**	**6,070**	**1,840**	**–**	**1,840**
Total	**826,578**	**–**	**826,578**	**818,880**	**15,926**	**834,806**

	Assets			Liabilities		
	Trading	Hedging	Total	Trading	Hedging	Total
At 31 December 2009	US$000	US$000	US$000	US$000	US$000	US$000
Foreign exchange	346,813	–	346,813	313,550	–	313,550
Interest rate	256,062	–	256,062	273,379	6,738	280,117
Equity	16,697	–	16,697	16,674	–	16,674
Credit	39,765	–	39,765	35,955	–	35,955
Commodity and other	2,964	–	2,964	1,599	–	1,599
Total	662,301	–	662,301	641,157	6,738	647,895

Use of derivatives

The group transacts derivatives for three primary purposes: to create risk management solutions for clients, for proprietary trading purposes, and to manage and hedge the group's own risks. Derivatives (except for derivatives which are designated as effective hedging instruments as defined in IAS 39) are held for trading. The held for trading classification includes two types of derivatives: those used in sales and trading activities, and those used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second category includes derivatives managed in conjunction with financial instruments designated at fair value. These activities are described more fully below.

The group's derivative activities give rise to significant open positions in portfolios of derivatives. These positions are managed constantly to ensure that they remain within acceptable risk levels, with matching deals being used to achieve this where necessary. When entering into derivative transactions, the group employs the same credit risk management procedures to assess and approve potential credit exposures that are used for traditional lending.

Trading derivatives

Most of the group's derivative transactions relate to sales and trading activities. Sales activities include the structuring and marketing of derivative products to customers to enable them to take, transfer, modify or reduce current or expected risks. Trading activities in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected

Notes on the Financial Statements (continued)

13 Derivatives *(continued)*

changes in exchange rates, interest rates, equity prices or other market parameters.

Trading includes market-making, positioning and arbitrage activities. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume; positioning means managing market risk positions in the expectation of benefiting from favourable movements in prices, rates or indices; arbitrage involves identifying and profiting from price differentials between markets and products.

As mentioned above, other derivatives classified as held-for-trading include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge effectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value.

Gains and losses from changes in the fair value of derivatives, including the contractual interest, that do not qualify for hedge accounting are reported in 'Net trading income', except for derivatives managed in conjunction with financial instruments designated at fair value, where gains and losses are reported in 'Net income from financial instruments designated at fair value', together with the gains and losses on the hedged items. Where the derivatives are managed with debt securities in issue, the contractual interest is shown in 'interest expense' together with the interest payable on the issued debt.

Notional contract amounts of derivatives held for trading purposes by product type

	2010	2009
	US$000	US$000
Foreign exchange	**40,768,090**	39,220,020
Interest rate	**25,481,493**	19,354,061
Equity	**751,405**	678,499
Credit	**2,628,405**	2,057,179
Commodity and other	**144,244**	30,349
Total derivatives	**69,773,637**	61,340,108

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

Derivatives valued using models with unobservable inputs

The difference between the fair value at initial recognition (the transaction price) and the value that would have been derived had valuation techniques used for subsequent measurement been applied at initial recognition, less subsequent releases, is as follows:

Unamortised balance of derivatives valued using models with unobservable inputs

	2010	2009
	US$000	US$000
Unamortised balance at 1 January	**14,132**	1,015
Deferral on new transactions	**2,006**	14,133
Recognised in the income statement during the period:		
– subsequent to unobservable inputs becoming observable	**(237)**	(1,015)
Exchange differences	–	(1)
Risk hedged	**(15,158)**	–
Unamortised balance at 31 December[1]	**743**	14,132

1 *This amount is yet to be recognised in the income statement.*

Hedging instruments

The group uses derivatives (principally interest rate swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the group to optimise the overall cost to the group of accessing debt capital markets, and to mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities.

13 Derivatives *(continued)*

The accounting treatment of hedge transactions varies according to the nature of the instrument hedged and the type of hedge transactions. Derivatives may qualify as hedges for accounting purposes if they are fair value hedges, cash flow hedges, or hedges in net investment of foreign operations. These are described under the relevant headings below.

The notional contract amounts of these instruments indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

Notional contract amounts of derivatives held for hedging purposes by product type

	31 December 2010		31 December 2009	
	Cash flow hedge	**Fair value hedge**	Cash flow hedge	Fair value hedge
	US$000	**US$000**	US$000	US$000
Interest rate	**499,918**	**–**	249,963	–

Fair value hedges

The group's fair value hedges principally consist of interest rate swaps that are used to protect against changes in the fair value of fixed-rate long-term financial instruments due to movements in market interest rates. For qualifying fair value hedges, all changes in the fair value of the derivative and in the fair value of the item in relation to the risk being hedged are recognised in the income statement. If the hedge relationship is terminated, the fair value adjustment to the hedged item continues to be reported as part of the basis of the item and is amortised to the income statement as a yield adjustment over the remainder of the hedging period.

The fair values of outstanding derivatives designated as fair value hedges at 31 December 2010, were assets of nil and liabilities of nil (2009: assets of nil and liabilities of nil).

Gains or losses arising from fair value hedges

	2010	2009
	US$000	US$000
Gains/ (losses)		
– on hedging instruments	**–**	83
– on hedged items attributable to the hedged risk	**–**	(54)

The gains and losses on ineffective portions of fair value hedges are recognised immediately in 'Net trading income'.

Cash flow hedges

The group's cash flow hedges consist principally of interest rate and cross-currency swaps that are used to protect against exposures to variability in future interest cash flows on non-trading assets and liabilities which bear interest at variable rates or which are expected to be re-funded or reinvested in the future. The amounts and timing of future cash flows, representing both principal and interest flows, are projected for each portfolio of financial assets and liabilities on the basis of their contractual terms and other relevant factors, including estimates of prepayments and defaults. The aggregate principal balances and interest cash flows across all portfolios over time form the basis for identifying gains and losses on the effective portions of derivatives designated as cash flow hedges of forecast transactions. Gains and losses are initially recognised in other comprehensive income, and accumulated in the cash flow hedging reserve, and are transferred to the income statement when the forecast cash flows affect the income statement.

Fair value of derivatives designated as cash flow hedges

	31 December 2010		31 December 2009	
	Assets	**Liabilities**	Assets	Liabilities
	US$000	**US$000**	US$000	US$000
Interest rate	**–**	**15,926**	–	6,738
	–	**15,926**	–	6,738

Notes on the Financial Statements (continued)

13 Derivatives *(continued)*

Forecast principal balances on which interest cash flows are expected to arise

	At 31 December 2010			
	3 month or less US$000	**1 year or less but more than 3 months US$000**	**5 years or less but more than 1 year US$000**	**More than 5 years US$000**
Assets	**499,918**	**499,918**	**499,918**	**–**
Liabilities	**–**	**–**	**–**	**–**
Net cash inflow/(outflow) exposure	**499,918**	**499,918**	**499,918**	**–**

	At 31 December 2009			
	3 month or less US$000	1 year or less but more than 3 months US$000	5 years or less but more than 1 year US$000	More than 5 years US$000
Assets	–	–	–	–
Liabilities	(250,000)	(250,000)	–	–
Net cash inflow/(outflow) exposure	(250,000)	(250,000)	–	–

This table reflects the interest rate repricing profile of the underlying hedged items.

The gains and losses on ineffective portions of such derivatives are recognised immediately in 'Net trading income'. During the years ended 31 December 2010 and 31 December 2009, no gains or losses were recognised due to hedge ineffectiveness.

14 Financial investments

	2010 US$000	2009 US$000
Financial investments:		
– not subject to repledge or resale by counterparties	**8,667,721**	7,873,086

	2010 US$000	2009 US$000
Treasury and other eligible bills		
– available-for-sale	**283,787**	517,025
Debt securities		
– available-for-sale	**8,265,287**	7,250,081
Equity securities		
– available-for-sale	**118,647**	105,980
Total financial investments	**8,667,721**	7,873,086

15 Interests in associates

Principal associates of the group

	At 31 December 2010			
	Country of incorporation	Principal activity	The group's interest in equity capital	Issued equity capital
Arabian Real Estate Investment Trust Management Limited	Cayman Islands	Real Estate	39.58%	US$3.9 million of which US$3.6 million is fully paid
HSBC Middle East Leasing Partnership	Dubai, UAE	Leasing	15.00%	US$10 million fully paid
MENA Infrastructure Fund (GP) Limited	Dubai, UAE	Private Equity fund management	33.33%	US$0.99 million fully paid
MENA Holdings Limited	Cayman Islands	Petrochemical by-product	33.33%	US$ 5.4 million fully paid
Rewards Management Middle East Free Zone Limited Liability Company	Dubai, UAE	Multi-participant loyalty programmes	40.00%	AED 0.5million

The group's share of associates' contingent liabilities amounted to US$ nil at 31 December 2010 (2009: US$809,214 thousand).

The associates are unlisted.

Arabian Real Estate Investment Trust Management Limited, HSBC Middle East Leasing Partnership and MENA Infrastructure Fund (GP) Limited operate in Dubai, UAE.

Rewards Management Middle East Free Zone Limited Liability Company operates in Dubai, UAE and Qatar.

MENA Holdings Limited operates in Cayman Islands.

HSBC Middle East Leasing Partnership is treated as an associate reflecting the significant influence over the company established as a result of representation on the Board of Directors.

On 29 October 2010, HSBC Bank Middle East Limited sold its 48.9 per cent shareholding in British Arab Commercial Bank plc for US$90 million in cash resulting in a loss of US$42 million.

Movement in investment in associates:

	2010	2009
	US$000	US$000
At 1 January	**170,284**	152,429
Additions	**50**	811
Transfer to held for sale assets	**(131,821)**	–
Retained profits and losses	**6,826**	(2,014)
Exchange and other movements	**(16,002)**	19,058
At 31 December	**29,337**	170,284

Summarised aggregate financial information on associates

The group's share of:

	2010	2009
	US$000	US$000
Assets	**41,141**	2,663,287
Liabilities	**7,608**	2,629,598
Revenue	**21,818**	49,478
Profit after tax	**8,813**	4,253

Notes on the Financial Statements (continued)

16 Intangible assets

Movement of intangible assets

	Internally generated software US$000	Purchased software US$000	Total US$000
Cost			
At 1 January 2010	**18,595**	**10,780**	**29,375**
Additions[1]	**5,180**	**632**	**5,812**
Disposals	–	–	–
Exchange differences	–	–	–
Other changes	**4,405**	–	**4,405**
At 31 December 2010	**28,180**	**11,412**	**39,592**
Accumulated amortisation			
At 1 January 2010	**(12,885)**	**(6,851)**	**(19,736)**
Charge for the year[2]	**(4,642)**	**(1,968)**	**(6,610)**
Impairment	–	–	–
Disposals	–	–	–
Other changes	–	**47**	**47**
At 31 December 2010	**(17,527)**	**(8,772)**	**(26,299)**
Net carrying amount at 31 December 2010 [3]	**10,653**	**2,640**	**13,293**
Cost			
At 1 January 2009	14,018	8,141	22,159
Additions[1]	4,578	2,708	7,286
Disposals	–	(70)	(70)
Exchange differences	–	1	1
Other changes	(1)	–	(1)
At 31 December 2009	18,595	10,780	29,375
Accumulated amortisation			
At 1 January 2009	(7,868)	(5,180)	(13,048)
Charge for the year [2]	(5,018)	(1,487)	(6,505)
Impairment	–	–	–
Disposals	–	56	56
Other changes	1	(240)	(239)
At 31 December 2009	(12,885)	(6,851)	(19,736)
Net carrying amount at 31 December 2009	5,710	3,929	9,639

1 *At 31 December 2010, the group did not have any contractual commitments to acquire intangible assets (2009: nil).*
2 *The amortisation and impairment charges for the year are recognised within the income statement under 'Amortisation of intangible assets'.*
3 *There are no intangible assets whose title is restricted and/or pledged as security for liabilities.*

17 Property, plant and equipment

	Freehold land and buildings US$000	Short leasehold land and buildings US$000	Equipment, fixtures and fittings US$000	Total US$000
Cost or fair value				
At 1 January 2010	**51,624**	**67,181**	**127,341**	**246,146**
Additions at cost[1]	**303**	**14,993**	**10,379**	**25,675**
Disposals	**–**	**(2,627)**	**(2,316)**	**(4,943)**
Exchange differences	**(38)**	**16**	**(147)**	**(169)**
Other changes	**–**	**4,358**	**(8,764)**	**(4,406)**
Reclassified as held for sale	**(9,180)**	**–**	**–**	**(9,180)**
At 31 December 2010	**42,709**	**83,921**	**126,493**	**253,123**
Accumulated depreciation				
At 1 January 2010	**(626)**	**(29,527)**	**(78,326)**	**(108,479)**
Depreciation charge for the year	**(1,633)**	**(7,367)**	**(14,636)**	**(23,636)**
Disposals	**94**	**1,080**	**1,288**	**2,462**
Impairment losses recognised	**(5,086)**	**–**	**–**	**(5,086)**
Exchange differences	**6**	**(13)**	**73**	**66**
Other changes	**148**	**(150)**	**(50)**	**(52)**
Reclassified as held for sale	**5,423**	**–**	**–**	**5,423**
At 31 December 2010	**(1,674)**	**(35,977)**	**(91,651)**	**(129,302)**
Net carrying amount at 31 December 2010	**41,035**	**47,944**	**34,842**	**123,821**
Cost or fair value				
At 1 January 2009	48,073	56,911	108,094	213,078
Additions at cost[1]	10,314	13,773	24,389	48,476
Disposals	(6,953)	(3,491)	(5,787)	(16,231)
Exchange differences	190	(12)	(584)	(406)
Other changes	–	–	1,229	1,229
At 31 December 2009	51,624	67,181	127,341	246,146
Accumulated depreciation				
At 1 January 2009	(4,074)	(27,885)	(68,319)	(100,278)
Depreciation charge for the year	(2,172)	(4,847)	(13,465)	(20,484)
Disposals	5,647	3,199	3,441	12,287
Exchange differences	(25)	5	192	172
Other changes	(2)	1	(175)	(176)
At 31 December 2009	(626)	(29,527)	(78,326)	(108,479)
Net carrying amount at 31 December 2009	50,998	37,654	49,015	137,667

1 *At 31 December 2010, the group had US$nil (2009:nil) of contractual commitments to acquire property, plant and equipment.*

Notes on the Financial Statements (continued)

17 Property, plant and equipment *(continued)*

Included within 'Short leasehold land and buildings' are the following amounts in respect of assets classed as improvements to buildings, which are carried at depreciated historical cost:

	2010		2009	
	Cost	**Accumulated depreciation**	Cost	Accumulated depreciation
	US$000	**US$000**	US$000	US$000
At 1 January	**62,407**	**(31,034)**	56,911	(27,059)
Additions	**9,976**	**–**	6,576	–
Disposals	**(2,400)**	**–**	(1,069)	–
Depreciation charge for the year	**–**	**(3,023)**	–	(3,970)
Exchange differences	**10**	**(3)**	(11)	(5)
Other changes	**4,354**	**–**	–	–
At 31 December	**74,347**	**(34,060)**	62,407	(31,034)
Net carrying amount at 31 December	**40,287**		31,373	

18 Investments in subsidiaries

Subsidiary undertakings of the bank

	Country of incorporation or registration	**Bank's interest in equity capital**
		%
HSBC Bank Middle East Nominees W.L.L.	Bahrain	95%
HSBC Financial Services (Middle East) Limited	Dubai, UAE	100%
HSBC Middle East Finance Company Limited	Dubai, UAE	80%
HSBC Middle East Securities LLC	Dubai, UAE	100%
HSBC Insurance Services (Lebanon) S.A.L.	Lebanon	100%

All the above make their financial statements up to 31 December.

The subsidiary undertakings are directly owned and are included in the consolidated financial statements of the group.

The countries of operation are the same as the countries of incorporation.

The subsidiary undertakings are unlisted.

In order to comply with local legal requirements, the ownership of the investment in HSBC Middle East Securities LLC is held 49.00% in the name of the bank and 51.00% in the personal name of Mr Abdul Wahid Al Ulama, as nominee. Under a Memorandum of Understanding, the nominee has transferred his legal and/or beneficial interest in HSBC Middle East Securities LLC to the bank. The total book value of the assets and equity and liabilities of HSBC Middle East Securities LLC amount to US$ 7,601 thousand (2009: US$11,650 thousand).

Special purpose entities ('SPEs') consolidated where the group owns less than 50% of the voting rights at 31 December 2010:

	Carrying value of total consolidated assets US$000	**Nature of SPE**
HSBC Private Equity Middle East LP	115,035	Private equity fund
HSBC Private Equity Middle East LP II	155,400	Private equity fund
HSBC Private Equity Middle East Management Limited	1,800	General partner to HSBC Private Equity Middle East LP
HSBC Private Equity Middle East Management II Limited	1,900	General partner to HSBC Private Equity Middle East LP II
HSBC Private Equity (Middle East) Limited	90,815	Investment and management services

19 Other assets

	2010 US$000	2009 US$000
Assets held for sale	**3,077**	1,465
Endorsements and acceptances	**1,201,496**	851,420
Other accounts	**65,420**	154,805
	1,269,993	1,007,690

	2010 US$000	2009 US$000
Non-current assets held for sale		
Property, plant and equipment	**3,077**	1,465
Total assets classified as held for sale	**3,077**	1,465

The property, plant and equipment classified as held for sale is a result of repossession of property and motor vehicles that had been pledged as collateral by customers. No fair value is calculated for repossessed properties.

Repossessed motor vehicles are held at fair value. Gains and losses recognised on impairment of these assets to fair value are reported in 'Loan impairment charges'.

20 Debt securities in issue

	2010		2009	
	Carrying amount US$000	**Fair value US$000**	Carrying amount US$000	Fair value US$000
Medium term notes	**4,393,001**	**4,327,379**	3,572,187	3,452,739
Other debt securities in issue	**–**	**–**	136,127	134,765
Non-equity preference shares	**1,350,000**	**1,337,592**	1,350,000	1,332,090
	5,743,001	**5,664,971**	5,058,314	4,919,594
Of which debt securities in issue reported as trading liabilities (see note 24)	**(54,456)**	**(54,456)**	31,894	31,894
	5,688,545	**5,610,515**	5,090,208	4,951,488

Non-equity preference share capital

Authorised

The authorised non-equity preference share capital of the bank at 31 December 2010 was 1,350,000 (2009: 1,350,000) cumulative redeemable preference shares of US$1.00 each and 1,150,000 (2009: 1,150,000) non-cumulative redeemable preference shares of US$1.00 each.

Notes on the Financial Statements (continued)

20 Debt securities in issue *(continued)*

Issued

Perpetual cumulative redeemable preference shares

Issue Number	Issue Date	Perpetual cumulative redeemable preference shares Number	Cumulative redeemable preference dividends %	Redeemable at the option of the bank on any date after Date
1	29 October 1997	50,000	12 month US dollar LIBOR+ 0.35	31 October 2002
2	01 April 1998	25,000	12 month US dollar LIBOR + 0.70	02 April 2003
6	14 March 2006	150,000	12 month US dollar LIBOR + 0.65	15 March 2011

1 *The perpetual cumulative redeemable preference shares have been issued at a nominal value of US$1 each with a premium of US$999 per share.*

2 *Cumulative redeemable preference dividends are payable annually on the issue price of each perpetual share.*

3 *The perpetual cumulative redeemable preference shares bear no mandatory redemption date. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.*

4 *Each share carries one vote at meetings of the shareholders of the bank.*

5 *In the event of a winding up, the US dollar preference shareholders would receive, in priority to the ordinary shareholders of the bank, repayment of US$1,000 per share, plus an amount equal to any accrued but unpaid dividends. With the exception of the above, the preference shares do not carry any right to participate in the surplus of assets on a winding up.*

Dated cumulative redeemable preference shares

Issue number	Issue date	Dated cumulative redeemable preference shares Number	Cumulative redeemable preference dividends %	Redeemable at the option of the bank on any date after Date	Earliest redemption date Date
4	26 August 2004	100,000	12 month US dollar LIBOR + 0.48	26 August 2009	26 August 2014
5	19 December 2005	100,000	12 month US dollar LIBOR + 0.30	19 December 2010	19 December 2015
6	14 March 2006	100,000	12 month US dollar LIBOR + 0.40	14 March 2011	14 March 2016
7	20 June 2007	100,000	12 month US dollar LIBOR + 0.33	20 June 2012	20 June 2017
8	28 April 2008	200,000	12 month US dollar LIBOR + 2.34	28 April 2013	28 April 2018
9	31 July 2008	300,000	6.70 fixed rate	31 July 2013	31 July 2018

1 *The dated cumulative redeemable preference shares have been issued at a nominal value of US$1 each with a premium of US$999 per share.*

20 Debt securities in issue *(continued)*

2 *Cumulative redeemable preference dividends are payable annually on the issue price of each dated share.*

3 *Redemption of the dated cumulative redeemable preference shares, other than at the option of the bank, will be subject to the approval of the ordinary shareholders of the bank. The earliest redemption date is as disclosed in the table above and if not approved by the shareholders will next fall for review at 10 yearly intervals thereafter. However, the shares may be redeemed at the option of the Bank without the approval of the ordinary shareholders of the bank. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.*

4 *Each share carries one vote at meetings of the shareholders of the bank.*

5 *In the event of a winding up, the US dollar preference shareholders would receive, in priority to the ordinary shareholders of the bank, repayment of US$1,000 per share, plus an amount equal to any accrued but unpaid dividends. With the exception of the above, the preference shares do not carry any right to participate in the surplus of assets on a winding up.*

Dated non-cumulative redeemable preference shares

Issue number	**Issue date**	**Dated cumulative redeemable preference shares**	**Cumulative redeemable preference dividends**	**Redeemable at the option of the bank on any date after**	**Earliest redemption date**
		Number	**%**	**Date**	**Date**
10	30 December 2009	225,000	12 month US dollar LIBOR + 6.80	30 December 2019	30 December 2014

1 *The dated non-cumulative redeemable preference shares have been issued at a nominal value of US$1 each with a premium of US$999 per share.*

2 *Non-cumulative redeemable preference dividends are payable annually on the issue price of each dated share.*

3 *Redemption of the dated cumulative redeemable preference shares, other than at the option of the bank, will be subject to the approval of the ordinary shareholders of the bank. The earliest redemption date is as disclosed in the table above and if not approved by the shareholders will next fall for review at 10 yearly intervals thereafter. However, the shares may be redeemed at the option of the bank without the approval of the ordinary shareholders of the bank. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.*

4 *Each share carries one vote at meetings of the shareholders of the bank.*

5 *As regards dividends and on a winding up of the company as regards capital, the non-cumulative preference shares shall rank after the undated and dated cumulative preference shares already in issue and ahead of the ordinary shares.*

21 Other liabilities

	2010	2009
	US$000	US$000
Share based payments liability to HSBC Holdings plc	**11,172**	6,504
Obligations under finance leases	**9,180**	9,180
Endorsements and acceptances	**1,201,494**	851,420
Other liabilities	**702,878**	331,740
	1,924,724	1,198,844

Notes on the Financial Statements (continued)

22 Provisions

	2010	2009
	US$000	US$000
At 1 January	**11,089**	6,252
Additional provisions/increase in provisions	**7,704**	4,856
Provisions utilised	**(383)**	(3,206)
Amounts reversed	**(5,084)**	(1,279)
Exchange differences and other movements	**2,046**	4,466
At 31 December	**15,372**	11,089

Included within Provisions is an amount of US$nil (2009: US$383 thousand) relating to the 'HSBC In The Community Middle East Foundation'. This is a charitable trust established by the group, whose aim is to provide funding, primarily for educational purposes and for environmental projects in the region. Funding is provided on a case by case basis, throughout the year.

23 Fair value of financial instruments

The classification of financial instruments is determined in accordance with the accounting policies set out in Note 2 (j). The use of assumptions and estimation in valuing financial instruments is described on page 59.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The following table sets out the financial instruments carried at fair value.

Financial instruments carried at fair value and bases of valuation

		Valuation techniques		
	Level 1 Quoted market price	**Level 2 using observable inputs**	**Level 3 with significant non-observable inputs**	**Total**
	US$000	**US$000**	**US$000**	**US$000**
At 31 December 2010				
Assets				
Trading assets	**86,160**	**441,939**	**190,577**	**718,676**
Derivatives	**–**	**824,123**	**2,455**	**826,578**
Financial investments:				
available-for-sale	**80,517**	**8,074,059**	**513,145**	**8,667,721**
Liabilities				
Trading liabilities	**–**	**121,733**	**–**	**121,733**
Derivatives	**–**	**824,269**	**10,537**	**834,806**
At 31 December 2009				
Assets				
Trading assets	80,865	175,669	196,815	453,349
Derivatives	–	648,161	14,140	662,301
Financial investments:				
available-for-sale	62,280	7,719,628	91,178	7,873,086
Liabilities				
Trading liabilities	–	12,874	–	12,874
Derivatives	–	644,703	3,192	647,895

23 Fair value of financial instruments *(continued)*

Control framework

Fair values are subject to a control framework designed to ensure that they are either determined, or validated, by a function independent of the risk-taker. To this end, ultimate responsibility for the determination of fair values lies with Finance, which reports functionally through the group's Chief Financial Officer to the HSBC Group Finance Director. Finance establishes the accounting policies and procedures governing valuation, and is responsible for ensuring that they comply with all relevant accounting standards.

For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is utilised. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the group will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, *inter alia:*

- the extent to which prices may be expected to represent genuine traded or tradeable prices;
- the degree of similarity between financial instruments;
- the degree of consistency between different sources;
- the process followed by the pricing provider to derive the data;
- the elapsed time between the date to which the market data relates and the balance sheet date; and
- the manner in which the data was sourced.

For fair values determined using a valuation model, the control framework may include, as applicable, independent development or validation of (i) the logic within valuation models; (ii) the inputs to those models; (iii) any adjustments required outside the valuation models; and, (iv) where possible, model outputs. Valuation models are subject to a process of due diligence and calibration before becoming operational and are calibrated against external market data on an ongoing basis.

The results of the independent validation process are reported to, and considered by, Valuation Committees. Valuation Committees are composed of valuation experts from several independent support functions (Product Control, Market Risk Management, Derivative Model Review Group and Finance) in addition to senior management. Any adjustments made to the assessed fair values as a result of the validation process are reported to senior management.

Determination of fair value

Fair values are determined according to the following hierarchy:

- Level *1 – quoted market price*: financial instruments with quoted prices for identical instruments in active markets.
- Level *2 – valuation technique using observable inputs*: financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.
- Level *3 – valuation technique with significant unobservable inputs*: financial instruments valued using models where one or more significant inputs are unobservable.

The best evidence of fair value is a quoted price in an actively traded market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. Where a financial instrument has a quoted price in an active market and it is part of a portfolio, the fair value of the portfolio is calculated as the product of the number of units and quoted price and no block discounts are made. In the event that the market for a financial instrument is not active, a valuation technique is used.

The judgement as to whether a market is active may include, but is not restricted to, the consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads.The bid/offer spread represents the difference in prices at which a market participant would be willing to buy compared with the price at which they would be willing to sell. In inactive markets, obtaining assurance that the transaction price provides evidence of fair value or determining the adjustments to transaction prices that are necessary to measure the fair value of the instrument requires additional work during the valuation process.

Notes on the Financial Statements (continued)

23 Fair value of financial instruments *(continued)*

Valuation techniques incorporate assumptions about factors that other market participants would use in their valuations, including interest rate yield curves, exchange rates, volatilities, and prepayment and default rates. The majority of valuation techniques employ only observable market data, However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, and for them, the derivation of fair value is more judgemental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's carrying amount and/ or inception profit ('day 1 gain or loss') is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the level at which an arm's length transaction would be likely to occur. It generally does not mean that there is no market data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used).

Structured notes issued and certain other hybrid instrument liabilities are included within trading liabilities and are measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the group issues structured notes. These market spreads are significantly smaller than credit spreads observed for plain vanilla debt or in the credit default swap markets.

Gains and losses arising from changes in the credit spread of liabilities issued by the group reverse over the contractual life of the debt, provided that the debt is not repaid at a premium or a discount.

Fair value valuation bases

Financial instruments measured at fair value using a valuation technique with significant unobservable inputs – Level 3

	Assets			Liabilities
	Available-for-sale US$000	**Held for Trading US$000**	**Derivatives US$000**	**Derivatives US$000**
At 31 December 2010				
Private equity investments	**106,769**	**190,577**	**–**	**–**
Other derivatives	**–**	**–**	**2,455**	**10,537**
Other portfolios	**406,376**	**–**	**–**	**–**
	513,145	**190,577**	**2,455**	**10,537**
At 31 December 2009				
Private equity investments	91,178	196,815	–	–
Other derivatives	–	–	12,945	3,192
Other portfolios	–	–	1,195	–
	91,178	196,815	14,140	3,192

Private equity

The group's private equity positions are generally classified as available-for-sale and are not traded in active markets. In the absence of an active market, an investment's fair value is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership.

Derivatives

OTC (i.e. non-exchange traded) derivatives are valued using valuation models. Valuation models calculate the present value of expected future cash flows, based upon 'no-arbitrage' principles. For many vanilla derivative products, such as interest rate swaps and European options, the modelling approaches used are standard across the industry. For more complex derivative products, there may be some differences in market practice. Inputs to valuation models are determined from observable market data wherever possible, including prices available from exchanges, dealers, brokers or providers of consensus pricing. Certain inputs may not be observable in the market directly, but can be determined from observable prices via model calibration procedures or estimated from historical data or other sources. Examples of inputs that may be unobservable include volatility surfaces, in whole or in part, for less commonly traded option products, and correlations between market factors such as foreign exchange rates, interest rates and equity.

23 Fair value of financial instruments *(continued)*

Other portfolios

Other portfolios include certain debt securities for which active quoted prices are not available and the valuations are based on internal assumptions.

Reconciliation of fair value measurements in Level 3 of the fair value hierarchy:

The following table provides a reconciliation of the movement between opening and closing balances of Level 3 financial instruments, measured at fair value using a valuation technique with significant unobservable inputs:

	Assets			Liabilities
	Available-for-sale US$000	Held for Trading US$000	Derivatives US$000	Derivatives US$000
2010				
At 1 January	**91,178**	**196,815**	**14,140**	**3,192**
Total gains or losses recognised in profit or loss	**13,063**	**(5,062)**	**(2,759)**	**(5,658)**
Total gains or losses recognised in other comprehensive income	**(13,045)**	**6**	**–**	**–**
Purchases	**284,607**	**–**	**–**	**–**
Sales	**–**	**–**	**–**	**–**
Settlements	**–**	**–**	**–**	**–**
Transfers out	**(333)**	**(46,688)**	**(13,518)**	**–**
Transfers in	**137,675**	**45,506**	**4,592**	**13,003**
At 31 December	**513,145**	**190,577**	**2,455**	**10,537**
Total gains/(losses) recognised in profit or loss relating to those assets and liabilities held on 31 December 2010	**16,063**	**3,080**	**(363)**	**5,348**
2009				
At 1 January	36,652	–	8,671	764
Total gains or losses recognised in profit or loss	(49)	–	(5,217)	(415)
Total gains or losses recognised in other comprehensive income	–	–	–	–
Purchases	6,678	–	–	–
Sales	(12,786)	–	–	–
Settlements	–	–	7,844	(39)
Transfers out	–	–	(6,750)	–
Transfers in	60,683	196,815	9,592	2,882
At 31 December	91,178	196,815	14,140	3,192
Total gains/(losses) recognised in profit or loss relating to those assets and liabilities held on 31 December 2009	414	–	(3,296)	415

For available-for-sale securities the absence of a local currency curve, proxy curve or secondary market prices available resulted in these assets being transferred into Level 3 during 2010.

For assets and liabilities classified as held for trading, realised and unrealised gains and losses are presented in the income statement under 'Trading income excluding net interest income'.

Realised gains and losses from available-for-sale securities are presented under 'Gains less losses of financial investments' in the income statement while unrealised gains and losses are presented in 'Fair value gains/(losses) taken to equity' within 'Available-for-sale investments' in other comprehensive income.

Notes on the Financial Statements (continued)

23 Fair value of financial instruments *(continued)*

Effects of changes in significant unobservable assumptions to reasonably possible alternatives

The fair value of financial instruments are, in certain circumstances, measured using valuation techniques that incorporate assumptions that are not evidenced by prices from observable current market transactions in the same instrument and are not based on observable market data. The following table shows the sensitivity of fair values to reasonably possible alternative assumptions:

Sensitivity of fair values to reasonable possible alternative assumptions

	Reflected in profit/(loss)		Reflected in equity	
	Favourable changes US$000	Unfavourable changes US$000	Favourable changes US$000	Unfavourable changes US$000
At 31 December 2010				
Derivatives/trading assets/trading liabilities[1]	**21,507**	**(19,291)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**11,050**	**(11,315)**
At 31 December 2009				
Derivatives/trading assets/trading liabilities[1]	21,213	(21,213)	–	–
Financial investments: available-for-sale	–	–	9,118	(9,118)

1 *Derivatives, trading assets and trading liabilities are presented as one category to reflect the manner in which these financial instruments are risk-managed.*

Sensitivity of fair values to reasonably possible alternative assumptions by Level 3 instrument type

	Reflected in profit/(loss)		Reflected in equity	
	Favourable changes US$000	Unfavourable changes US$000	Favourable changes US$000	Unfavourable changes US$000
At 31 December 2010				
Private equity investments	**19,058**	**(19,058)**	**10,676**	**(10,676)**
Other derivatives	**2,449**	**(233)**	**–**	**–**
Other portfolio	**–**	**–**	**374**	**(639)**
At 31 December 2009				
Private equity investments	19,682	(19,682)	9,118	(9,118)
Other derivatives	1,531	(919)	–	–
Other portfolio	–	–	–	–

Fair values of financial instruments not carried at fair value

Fair values of financial instruments which are not carried at fair value on the balance sheet

	At 31 December 2010		At 31 December 2009	
	Carrying amount US$000	**Fair value US$000**	Carrying amount US$000	Fair value US$000
Assets				
Loans and advances to banks	**8,229,772**	**8,234,817**	8,106,050	8,102,354
Loans and advances to customers	**20,586,712**	**20,649,254**	19,883,399	19,577,859
Liabilities				
Deposits by banks	**1,547,700**	**1,524,829**	1,674,632	1,670,347
Customer accounts	**26,343,980**	**26,389,478**	26,524,487	26,392,031
Debt securities in issue	**5,688,545**	**5,610,515**	5,090,208	4,951,488

23 Fair value of financial instruments *(continued)*

Valuation

The calculation of fair value incorporates the group's estimate of the amount at which financial assets could be exchanged, or financial liabilities settled, between knowledgeable, willing parties in an arm's length transaction. It does not reflect the economic benefits and costs that the group expects to flow from the instruments' cash flows over their expected future lives. Other reporting entities may use different valuation methodologies and assumptions in determining fair values for which no observable market prices are available, so comparisons of fair values between entities may not be meaningful and users are advised to exercise caution when using this data.

(i) *Loans and advances to banks and customers*

The fair value of loans and advances is based on observable market transactions, where available. In the absence of observable market transactions, fair value is estimated using discounted cash flow models. Performing loans are grouped, as far as possible, into homogeneous pools segregated by maturity and interest rates. In general, contractual cash flows are discounted using the group's estimate of the discount rate that a market participant would use in valuing instruments with similar maturity, repricing and credit risk characteristics.

The fair value of a loan portfolio reflects both loan impairments at the balance sheet date and estimates of market participants' expectations of credit losses over the life of the loans. For impaired loans, fair value is estimated by discounting the future cash flows over the time period in which they are expected to be recovered.

(ii) *Financial investments*

The fair values of listed financial investments are determined using bid market prices. The fair values of unlisted financial investments are determined using valuation techniques that take into consideration the prices and future earnings streams of equivalent quoted securities.

(iii) *Deposits by banks and customer accounts*

For the purposes of estimating fair value, deposits by banks and customer accounts are grouped by remaining contractual maturity. Fair values are estimated using discounted cash flows, applying current rates offered for deposits of similar remaining maturities. The fair value of a deposit repayable on demand is assumed to be the amount payable on demand at the balance sheet date.

(iv) *Debt securities in issue and subordinated liabilities*

Fair values are determined using quoted market prices at the balance sheet date where available, or by reference to quoted market prices for similar instruments.

The fair values in this note are stated at a specific date and may be significantly different from the amounts which will actually be paid on the maturity or settlement dates of the instruments. In many cases, it would not be possible to realise immediately the estimated fair values given the size of the portfolios measured. Accordingly, these fair values do not represent the value of these financial instruments to the group as a going concern.

24 Trading liabilities

	2010 **US$000**	2009 US$000
Debt securities in issue	**54,456**	(31,894)
Other liabilities – net short positions	**67,277**	44,768
	121,733	12,874

Notes on the Financial Statements (continued)

25 Maturity analysis of assets and liabilities

The following is an analysis by remaining contractual maturities at the balance sheet date, of assets and liability line items that combine amounts expected to be recovered or settled within one year and after more than one year.

Trading assets and liabilities are excluded because they are not held for collection or settlement over the period of contractual maturity.

Maturity analysis of assets and liabilities

	At 31 December 2010			At 31 December 2009		
	Due within one year US$000	**Due after more than one year US$000**	**Total US$000**	Due within one year US$000	Due after more than one year US$000	Total US$000
Assets						
Loans and advances to banks	**7,928,774**	**300,998**	**8,229,772**	7,883,272	222,778	8,106,050
Loans and advances to customers	**13,599,504**	**6,987,208**	**20,586,712**	12,972,702	6,910,697	19,883,399
Financial investments	**7,681,232**	**986,489**	**8,667,721**	6,378,182	1,494,904	7,873,086
Other financial assets	**1,260,234**	**6,438**	**1,266,672**	1,000,471	5,847	1,006,318
	30,469,744	**8,281,133**	**38,750,877**	28,234,627	8,634,226	36,868,853
Liabilities						
Deposits by banks	**1,546,760**	**940**	**1,547,700**	1,649,680	24,952	1,674,632
Customer accounts	**25,952,958**	**391,022**	**26,343,980**	25,162,304	1,362,183	26,524,487
Debt securities in issue	**1,394,969**	**4,293,576**	**5,688,545**	2,283,107	2,807,101	5,090,208
Other financial liabilities	**1,898,062**	**12,229**	**1,910,291**	1,171,539	21,815	1,193,354
	30,792,749	**4,697,767**	**35,490,516**	30,266,630	4,216,051	34,482,681

The following is an analysis, by remaining contractual maturities at the balance sheet date, of undiscounted cash flows payable under financial liabilities.

	On demand US$000	**Due within 3 months US$000**	**Due between 3 and 12 months US$000**	**Due between 1 and 5 years US$000**	**Due after 5 years US$000**
At 31 December 2010					
Deposits by banks	**704,348**	**786,920**	**8,105**	**40**	**–**
Customer accounts	**17,748,140**	**5,495,001**	**2,452,898**	**482,808**	**941**
Derivatives	**834,804**	**–**	**2,258**	**–**	**–**
Debt securities in issue	**–**	**130,242**	**1,321,404**	**3,204,802**	**–**
Other financial liabilities	**117,532**	**774,466**	**543,976**	**9,768**	**–**
	19,404,824	**7,186,629**	**4,328,641**	**3,697,418**	**941**
Loan commitments	**3,893,184**	**3,665,645**	**4,494,754**	**2,830,788**	**309,152**
	23,298,008	**10,852,274**	**8,823,395**	**6,528,206**	**310,093**
At 31 December 2009					
Deposits by banks	862,081	720,614	15,372	2,861	2,622
Customer accounts	16,317,139	6,745,071	2,180,117	1,367,856	24,571
Derivatives	650,761	–	3,111	–	–
Debt securities in issue	–	34,286	1,910,266	1,888,094	1,206,470
Other financial liabilities	7,999	264,147	107,404	356,265	127,256
	17,837,980	7,764,118	4,216,270	3,615,076	1,360,919
Loan commitments	1,425,233	3,292,504	4,027,486	4,637,917	2,452,465
	19,263,213	11,056,622	8,243,756	8,252,993	3,813,384

25 Maturity analysis of assets and liabilities *(continued)*

Trading liabilities and trading derivatives have been included in the 'On demand' time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The undiscounted cash flows on hedging derivative liabilities are classified according to their contractual maturity. The undiscounted cash flows potentially payable under financial guarantee contracts are classified on the basis of the earliest date they can be drawn down.

Further discussion of the group's liquidity and funding management can be found in Note 30 'Risk management'.

26 Foreign exchange exposures

Structural foreign exchange exposures

The group's structural foreign currency exposure is represented by the net asset value of its foreign currency equity and subordinated debt investments in subsidiary undertakings, branches and associates. Gains or losses on structural foreign exchange exposures are recognised in other comprehensive income.

The group's management of structural foreign currency exposures is discussed in Note 30.

Net structural currency exposures

Currency of structural exposure

	2010	2009
	US$000	US$000
Algerian dinar	156,333	146,374
Bahraini dinar	132,427	83,757
Jordanian dinar	180,395	159,536
Kuwaiti dinar	97,858	95,755
Lebanese pound	71,464	63,475
Omani riyal	233,413	211,468
Pakistani rupee	12,038	4,122
Qatari riyal	509,826	384,126
Pound sterling	-	226
UAE dirham	2,468,419	2,248,284
Total	3,862,173	3,397,123

27 Assets charged as security for liabilities and collateral accepted as security for assets

Collateral accepted as security for assets

The fair value of financial assets accepted as collateral that the group is permitted to sell or repledge in the absence of default is US$188,814 thousand (2009: US$103,876 thousand). The fair value of financial assets accepted as collateral that have been sold or repledged is US$3,488 thousand (2009: US$24,023 thousand). The group is obliged to return these assets.

28 Called up share capital

Authorised

The authorised ordinary share capital of the Bank at 31 December 2010 was 1,500,000,000 (2009: 1,500,000,000) ordinary shares of US$1.00 each.

On 29 December 2009, the Bank issued 300,000,000 ordinary shares of US$1.00 each, fully paid, at par.

Notes on the Financial Statements (continued)

28 Called up share capital *(continued)*

Issued and fully paid

	Number	US$000
At 1 January 2010	**931,055,000**	**931,055**
Shares issued	**–**	**–**
At 31 December 2010	**931,055,000**	**931,055**
At 1 January 2009	631,055,000	631,055
Shares issued	300,000,000	300,000
At 31 December 2009	931,055,000	931,055

29 Notes on the cash flow statement

Non-cash items included in profit before tax

	2010 US$000	2009 US$000
Depreciation, amortisation and impairment	**35,332**	26,989
Share-based payment expense	**805**	4,625
Loan impairment losses gross of recoveries	**586,911**	1,300,051
Provisions	**2,933**	4,824
Impairment of financial investments	**204**	(626)
Charge for defined benefit plans	**12,246**	14,805
Accretion of discounts and amortisation of premiums	**(12,575)**	(4,649)
	625,856	1,346,019

Change in operating assets

	2010 US$000	2009 US$000
Change in prepayments and accrued income	**23,644**	38,187
Change in net trading securities and net derivatives	**(164,154)**	(128,694)
Change in loans and advances to banks	**181,099**	(201,693)
Change in loans and advances to customers	**(1,272,006)**	2,516,515
Change in other assets	**(260,677)**	341,877
	(1,492,094)	2,566,192

Change in operating liabilities

	2010 US$000	2009 US$000
Change in accruals and deferred income	**(6,277)**	14,999
Change in deposits by banks	**(126,932)**	(136,776)
Change in customer accounts	**(180,507)**	(2,220,804)
Change in debt securities in issue	**598,337**	663,873
Change in other liabilities	**716,518**	(292,661)
	1,001,139	(1,971,369)

Cash and cash equivalents

	2010 US$000	2009 US$000
Cash and balances at central banks	**719,363**	432,386
Items in the course of collection from other banks	**61,085**	49,259
Loans and advances to banks of one month or less	**6,952,985**	6,646,160
Treasury bills, other bills and certificates of deposit less than three months	**4,015,918**	4,309,029
Less: items in the course of transmission to other banks	**(766,308)**	(65,703)
Total cash and cash equivalents	**10,983,043**	11,371,131

Total interest paid by the group during the year was US$385,065 thousand (2009: US$558,583 thousand). Total interest received by the group during the year was US$1,591,301 thousand (2009: US$1,873,250 thousand). Total dividends received by the group during the year was US$15,211 thousand (2009: US$11,508 thousand).

30 Risk management

All the group's activities involve, to varying degrees, the analysis, evaluation, acceptance and management of risks or combinations of risks. The most important categories of risk that the group is exposed to are credit risk (including cross-border country risk), market risk, operational risks in various forms, liquidity risk, pension risk, residual value risk, reputational risk, legal risk and sustainability (environmental and social) risks. Market risk includes foreign exchange, interest rate and equity price risks.

The management of these various risk categories is discussed below.

The risk profiles of the group and of individual operating entities change constantly under the influence of a wide range of factors. The risk management framework established by the group fosters the continuous monitoring of the risk environment and an integrated evaluation of risks and their interdependencies.

Risk governance and ownership

A well-established risk governance and ownership structure ensures oversight of, and accountability for, the effective management of risk at group, regional, customer group and operating entity levels.

The Board approves the group's risk appetite framework, plans and performance targets for the group and its principal operating subsidiaries, the appointment of senior officers, the delegation of authorities for credit and other risks and the establishment of effective control procedures. The Audit and Risk Committee is responsible for advising the Board on material risk matters and providing non-executive oversight of risk. Under authority delegated by the Board, the separately convened Risk Management Committee ('RMC') formulates high-level group risk management policy, exercises delegated risk authorities and oversees the implementation of risk appetite and controls. The RMC together with the Asset and Liability Committee ('ALCO') monitors all categories of risk, receives reports on actual performance and emerging issues, determines action to be taken and reviews the efficacy of the group's risk management framework.

In their oversight and stewardship of risk management at group level, RMC are supported by a dedicated Risk function headed by the Chief Risk Officer ('CRO'), who is a member of RMC and reports to Chief Executive Officer.

Risk has functional responsibility for the principal financial risk types, namely retail and wholesale credit, market, operational, security and fraud risks. For these it establishes group policy, exercises group-wide oversight and provides reporting and analysis of portfolio composition on a regional basis to senior management.

Risk appetite

The group's risk appetite framework describes the quantum and types of risk that the group is prepared to take in executing its strategy. It is central to an integrated approach to risk, capital and business management and supports the group in achieving its return on equity objectives, as well as being a key element in meeting the group's obligations under Basel II.

The formulation of risk appetite considers the group's risk capacity, its financial position, the strength of its core earnings and the resilience of its reputation and brand. It is expressed both qualitatively, describing which risks are taken and why, and quantitatively. The Board attaches quantitative metrics to individual risk types to ensure that:

- underlying business activity may be guided and controlled, so that it continues to be aligned to the risk appetite framework;
- key assumptions underpinning risk appetite can be monitored and, as necessary, adjusted through subsequent business planning cycles; and
- business decisions anticipated to be necessary to mitigate risk are flagged and acted upon promptly.

The risk appetite framework, governed by the Board and overseen in its implementation on an ongoing basis by the Board and RMC, is also maintained at regional and customer group levels. It operates through two key mechanisms:

- the framework itself defines the governance bodies, processes, metrics and other features of how the group addresses risk appetite as part of its ongoing business; and

Notes on the Financial Statements (continued)

30 Risk management *(continued)*

– periodic risk appetite statements define, at various levels in the business, the desired level of risk commensurate with return and growth targets and in line with the corporate strategy and stakeholder objectives.

The risk appetite framework covers both the beneficial and adverse aspects of risk. Within it, economic capital is the common currency through which risk is measured and used as the basis for risk evaluation, capital allocation and performance measurement across regions and customer groups. Risk appetite is executed through the operational limits that control the levels of risk run by the group, geographic segments and customer groups and is measured using risk-adjusted performance metrics.

Risk control culture

The group's risk management policies are encapsulated in the HSBC Group Standards Manual and cascaded in a hierarchy of policy manuals throughout the HSBC Group and communicated standards, instructions and guidance to employees. They support the formulation of risk appetite and establish procedures for monitoring and controlling risks, with timely and reliable reporting to management. The group regularly reviews and updates its risk management policies, systems and methodologies to reflect changes in law, regulation, markets, products and emerging best practice.

It is the responsibility of all HSBC Group officers to identify, assess and manage risk within the scope of their assigned responsibilities. Personal accountability, reinforced by the group's governance structure and instilled by training and experience, helps to foster throughout the HSBC Group a disciplined and constructive culture of risk management and control.

Credit risk

Credit risk management

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises principally from direct lending, trade finance and leasing business, but also from off-balance sheet products such as guarantees and credit derivatives, and from the group's holdings of debt securities. Amongst the risks in which the group engages, credit risk generates the largest regulatory capital requirements.

HSBC Holdings plc is responsible for the formulation of high-level credit risk policies and provides high-level centralised oversight and management of credit risk for the HSBC Group worldwide. In addition its responsibilities include:

- Controlling exposures to sovereign entities, banks and other financial institutions, as well as debt securities which are not held solely for the purpose of trading.
- Monitoring intra-HSBC Group exposures to ensure they are maintained within regulatory limits.
- Controlling cross-border exposures, through the imposition of country limits with sub-limits by maturity and type of business. Country limits are determined by taking into account economic and political factors, and applying local business knowledge. Transactions with countries deemed to be higher risk are considered case by case.

Within the group, the Credit Risk function is headed by the Chief Risk Officer and reports to the Chief Executive Officer, with a functional reporting line to the HSBC Group Chief Risk Officer. Its responsibilities include:

- Formulating and recording detailed credit policies and procedures, consistent with HSBC Group policy.
- Issuing policy guidelines to subsidiaries and offices on appetite for credit risk exposure to specified market sectors, activities and banking products and controlling exposures to certain high-risk sectors.
- Undertaking independent review and objective assessment of risk. Credit Risk assesses all commercial non-bank credit facilities and exposures over designated limits, prior to the facilities being committed to customers or transactions being undertaken.
- Monitoring the performance and management of portfolios.
- Maintaining policy on large credit exposures, ensuring that concentrations of exposure by counterparty, sector or geography do not become excessive in relation to the group's capital base and remain within internal and regulatory limits.

30 Risk management *(continued)*

- Maintaining and developing the governance and operation of HSBC Group's risk rating framework and systems, to classify exposures.
- Reporting on retail portfolio performance, high risk portfolios, risk concentrations, country limits and cross-border exposures, large impaired accounts, impairment allowances and stress testing results and recommendations to the Risk Management Committee, the Audit and Risk Committee and the Board of Directors.
- Acting on behalf of the group as the primary interface, for credit-related issues, with external parties including the rating agencies, corporate analysts, trade associations etc.

The group is required to implement credit policies, procedures and lending guidelines that meet local requirements while conforming to the HSBC Group standards. Credit approval authorities are delegated by the Board of Directors of HSBC Holdings to the most senior Chief Executive Officers, who receive commensurate delegations from their own Boards.

The group is responsible for the quality and performance of its credit portfolios and for monitoring and controlling all credit risks in them, including those subject to central approval by HSBC Group Risk. This includes managing its own risk concentrations by market sector, geography and product. Local systems are in place throughout the HSBC Group to enable operating companies to control and monitor exposures by customer and retail product segments.

Credit quality

The group's credit risk rating systems and processes differentiate exposures in order to highlight those with greater risk factors and higher potential severity of loss. In the case of individually significant accounts, risk ratings are reviewed regularly and any amendments are implemented promptly. Within the group's retail business, risk is assessed and managed using a wide range of risk and pricing models to generate portfolio data.

Special attention is paid to problem exposures, which are subject to more frequent and intensive review and reporting, in order to accelerate remedial action. Where appropriate, the group maintain or establish specialist units to provide customers with support in order to help them avoid default wherever possible.

Periodic risk-based audits of the group's credit processes and portfolios are also undertaken by an independent function.

Impairment Assessment

It is the group's policy that each operating company creates allowances for impaired loans promptly and consistently.

Impairment allowances may be assessed and created either for individually significant accounts or, on a collective basis, for groups of individually significant accounts for which no evidence of impairment has been individually identified or for high-volume groups of homogeneous loans that are not considered individually significant.

When impairment losses occur, the group reduces the carrying amount of loans and advances through the use of an allowance account. When impairment of available-for-sale financial assets and held-to-maturity financial investments occurs, the carrying amount of the asset is reduced directly.

Write-off of loans and advances

Loans are normally written off, either partially or in full, when there is no realistic prospect of further recovery. Where loans are secured, this is generally after receipt of any proceeds from the realisation of security.

Unsecured personal facilities, including credit cards, are generally written off at between 150 and 210 days past due, the standard period being the end of the month in which the account becomes 180 days contractually delinquent.

In the event of bankruptcy or analogous proceedings, write-off may occur earlier than at the periods stated above. Collections procedures may continue after write-off.

Cross-border exposures

Management assesses the vulnerability of countries to foreign currency payment restrictions, including economic and political factors, when considering impairment allowances on cross-border exposures.

30 Risk management *(continued)*

Impairment allowances are assessed in respect of all qualifying exposures within these countries unless these exposures and the inherent risks are:

– performing, trade-related and of less than one year's maturity;

– mitigated by acceptable security cover which is, other than in exceptional cases, held outside the country concerned;

– in the form of securities held for trading purposes for which a liquid and active market exists, and which are measured at fair value daily; and

– performing facilities with a principal (excluding security) of US$1 million or below; or performing facilities with maturity dates shorter than three months.

Credit exposure

Maximum exposure to credit risk

The group's exposure to credit risk is spread across many asset classes, including derivatives, trading assets, loans and advances to customers, loans and advances to banks, and financial investments.

The following table presents the maximum exposure to credit risk from balance sheet and off-balance sheet financial instruments, before taking account of any collateral held or other credit enhancements (unless such credit enhancements meet offsetting requirements). For financial assets recognised on the balance sheet, the exposure to credit risk equals their carrying amount; for financial guarantees granted, it is the maximum amount that the group would have to pay if the guarantees were called upon. For loan commitments and other credit-related commitments that are irrevocable over the life of the respective facilities, the maximum exposure to credit risk is the full amount of the committed facilities.

30 Risk management *(continued)*

Maximum exposure to credit risk

	At 31 December 2010			At 31 December 2009		
	Maximum exposure US$000	**Offset US$000**	**Exposure to credit risk (net) US$000**	Maximum exposure US$000	Offset US$000	Exposure to credit risk (net) US$000
Cash and balances at central banks	**719,363**	**–**	**719,363**	432,386	–	432,386
Items in the course of collection from other banks	**61,085**	**–**	**61,085**	49,259	–	49,259
Trading assets	**511,515**	**–**	**511,515**	243,005	–	243,005
– treasury and other eligible bills	**45,494**	**–**	**45,494**	–	–	–
– debt securities	**452,016**	**–**	**452,016**	235,750	–	235,750
– loans and advances to customers	**14,005**	**–**	**14,005**	7,255	–	7,255
Derivatives	**826,578**	**–**	**826,578**	662,301	–	662,301
Loans and advances held at amortised cost	**28,816,484**	**–**	**28,816,484**	27,989,449	–	27,989,449
– loans and advances to banks	**8,229,772**	**–**	**8,229,772**	8,106,050	–	8,106,050
– loans and advances to customers	**20,586,712**	**–**	**20,586,712**	19,883,399	–	19,883,399
Financial investments	**8,549,074**	**–**	**8,549,074**	7,767,106	–	7,767,106
– treasury and other similar bills	**283,787**	**–**	**283,787**	517,025	–	517,025
– debt securities	**8,265,287**	**–**	**8,265,287**	7,250,081	–	7,250,081
Other assets	**1,416,425**	**–**	**1,416,425**	1,178,980	–	1,178,980
– endorsements and acceptances	**1,201,496**	**–**	**1,201,496**	851,420	–	851,420
– accrued income and other	**214,929**	**–**	**214,929**	327,560	–	327,560
Financial guarantees	**5,911,520**	**–**	**5,911,521**	5,430,742	–	5,430,742
Loan commitments and other credit-related commitments	**16,506,857**	**–**	**16,506,858**	16,852,098	–	16,852,098
	63,318,903	**–**	**63,318,903**	60,605,326	–	60,605,326

Collateral and other credit enhancements

Collateral held against financial instruments presented above in the maximum exposure to credit risk table is described in more detail below.

Items in the course of collection from other banks

The group substantially mitigates settlement risk on many transactions, particularly those involving securities and equities, by settling through assured payment systems or on a delivery-versus-payment basis.

Treasury, other eligible bills and debt securities

Debt securities, treasury and other eligible bills are generally unsecured except for Asset-Backed Securities ('ABSs') and similar instruments, which are secured by pools of financial assets.

Notes on the Financial Statements (continued)

30 Risk management *(continued)*

Derivatives

The International Swaps and Derivatives Association ('ISDA') Master Agreement is the group's preferred agreement for documenting derivatives activity. It provides the contractual framework within which dealing activity across a full range of over-the-counter products is conducted, and contractually binds both parties to apply close-out netting across all outstanding transactions covered by an agreement if either party defaults or other pre agreed termination events occur. It is common, and the group's preferred practice, for the parties to execute a Credit Support Annex ('CSA') in conjunction with the ISDA Master Agreement. Under a CSA, collateral is passed between the parties to mitigate the market-contingent counterparty risk inherent in the outstanding positions.

Loans and advances

Although collateral can be an important mitigant of credit risk, it is the group's policy, when lending, to do so within the customer's capacity to repay, rather than rely on the value of security offered. Depending on the customer's standing and the type of product, facilities may be provided unsecured.

The principal collateral types employed by the group are as follows:

- in the personal sector, mortgages over residential properties;
- in the commercial and industrial sector, charges over business assets such as premises, stock and debtors;
- in the commercial real estate sector, charges over the properties being financed; and
- in the financial sector, charges over financial instruments such as debt securities and equities in support of trading facilities.

In addition, credit derivatives and securitisation structures are used to hedge or transfer credit risk within the group's loan portfolio.

The group does not disclose the fair value of collateral held as security or other credit enhancements on loans and advances past due but not impaired, or on individually assessed impaired loans and advances, as it is not practicable to do so.

Concentration of exposure

Concentrations of credit risk arise when a number of counterparties or exposure have comparable economic characteristics, or such counterparties are engaged in similar activities, or operate in the same geographical areas or industry sectors, so that their collective ability to meet contractual obligations is uniformly affected by changes in economic, political or other conditions.

The group provides a diverse range of financial services both in the Middle East and internationally. As a result, its portfolio of financial instruments with credit risk is diversified, with no exposures to individual industries or economic groupings totalling more than 10% of consolidated total assets, except as follows:

- the majority of the group's exposure to credit risk is concentrated in the Middle East. Within the Middle East, the group's credit risk is diversified over a wide range of industrial and economic groupings; and
- the group'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 2010 and 31 December 2009 was concentrated in the Middle East.

Debt securities, treasury and other eligible bills

At US$8,549 million total financial investments excluding equity securities were 10% higher at 31 December 2010 than at 31 December 2009. Debt securities, at US$8,265 million, represented the largest concentration of financial investments at 97% of the total, compared with US$7,250 million (93%) at 31 December 2009. The group's holdings of government, corporate debt, and other securities were spread across a wide range of issuers and geographical regions.

Investments in securities of governments and government agencies of US$7,483 million were 88% of overall financial investments excluding equity shares (2009 - US$6,590 million (85%)).

Derivatives exposures at 31 December 2010 were US$826,578 thousand, an increase of 25% from 31 December 2009, with increases across all asset classes, notably interest rate, foreign exchange, commodity and other derivatives. Higher volatility within the financial markets, flattening yield curves in major currencies and widening credit spreads led to an increase in the fair value of outstanding derivative contracts. Derivatives exposure is shown gross under IFRSs. Derivative liabilities increased for the same reasons.

30 Risk management *(continued)*

Loans and advances

Loans and advances to banks were widely distributed across major institutions.

Gross loans and advances to customers by industry sector

	Gross loans and advances to customers	
At 31 December 2010	**Total US$000**	**As a % of total gross loans %**
Personal		
Residential mortgages	**1,748,385**	**7.93**
Other personal	**3,208,214**	**14.55**
	4,956,599	**22.48**
Corporate and commercial		
Commercial, industrial and international trade	**9,265,264**	**42.01**
Commercial real estate	**1,039,723**	**4.71**
Other property-related	**1,709,730**	**7.75**
Government	**1,154,751**	**5.24**
Other commercial	**2,731,875**	**12.39**
	15,901,343	**72.10**
Financial		
Non-bank financial institutions	**1,189,390**	**5.39**
Settlement accounts	**5,778**	**0.03**
	1,195,168	**5.42**
Total gross loans and advances	**22,053,110**	**100.00**
Impaired loans		
– as a percentage of gross loans and advances to customers	**9.74%**	
Total impairment allowances		
– as a percentage of gross loans and advances to customers	**6.65%**	
At 31 December 2009		
Personal		
Residential mortgages	1,894,395	8.95
Other personal	4,167,672	19.69
	6,062,067	28.64
Corporate and commercial		
Commercial, industrial and international trade	7,842,194	37.05
Commercial real estate	1,240,418	5.86
Other property-related	1,289,371	6.09
Government	1,311,613	6.20
Other commercial	2,443,404	11.54
	14,127,000	66.74
Financial		
Non-bank financial institutions	973,423	4.60
Settlement accounts	3,053	0.02
	976,476	4.62
Total gross loans and advances	21,165,543	100.00
Impaired loans		
– as a percentage of gross loans and advances to customers	7.32%	
Total impairment allowances		
– as a percentage of gross loans and advances to customers	6.06%	

Notes on the Financial Statements (continued)

30 Risk management *(continued)*

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.

Areas of special interest

Dubai and UAE

In 2009, Dubai World requested a standstill agreement with creditors in respect of the indebtedness of certain Dubai World group companies. The market disruption that ensued cut would-be borrowers off from the capital markets, although continued restructuring efforts throughout 2010 saw the return of significant positive sentiment from investors. As one of the long-term bankers to Dubai World and the various entities related to the Government of Dubai, the group has worked closely during 2010 to address the prevailing issues. In October 2010, Dubai World obtained an agreement to restructure US$25 billion of its debt subject to final documentation expected to be signed in the first half of 2011. The arrangement extends banks' maturities for five to eight years at discounted rates allowing Dubai World time to sell off its non-core assets while focusing on its core earnings. The group's exposure in Dubai is primarily spread across operating companies within the emirate.

Geo-political Developments

Political developments in the region are being monitored closely and action taken to mitigate their impact. It is too early to foresee how events may unfold; hitherto, our business in the region has for the most part operated without serious disruption. In the medium term, economic growth in the region may be adversely affected, with wider implications if the prices of oil, food and commodities rise significantly.

Wholesale lending

Wholesale lending covers the range of credit facilities granted to sovereign borrowers, banks, non-bank financial institutions and corporate entities. The group's wholesale portfolios are well diversified across industry sectors throughout the region, with exposure subject to portfolio controls. Overall credit quality stabilised although business confidence remained low in some sectors amidst ongoing uncertain economic conditions.

Following government intervention in 2009 to stabilise their financial systems, 2010 was characterised by a reliance on government impetus for economic activity through infrastructural projects. Nonetheless, credit risk levels remained high, with customers and counterparties facing the challenges of a significant reduction in available bank credit and much reduced demand for their products and services. However, there was considerable interest from international and regional investors, attracted by higher yields, to support bond issuances in the region. The borrowers took advantage of longer tenors available.

The proactive measures adopted in 2009 assisted us to address identified problems early on and thereby minimise the likelihood of adverse situations developing. The group has taken steps to improve the structure of facilities, including tenor and collateral, in response to the heightened risks.

Commercial real estate

Commercial real estate lending to customers for the purpose of property investment at 31 December 2010 represented 4.71% (2009: 5.86%) of total gross loans and advances to customers. The sector continued to experience deterioration in credit quality due to a decline in valuations, increased rent shortfalls due to vacant properties or non-payment, a decline in demand for new housing, a prospective decline in rental cash flows and significantly reduced refinancing options. Impairment occurred in a limited number of cases. The group's exposure to the decline in credit quality was mitigated by long-standing policies on asset origination which focus on relationships with long-term customers and limited initial leverage, as well as guidelines and controls preventing higher risk concentrations.

Sovereign counterparties

The overall quality of the group's sovereign portfolio remained strong during the period with the large majority of both in-country and cross-border limits extended to countries with strong internal credit risk ratings. There was some downward shift in the quality composition of the portfolio as credit spreads and external ratings were subject to downgrade and volatility. The group regularly updates its assessment of higher risk countries and adjusts its risk appetite to reflect such changes.

30 Risk management *(continued)*

Personal lending

The group provides a broad range of secured and unsecured personal lending products to meet customer needs. Given the diverse nature of the markets in which the group operates, the range is not standardised across all countries but is tailored to meet the demands of individual markets while using appropriate distribution channels and, wherever possible, common global IT platforms.

Personal lending includes advances to customers for asset purchase, such as residential property and motor vehicles, where the loans are typically secured on the assets being acquired. The group also offers loans secured on existing assets; unsecured lending products such as overdrafts, credit cards and payroll loans; and debt consolidation loans which may be secured or unsecured.

During 2010, the growth strategy focused on higher quality accounts, particularly employees of companies that have remained strong through the recent history. At a portfolio level, loan impairment charges reduced from prior year levels as the economic situation stabilised. The portfolio primarily consists of seasoned accounts, that have managed to maintain payments throughout the downturn, and recent originations that passed through a strong credit criterion.

Renegotiated loans

Restructuring activity is designed to manage customer relationships, maximise collection opportunities and, if possible, avoid foreclosure or repossession. Such activities include extended payment arrangements, lower interest rates, approved external debt management plans, deferring foreclosure, modification, loan rewrites and/or deferral of payments pending a change in circumstances. Restructuring is most commonly applied to consumer finance portfolios.

Our credit risk management policy on restructured loans sets out restrictions on the number and frequency of restructures, the minimum period an account must have been opened before any restructure can be considered and the number of qualifying payments that must be received before the account may be considered restructured and up to date. The application of this policy varies according to the nature of the market, the product, and the availability of empirical data.

These restructuring policies and practices are based on criteria which, in the judgement of local management, indicate that repayment is likely to continue, and are kept under continual review.

Loans that are subject to restructuring may only be classified as restructured and up to date once a specified number and/or amount of qualifying payments have been received. These qualifying payments are set at a level appropriate to the nature of the loan and the customer's circumstances to provide evidence that repayment is likely to continue. Typically the receipt of two or more qualifying payments is required within a certain period, generally 60 days.

Renegotiated loans are segregated from other parts of the loan portfolio for collective impairment assessment, to reflect their risk profile. When empirical evidence indicates an increased propensity to default on restructured accounts, the use of roll rate methodology ensures this factor is taken into account when calculating impairment allowances. Interest is recorded on renegotiated loans on the basis of the new contractual terms following renegotiation.

Renegotiated loans that would otherwise be past due or impaired

	At 31 December	
	2010	2009
	US$000	US$000
Loans and advances to customers	**50,630**	102,925

Credit quality of financial instruments

The five credit quality classifications defined below each encompass a range of more granular, internal credit rating grades assigned to wholesale and retail lending business, as well as the external rating, attributed by external agencies to debt securities. There is no direct correlation between the internal and external ratings at granular level, except to the extent each falls within a single quality classification.

Notes on the Financial Statements (continued)

30 Risk management *(continued)*

Credit quality

	Wholesale	Retail lending	Debt securities/other
Quality classification	**Internal credit rating**	**Internal credit rating**	**External credit rating**
Strong	CRR 1 to CRR 2	EL 1 to EL 2	A- and above
Good	CRR 3	EL 3	BBB+ to BBB-
Satisfactory	CRR 4 to CRR 5	EL 4 to EL 5	BB+ to B+ and unrated
Sub – standard	CRR 6 to CRR 8	EL 6 to EL 8	B and below
Impaired	CRR 9 to CRR 10	EL 9 to EL 10	Impaired

Quality classification definitions

'Strong': exposures demonstrate a strong capacity to meet financial commitments, with negligible or low probability of default and/or low levels of expected loss. Retail accounts operate within product parameters and only exceptionally show any period of delinquency.

'Good': exposures require closer monitoring and demonstrate a good capacity to meet financial commitments, with low default risk. Retail accounts typically show only short periods of delinquency, with any losses expected to be minimal following the adoption of recovery processes.

'Satisfactory': exposures require closer monitoring and demonstrate an average to fair capacity to meet financial commitments, with moderate default risk. Retail accounts typically show only short periods of delinquency, with any losses expected to be minor following the adoption of recovery processes.

'Sub-standard': exposures require varying degrees of special attention and default risk is of greater concern. Retail portfolio segments show longer delinquency periods of generally up to 90 days past due and/or expected losses are higher due to a reduced ability to mitigate these through security realisation or other recovery processes.

'Impaired': exposures have been assessed, individually or collectively, as impaired.

Risk rating scales

The Customer Risk Rating ('CRR') 10-grade scale above summarises a more granular underlying 22 grade scale of obligor probability of default ('PD'). All distinct customers Group-wide are rated using one of these two PD scales, depending on the degree of sophistication of the Basel II approach adopted for the exposure.

The Expected Loss ('EL') 10-grade scale for retail business summarises a more granular underlying EL scale for these customer segments; this combines obligor and facility/product risk factors in a composite measure.

For debt securities and certain other financial instruments, external ratings have been aligned to the five quality classifications. The ratings of Standard and Poor's are cited, with those of other agencies being treated equivalently. Debt securities with short-term issue ratings are reported against the long-term rating of the issuer of those securities. If major rating agencies have different ratings for the same debt securities, a prudent rating selection is made in line with regulatory requirements.

For the purpose of the following disclosure, retail loans which are past due up to 89 days and are not otherwise classified as EL9 or EL10, are separately classified as past due but not impaired.

30 Risk management *(continued)*

The following tables set out the group's distribution of financial instruments by measures of credit quality.

Distribution of financial instruments by credit quality

	31 December 2010							
	Neither past due nor impaired							
	Strong US$000	Good US$000	Satisfactory US$000	Sub-Standard US$000	Past due not impaired US$000	Impaired US$000	Impairment allowances US$000	Total US$000
Cash and balances at central banks	719,363	–	–	–	–	–	–	719,363
Items in the course of collection from other banks	6,834	4,127	50,124	–	–	–	–	61,085
Trading assets	192,159	74,378	232,957	12,021	–	–	–	511,515
– treasury and other eligible bills	–	–	45,494	–	–	–	–	45,494
– debt securities	178,154	74,378	187,463	12,021	–	–	–	452,016
– loans and advances to customers	14,005	–	–	–	–	–	–	14,005
Derivatives	118,811	368,061	339,317	389	–	–	–	826,578
Loans and advances held at amortised cost	13,187,072	5,221,814	6,312,608	2,072,218	1,337,386	2,168,813	(1,483,427)	28,816,484
– loans and advances to banks	7,432,054	179,408	161,281	454,033	–	20,025	(17,029)	8,229,772
– loans and advances to customers	5,755,018	5,042,406	6,151,327	1,618,185	1,337,386	2,148,788	(1,466,398)	20,586,712
Financial investments	2,742,356	–	5,272,662	534,056	–	–	–	8,549,074
– treasury and other eligible bills	150,107	–	67,166	66,514	–	–	–	283,787
– debt securities	2,592,249	–	5,205,496	467,542	–	–	–	8,265,287
Other assets	93,086	207,887	968,438	145,335	957	722	–	1,416,425
– endorsements and acceptances	88,549	207,887	758,043	145,335	957	725	–	1,201,496
– accrued income and other	4,537	–	210,395	–	–	(3)	–	214,929

Notes on the Financial Statements (continued)

30 Risk management *(continued)*

	31 December 2009							
	Neither past due nor impaired							
	Strong	Good	Satisfactory	Sub-Standard	Past due not impaired	Impaired	Impairment allowances	Total
	US$000	US$000	US$000	US$000	US$000	US$000	US$000	US$000
Cash and balances at central banks	432,386	–	–	–	–	–	–	432,386
Items in the course of collection from other banks	–	–	49,259	–	–	–	–	49,259
Trading assets	90,803	117,255	33,172	1,775	–	–	–	243,005
– debt securities	83,548	117,255	33,172	1,775	–	–	–	235,750
– loans and advances to customers	7,255	–	–	–	–	–	–	7,255
Derivatives	117,460	317,700	227,137	4	–	–	–	662,301
Loans and advances held at amortised cost	12,754,592	4,280,144	6,928,922	2,108,913	1,644,963	1,569,082	(1,297,167)	27,989,449
– loans and advances to banks	6,363,099	1,192,355	272,814	272,782	–	20,025	(15,025)	8,106,050
– loans and advances to customers	6,391,493	3,087,789	6,656,108	1,836,131	1,644,963	1,549,057	(1,282,142)	19,883,399
Financial investments	3,088,213	1,982	4,152,020	524,891	–	–	–	7,767,106
– treasury and other eligible bills	165,752	–	55,134	296,139	–	–	–	517,025
– debt securities	2,922,461	1,982	4,096,886	228,752	–	–	–	7,250,081
Other assets	26,786	31,406	929,107	110,412	9,824	71,445	–	1,178,980
– endorsements and acceptances	26,190	31,406	604,000	110,412	8,950	70,462	–	851,420
– accrued income and other	596	–	325,107	–	874	983	–	327,560

30 Risk management *(continued)*

Past due but not impaired gross financial instruments

The following table provides an analysis of gross loans and advances to customers held at amortised cost which are past due but not considered impaired. There are no other significant balance sheet items where past due balances are not considered impaired.

	Up to 29 days US$000	30-59 days US$000	60-89 days US$000	90-179 days US$000	Over 180 days US$000	Total US$000
At 31 December 2010	**924,358**	**49,336**	**100,423**	**157,834**	**105,435**	**1,337,386**
At 31 December 2009	1,068,958	122,296	240,786	82,152	130,771	1,644,963

Collateral and other credit enhancements obtained

The group obtained assets by taking possession of collateral held as security, or calling upon other credit enhancements, as follows:

Nature of assets	At 31 December **2010** US$000	2009 US$000
Residential property and motor vehicles	**3,077**	1,465

Repossessed properties and motor vehicles are made available for sale in orderly fashion, with the proceeds used to reduce or repay the outstanding indebtedness. Where excess funds are available they are used either for other secured lenders with lower priority or are returned to the customer. The group does not generally occupy the repossessed properties for its business use.

Impaired allowances and charges on loans and advances to customers and banks

Movement in impairment allowances on loans and advances to customers and banks

	Banks	Customers		
	Individually assessed US$000	Individually assessed US$000	Collectively assessed US$000	Total US$000
At 1 January 2010	**15,025**	**611,167**	**670,975**	**1,297,167**
Amounts written off	–	**(11,671)**	**(372,766)**	**(384,437)**
Recoveries of loans and advances written off in previous years	–	**4,182**	**52,534**	**56,716**
Charge to income statement	**2,004**	**409,416**	**118,775**	**530,195**
Exchange and other movements	–	**(16,291)**	**77**	**(16,214)**
At 31 December 2010	**17,029**	**996,803**	**469,595**	**1,483,427**
At 1 January 2009	25	111,139	267,579	378,743
Amounts written off	–	(10,934)	(371,401)	(382,335)
Recoveries of loans and advances written off in previous years	–	2,469	24,873	27,342
Charge to income statement	15,000	509,052	749,855	1,273,907
Exchange and other movements	–	(559)	69	(490)
At 31 December 2009	15,025	611,167	670,975	1,297,167

Notes on the Financial Statements (continued)

30 Risk management *(continued)*

Impairment allowances as a percentage of gross loans and advances to banks and customers[1]

	At 31 December	
	2010	2009
	%	%
Banks		
Individually assessed impairment allowances	**0.20%**	0.18%
Customers		
Individually assessed impairment allowances	**4.52%**	2.89%
Collectively assessed impairment allowances	**2.13%**	3.17%
	6.65%	6.06%

1 *Net of reverse repo transactions and settlement accounts.*

Liquidity and funding management

Liquidity risk is the risk that the group does not have sufficient financial resources to meet its obligations as they fall due, or will have to do so at an excessive cost. This risk arises from mismatches in the timing of cash flows. Funding risk (a form of liquidity risk) arises when the liquidity needed to fund illiquid asset positions cannot be obtained on the expected terms and when required.

The objective of the group's liquidity and funding management framework is to ensure that all foreseeable funding commitments, including deposit withdrawals, can be met when due, and that access to the wholesale markets is co-ordinated and cost-effective. To this end, the group maintains a diversified and stable funding base comprising core retail and corporate customer deposits and institutional balances. This is augmented with wholesale funding and portfolios of highly liquid assets diversified by currency and maturity which are held to enable the group to respond quickly and smoothly to unforeseen liquidity requirements.

The group requires its operating entities to maintain strong liquidity positions and to manage the liquidity profiles of their assets, liabilities and commitments with the objective of ensuring that their cash flows are balanced appropriately and that all their obligations can be met when due.

The group adapts its liquidity and funding risk management framework in response to changes in the mix of business that it undertakes, and to changes in the nature of the markets in which it operates. The group has continuously monitored the impact of recent market events on the group's liquidity positions and introduced more conservative assumptions where justified. The liquidity and funding risk management framework will continue to evolve as the group assimilates knowledge from the recent market events.

Policies and procedures

The management of liquidity and funding is primarily undertaken locally in the group's operating entities in compliance with practices and limits set by the HSBC Group's Risk Management Meeting ('RMM'). These limits vary according to the depth and liquidity of the market in which the entities operate. It is HSBC's general policy that each banking entity should be self-sufficient when funding its own operations. Exceptions are permitted for certain short-term treasury requirements and start-up operations or branches which do not have access to local deposit markets. These entities are funded under limits from the group's largest banking operations and clearly defined internal and regulatory guidelines and limits which serve to place formal limitations on the transfer of resources between group entities and are necessary to reflect the range of currencies, markets and time zones within which the group operates.

The group's liquidity and funding management process includes:

- projecting cash flows by major currency under various stress scenarios and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity and advances to deposits ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing the concentration and profile of debt maturities;

30 Risk management *(continued)*

- managing contingent liquidity commitment exposures within pre-determined caps;
- maintaining debt financing plans;
- monitoring depositor concentration in order to avoid undue reliance on large individual depositors and ensure a satisfactory overall funding mix; and
- maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises, while minimising adverse long-term implications for the business.

Primary sources of funding

Current accounts and savings deposits payable on demand or at short notice form a significant part of the group's funding, and the group places considerable importance on maintaining their stability. For deposits, which are a primary source of funding, stability depends upon preserving depositor confidence in the group's capital strength and liquidity, and on competitive and transparent pricing.

Cash flows payable in respect of customer accounts are primarily contractually repayable on demand or at short notice. However, in practice, short-term deposit balances remain stable as inflows and outflows broadly match and a significant portion of loan commitments expire without being drawn upon.

Of total liabilities of US$37,665,825 thousand at 31 December 2010, funding from customers amounted to US$26,343,980 thousand, of which US$25,952,958 thousand was contractually repayable within one year.

An analysis of cash flows payable by the group under financial liabilities by remaining contractual maturities at the balance sheet date is included in Note 25.

Assets available to meet these liabilities, and to cover outstanding commitments to lend (US$16,506,857 thousand), included cash, central bank balances, items in the course of collection and treasury and other bills (US$1,109,729 thousand); loans to banks (US$8,229,772 thousand, including US$7,928,774 thousand repayable within one year); and loans to customers (US$20,586,712 thousand, including US$13,599,504 thousand repayable within one year). In the normal course of business, a proportion of customer loans contractually repayable within one year will be extended.

Advances to core funding ratio

The group emphasises the importance of core customer deposits as a source of funds to finance lending to customers, and discourages reliance on short-term professional funding. This is achieved by placing limits on banking entities (including branches) which restrict their ability to increase loans and advances to customers without corresponding growth in core customer deposits or long term debt funding. This measure is referred to as the 'advances to core funding' ratio (previously referred to as the 'advances to deposits' ratio).

Advances to core funding ratio limits are set by the Asset and Liability Management Committee ('ALCO'). The ratio describes current loans and advances to customers as a percentage of the total of core customer deposit and term funding with a remaining term to maturity in excess of one year. Loans and advances to customers which are part of reverse repurchase arrangements, and where the group receives securities which are deemed to be liquid, are excluded from the advances to core funding ratio. The classification of a deposit as 'core' includes consideration of the size of the deposit balance, the pricing, the type of customer and the deposit's behavioural characteristics. Due to the distinction between core and non-core deposits, the group's measure of advances to deposits will be more restrictive than that which could be inferred from the published financial statements.

	Advances to core funding ratio during:		Stressed one month coverage ratio during:	
	2010	2009	**2010**	2009
	%	%	**%**	%
Year-end	**111.3**	122.4	**139.0**	120.0
Maximum	**122.2**	140.0	**139.0**	120.0
Minimum	**106.5**	122.4	**119.0**	94.0
Average	**113.3**	140.0	**126.3**	103.0

Notes on the Financial Statements (continued)

30 Risk management *(continued)*

The group would meet any unexpected net cash outflows by selling securities and accessing additional funding sources such as interbank or collateralised lending markets.

Projected cash flow scenario analysis

The group uses a number of standard projected cash flow scenarios designed to model both group-specific and market-wide liquidity crises, in which the rate and timing of deposit withdrawals and drawdowns on committed lending facilities are varied and the ability to access interbank funding and term debt markets and generate funds from asset portfolios is restricted. The scenarios are modelled by all group banking entities. The appropriateness of the assumptions under each scenario is regularly reviewed. In addition to the group's standard projected cash flow scenarios, individual entities are required to design their own scenarios tailored to reflect specific local market conditions, products and funding bases.

Limits for cumulative net cash flows under stress scenarios are set for each banking entity.

Both ratio and cash flow limits reflect the local market place, the diversity of funding sources available and the concentration risk from large depositors. Compliance with entity level limits is monitored and reported regularly to ALCO.

Stressed one month coverage ratio

The stressed one month coverage ratios tabulated above are derived from these scenario analyses, and express the stressed cash inflows as a percentage of stressed cash outflows over a one month time horizon. Our entities are required to target a ratio of 100% or greater.

Market risk management

Market risk is the risk that movements in market risk factors, including foreign exchange rates and commodity prices, interest rates, credit spreads and equity prices will reduce the group's income or the value of its portfolios.

The group separates exposures to market risk into trading or non-trading portfolios. Trading portfolios include those positions arising from market-making, position-taking and others designated as marked-to-market positions. Non-trading portfolios include positions that primarily arise from the interest rate management of the group's retail and commercial banking assets and liabilities, financial investments designated as available-for-sale and held-to-maturity.

Monitoring and limited market risk exposure:

The objective of the group's market risk management is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with the group's status as a premier provider of financial products and services.

The management of market risk is principally undertaken in Global Markets using risk limits approved by the board. Limits are set for portfolios, products and risk types, with market liquidity being a principal factor in determining the level of limits set. HSBC Group Risk, an independent unit within the Group Management Office of HSBC Holdings plc, is responsible for HSBC's market risk management policies and measurement techniques. Each major operating entity has an independent market risk management and control function which is responsible for measuring market risk exposures in accordance with the policies defined by HSBC Group Risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis.

Each operating entity is required to assess the market risks arising on each product in its business and to transfer these risks to either its local Global Markets unit for management, or to separate books managed under the supervision of the local Asset and Liability Management Committee ('ALCO'). The aim is to ensure that all market risks are consolidated within operations which have the necessary skills, tools, management and governance to manage such risks professionally. In certain cases where the market risks cannot be fully transferred, simulation modelling is used to identify the impact of varying scenarios on valuations and net interest income.

The group uses a range of tools to monitor and limit market risk exposures. These include sensitivity analysis, value at risk ('VAR') and stress testing.

Sensitivity analysis

Sensitivity measures are used to monitor the market risk positions within each risk type, for example, present value of

30 Risk management *(continued)*

a basis point movement in interest rates, for interest rate risk. Sensitivity limits are set for portfolios, products and risk types, with the depth of the market being one of the principal factors in determining the level of limits set.

Value at risk ('VAR')

VAR is a technique that estimates the potential losses that could occur on risk positions as a result of movements in market rates and prices over a specified time horizon and to a given level of confidence.

The VAR models used by the group are predominantly based on historical simulation. These models derive plausible future scenarios from past market rate and price time series, taking into account inter-relationships between different markets and rates, such as interest rates and foreign exchange rates. The models also incorporate the impact of option features on the underlying exposures.

The historical simulation models assess potential market movements with reference to data from the past two years and calculate VAR to a 99% confidence level and for a one-day holding period.

The group routinely validates the accuracy of its VAR models by back-testing the actual daily profit and loss results, adjusted to remove non-modelled items such as fees and commissions, against the corresponding VAR numbers. Statistically, the group would expect to see losses in excess of VAR only 1% of the time over a one-year period. The actual number of excesses over this period can therefore be used to gauge how well the models are performing.

Although a valuable guide to risk, VAR should always be viewed in the context of its limitations:

- the use of historical data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;
- the use of a one-day holding period assumes that all positions can be liquidated or the risks offset in one day. This may not fully reflect the market risk arising at times of severe illiquidity, when a one-day holding period may be insufficient to liquidate or hedge all positions fully;
- the use of a 99% confidence level, by definition, does not take into account losses that might occur beyond this level of confidence;
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures; and
- VAR is unlikely to reflect loss potential on exposures that only arise under significant market movements.

Stress testing

In recognition of the limitations of VAR, the group augments VAR with stress testing to evaluate the potential impact on portfolio values of more extreme, although plausible, events or movements in a set of financial variables.

The process is governed by the Stress Testing Review Group forum which, in conjunction with the regional risk managers, determines the scenarios to be applied at portfolio and consolidated level, as follows:

- sensitivity scenarios consider the impact of any single risk factor or a set of factors that are unlikely to be captured within the VAR models such as the break of a currency peg;
- technical scenarios, consider the largest move in each risk factor, without consideration of any underlying market correlation;
- hypothetical scenarios, which consider potential macro economic events, for example, a global flu pandemic; and
- historical scenarios incorporate historical observations of market movement during previous periods of stress which would not be captured within VAR.

Stress testing results provide senior management with an assessment of the financial impact such events would have on the group's profit. The daily losses experienced during 2010 were within the stress loss scenarios reported to senior management.

30 Risk management *(continued)*

Trading and non-trading portfolios

The following table provides an overview of the reporting of risks within this section:

	Portfolio	
	Trading	Non-trading
Risk type		
Foreign exchange and commodity	VAR	VAR[1]
Interest rate	VAR	VAR
Credit spread	VAR[2]	VAR

1 *The reporting of commodity risk is consolidated with foreign exchange risk and is not applicable to non-trading portfolios.*
2 *Credit spread VAR for trading portfolios has been included in VAR from 2010.*

Value at risk of the trading and non-trading portfolios

The VAR, both trading and non-trading, for the group was as follows:

	US$000
Total	
At 31 December 2010	**2,241**
At 31 December 2009	4,223

	Average US$000	Minimum US$000	Maximum US$000
2010	**4,436**	**1,823**	**8,378**
2009	4,489	3,273	5,999

Trading portfolios

The group's control of market risk is based on a policy of restricting individual operations to trading within a list of permissible instruments authorised for each site by HSBC Group Risk, of enforcing rigorous new product and approval procedures, and of restricting trading in the more complex derivative products only to offices with appropriate levels of product expertise and robust control systems.

Market-making and position-taking is undertaken within Global Markets. The VAR for such trading activity at 31 December 2010 was US$1,498 thousand (2009: US$1,576 thousand). This is analysed below by risk type:

VAR by risk type for the trading activities

	Foreign exchange US$000	Interest rate US$000	Credit US$000	Total[1] US$000
At 31 December 2010	**1,923**	**2,659**	**994**	**1,498**
At 31 December 2009	4,225	4,349	–	1,576
Average				
2010	**4,151**	**3,320**	**1,272**	**3,053**
2009	2,259	2,031	–	1,695
Minimum				
2010	**1,900**	**1,811**	**547**	**1,467**
2009	444	476	–	924
Maximum				
2010	**5,945**	**4,981**	**5,491**	**5,415**
2009	6,222	4,713	–	3,480

1 *The total VAR is non-additive across risk types due to diversification effects.*

30 Risk management *(continued)*

Gap risk

Even for transactions which are structured to render the risk to the group negligible under a wide range of market conditions or events, there exists a remote possibility that a significant gap event could lead to loss. A gap event could arise from a significant change in market price with no accompanying trading opportunity, with the result that the threshold is breached beyond which the risk profile changes from no risk to full exposure to the underlying structure. Such movements may occur for example, when, in reaction to an adverse event or unexpected news announcement, the market for a specific investment becomes illiquid, making hedging impossible.

Given the characteristics of these transactions, they will make little or no contribution to VAR or to traditional market risk sensitivity measures. The group captures the risks for such transactions within the stress testing scenarios and monitor gap risk on an ongoing basis. The group incurred no material gap losses arising from movements in the underlying market price on such transactions in the 12 months ended 31 December 2010.

Non-trading portfolios

The principal objective of market risk management of non-trading portfolios is to optimise net interest income.

Interest rate risk in non-trading portfolios arises principally from mismatches between the future yield on assets and their funding cost as a result of interest rate changes. Analysis of this risk is complicated by having to make assumptions on embedded optionality within certain product areas, such as the incidence of mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand such as current accounts.

The control of market risk in the non-trading portfolios is based on transferring the risks to the books managed by Global Markets or the local ALCO. The net exposure is typically managed through the use of interest rate swaps within agreed limits. The VAR for these portfolios is included within the group VAR.

Equity securities classified as available-for-sale

Market risk arises on equity securities held as available-for-sale. The fair value of these securities at 31 December 2010 was US$118,647 thousand (2009: US$105,980 thousand).

Sensitivity of net interest income

A principal element of the group's management of market risk in non-trading portfolios is monitoring the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). The group aims to mitigate the impact of prospective interest rate movements which could reduce future net interest income, while balancing the cost of hedging such activities on the current net revenue stream.

For simulation modelling, businesses use a combination of standard scenarios which are required throughout the group. The standard scenarios are consolidated to illustrate the combined pro forma effect on the group's consolidated portfolio valuations and net interest income.

Structural foreign exchange exposures

Structural foreign exchange exposures represent net investments in subsidiaries, branches or associates, the functional currencies of which are currencies other than the US dollar. An entity's functional currency is the currency of the primary economic environment in which the entity operates.

Exchange differences on structural exposures are recorded in other comprehensive income . The main operating (or functional) currencies of the group are UAE dirham and other Gulf currencies that are linked to the US dollar.

The group's policy is to hedge structural foreign currency exposures only in limited circumstances. The group's structural foreign exchange exposures are managed with the primary objective of ensuring, where practical, that the group's capital ratio is protected from the effect of changes in exchange rates. This is usually achieved by holding qualifying capital broadly in proportion to the corresponding foreign-currency-denominated risk-weighted assets. The group considers hedging structural foreign currency exposures only in limited circumstances to protect the capital ratio or the US dollar value of capital invested. Such hedging would be undertaken using forward foreign exchange controls or by financing the borrowings in the same currencies as the functional currencies involved.

Notes on the Financial Statements (continued)

30 Risk management *(continued)*

Defined benefit pension scheme

Market risk also arises within the group's defined benefit pension schemes to the extent that the obligations of the schemes are not fully matched by assets with determinable cash flows. Pension scheme obligations fluctuate with changes in long-term interest rates, inflation, salary levels and the longevity of scheme members. Pension scheme assets include equities and debt securities, the cash flows of which change as equity prices and interest rates vary. There is a risk that market movements in equity prices and interest rates could result in asset values which, taken together with regular ongoing contributions, are insufficient over time to cover the level of projected obligations and these, in turn, could increase with a rise in inflation and members living longer. Management, together with the trustees who act on behalf of the pension scheme beneficiaries, assess these risks using reports prepared by independent external actuaries and takes action and, where appropriate, adjust investment strategies and contribution levels accordingly.

Operational risk management

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk. Operational risk is relevant to every aspect of the group's business and covers a wide spectrum of issues. Losses arising through fraud, unauthorised activities, errors, omission, inefficiency, systems failure or from external events all fall within the operational risk definition.

A formal governance structure provides oversight over the management of operational risk. An Operational Risk and Internal Control Committee, which reports to the Risk Management Committee, meets monthly to discuss key risk issues and review the effectiveness of the operational risk management framework.

Business managers are responsible for maintaining an acceptable level of internal control, commensurate with the scale and nature of operations. They are responsible for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The operational risk management framework helps managers to fulfil these responsibilities by defining a standard risk and control assessment methodology and loss reporting policy.

A centralised database is used to record the results of the operational risk management process. Operational risk and control assessments, and losses, are input and maintained by the business units. To ensure that operational risk losses are consistently reported and monitored at group level, all group companies are required to report individual losses when the net loss is expected to exceed US$10,000.

Legal risk

Each operating company is required to implement procedures to manage legal risk that conform to group standards. Legal risk falls within the definition of operational risk and includes contractual risk, dispute risk, legislative risk and non-contractual rights risk.

- Contractual risk is the risk that the rights and/or obligations of a group company within a contractual relationship are defective.
- Dispute risk is the risk that a group company is subject to when it is involved in or managing a potential or actual dispute.
- Legislative risk is the risk that a group company fails to adhere to the laws of the jurisdictions in which it operates.
- Non-contractual rights risk is the risk that a group company's assets are not properly owned or are infringed by others, or a group company infringes another party's rights.

The group has a legal function to assist management in controlling legal risk. The function provides legal advice and support in managing claims against group companies, as well as in respect of non-routine debt recoveries or other litigation against third parties.

Operating companies must notify the legal department immediately if any litigation is either threatened or commenced against the group or an employee. The legal department must be immediately advised (and must in turn immediately advise the HSBC Group Head Office legal department) of any action by a regulatory authority, where the proceedings are criminal, or where the claim might materially affect HSBC Group's reputation. Further, any claims which exceed US$1.5 million or equivalent must also be advised to the legal department and the legal department must immediately advise the

30 Risk management *(continued)*

HSBC Group Head Office if any such claim exceeds US$5 million. All such matters are then reported to the HSBC Group Risk Management Meeting of the HSBC Holdings plc Board in a monthly paper.

An exception report must be made to the local compliance function and escalated to the head of group compliance in respect of any breach which has given rise to a fine and/or costs levied by a court of law or regulatory body where the amount is US$1,500 or more, and material or significant issues are reported to RMM and/or the group Audit Committee.

In addition, operating companies are required to submit quarterly returns detailing outstanding claims where the claim (or group of similar claims) exceeds US$10 million, where the action is by a regulatory authority, where the proceedings are criminal, where the claim might materially affect the group's reputation, or, where the HSBC Group Head Office has requested returns be completed for a particular claim. These returns are used for reporting to the HSBC Group Audit Committee and the Board of HSBC Holdings.

Capital management

The Jersey Financial Services Commission (JFSC) supervises the bank on a solo basis and, as such, receives information on the capital adequacy of, and sets capital requirements for, the bank as a whole. Individual branches and subsidiaries are directly regulated by their local banking supervisors, who set and monitor their capital adequacy requirements.

Under the Banking Business (Jersey) Law 1991, the JFSC requires each bank to maintain a ratio of total capital to risk-weighted assets taking into account both balance sheet assets and off-balance sheet transactions.

The bank's capital is divided into two tiers:

- Tier 1 capital comprises shareholders' funds less deductions for the book values of intangible assets and 50% of the investment in subsidiaries, associates and capital of other banks at cost, and after adjusting for items reflected in shareholders' funds which are treated differently for the purposes of capital adequacy.
- Tier 2 capital comprises qualifying non-equity preference share capital, collective impairment allowances and reserves arising from the revaluation of properties less deductions for 50% of the investment in subsidiaries, associates and capital of other banks at cost.

Various limits are applied to elements of the capital base. Qualifying tier 2 capital cannot exceed tier 1 capital, and qualifying term non-equity preference share capital may not exceed 50% of tier 1 capital.

There are also limitations on the amount of collective impairment allowances which may be included as part of tier 2 capital. From the total of tier 1 and tier 2 capital are deducted the net asset value of investments in associates and the book value of investments in the capital of banks.

Risk-weighted assets are measured by means of a hierarchy of risk weightings classified according to the nature of each asset and counterparty, taking into account any eligible collateral or guarantees. 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.

During 2009 and up to 30 June 2010 the bank operated under both Basel I and Basel II standardised frameworks for the calculation and monitoring of capital adequacy ratios. From 1 July 2010 the bank operated under the Basel II standardised framework only. The bank complied with the JFSC capital adequacy requirements during that period.

Notes on the Financial Statements (continued)

30 Risk management *(continued)*

Capital structure at 31 December (solo basis)

	2010 Basel II US$000	2009 Basel II US$000
Composition of regulatory capital		
Tier 1 capital	**3,544,613**	3,013,441
Tier 2 capital	**1,532,204**	1,569,252
Total regulatory capital	**5,076,817**	4,582,693
Risk weighted assets		
Credit and counterparty risk	**28,368,467**	27,893,669
Market risk	**1,967,382**	1,637,232
Operational risk	**3,940,571**	3,720,795
	34,276,420	33,251,696
Capital ratios	**%**	%
Capital adequacy ratio	**14.81**	13.78

31 Contingent liabilities, contractual commitments and guarantees

	2010 US$000	2009 US$000
Guarantees and other contingent liabilities		
Guarantees and irrevocable letters of credit pledged as collateral security	**11,328,404**	10,548,006
	11,328,404	10,548,006
Commitments		
Documentary credits and short-term trade-related transactions	**1,313,334**	954,477
Undrawn formal standby facilities, credit lines and other commitments to lend:		
– one year and under	**14,479,542**	15,270,007
– over one year	**713,981**	627,614
	16,506,857	16,852,098

The table above discloses the nominal principal amounts of commitments, excluding capital commitments, which are separately disclosed below, guarantees and other contingent liabilities; mainly credit-related instruments which include both financial and non-financial guarantees and commitments to extend credit. Nominal principal amounts represent the amounts at risk should contracts be fully drawn upon and clients default. As a significant portion of guarantees and commitments is expected to expire without being drawn upon, the total of these nominal principal amounts is not representative of future liquidity requirements.

Included in the above are the following liabilities on account of other members of the HSBC Group:

	2010 US$000	2009 US$000
Guarantees and assets pledged by the bank as collateral security	**1,021,947**	876,808
Documentary credits and short-term trade-related transactions	**116,287**	150,307
	1,138,234	1,027,115

Guarantees

The group provides guarantees and similar undertakings on behalf of both third party customers and other entities within the group. These guarantees are generally provided in the normal course of the group's banking business. The principal types of guarantees provided, and the maximum potential amount of future payments which the group could be required to make at 31 December, were as follows:

31 Contingent liabilities, contractual commitments and guarantees *(continued)*

	At 31 December 2010		At 31 December 2009	
	Guarantees in favour of third parties US$000	**Guarantees by the group in favour of other HSBC Group entities US$000**	Guarantees in favour of third parties US$000	Guarantees by the group in favour of other HSBC Group entities US$000
Guarantee type				
Financial guarantee contracts[1]	**1,189,951**	**185,811**	853,594	135,502
Standby letters of credit which are financial guarantee contracts[2]	**293,447**	**–**	918,712	–
Other direct credit substitutes[3]	**972,989**	**–**	651,357	–
Performance bonds[4]	**4,844,930**	**571,955**	4,626,051	491,213
Bid bonds[4]	**579,598**	**45,739**	427,016	55,039
Other transaction-related guarantees[4]	**2,425,542**	**218,443**	2,194,468	195,054
Other items				
Total	**10,306,457**	**1,021,948**	9,671,198	876,808

1 *Financial guarantees contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss incurred because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. The amounts in the above table are nominal principal amounts. Intra-group financial guarantees include a guarantee of a capital nature issued by the group to a HSBC Group entity for inclusion as capital support by the latter's regulator.*

2 *Standby letters of credit which are financial guarantee contracts are irrevocable obligations on the part of the group and/or the bank to pay third parties when customers fail to make payments when due.*

3 *Other direct credit substitutes include reinsurance letters of credit and trade-related letters of credit issued without provision for the issuing entity to retain title to the underlying shipment.*

4 *Performance bonds, bid bonds, standby letters of credit and other transaction-related guarantees are undertakings by which the obligation on the group and/or the bank to make payment depends on the outcome of a future event.*

The amounts disclosed in the above table reflect the group's maximum exposure under a large number of individual guarantee undertakings. The risks and exposures arising from guarantees are captured and managed in accordance with the group's overall credit risk management policies and procedures. Guarantees with terms of more than one year are subject to the group's annual credit review process.

When the group gives a guarantee on behalf of a customer, it retains the right to recover from that customer amounts paid under the guarantee.

Provisions in respect of the group's obligations under outstanding guarantees

	2010 US$000	2009 US$000
Other items	**246**	3,725
	246	3,725

Other commitments

In addition to the commitments disclosed above, at 31 December 2010 the group had contractual commitments to purchase, within one year, land and buildings and other fixed assets from a number of suppliers for a value of US$1,423 thousand (2009: US$8 thousand).

Associates

The group and its operations are contingently liable with respect to lawsuits and other matters that arise in the normal course of business. Management is of the opinion that the eventual outcome of the legal and financial liability is not expected to materially affect the group's financial position and operations.

Notes on the Financial Statements (continued)

32 Lease commitments

Finance lease commitments

The group leases land and buildings (including branches) and equipment from third parties under finance lease arrangements to support its operations.

	2010			2009		
	Total future minimum payments US$000	**Future interest charges US$000**	**Present value of finance lease commitments US$000**	Total future minimum payments US$000	Future interest charges US$000	Present value of finance lease commitments US$000
No later than one year	**–**	**9,180**	**9,180**	–	–	–
Later than one year and no later than five years	**–**	**–**	**–**	–	9,180	9,180
	–	**9,180**	**9,180**	–	9,180	9,180

Operating lease commitments

At 31 December 2010, the group was obligated under a number of non-cancellable operating leases for properties, plant and equipment for which the future minimum lease payments extend over a number of years.

	Land and buildings	
	2010 US$000	2009 US$000
Future minimum lease payments under non-cancellable operating leases expiring:		
– no later than one year	**16,643**	14,072
– later than one year and no later than five years	**57,734**	46,408
– later than five years	**26,109**	24,141
	100,486	84,621

In 2010, US$22,401 thousand (2009: US$14,501 thousand) was charged to ‘General and administrative expenses’ in respect of lease agreements related to minimum lease payments.

Finance lease receivables

The group leases a variety of assets to third parties under finance leases. At the end of the lease terms, assets may be sold to third parties or leased for further terms. Lessees may participate in any sales proceeds achieved. Lease rentals arising during the lease terms will either be fixed in quantum or be varied to reflect changes in, for example, tax or interest rates. Rentals are calculated to recover the cost of assets less their residual value, and earn future income.

	2010			2009		
	Total future minimum payments US$000	**Future interest charges US$000**	**Present value of finance lease commitments US$000**	Total future minimum payments US$000	Future interest charges US$000	Present value of finance lease commitments US$000
No later than one year	**88,863**	**12,100**	**100,963**	46,189	–	46,189
Later than one year and no later than five years	**318,860**	**139,249**	**458,109**	345,702	–	345,702
Later than five years	**193,908**	**–**	**193,908**	–	–	–
	601,631	**151,349**	**752,980**	391,891	–	391,891

33 Litigation

The group, through a number of its branches, is named in and is defending legal actions in various jurisdictions arising from its normal business. No material adverse impact on the financial position of the group is expected to arise from these proceedings.

34 Related party transactions

The ultimate parent company of the group is HSBC Holdings plc, which is incorporated in England.

Copies of the HSBC Group financial statements may be obtained from the following address:

HSBC Holdings plc
8 Canada Square
London
E14 5HQ

The group's related parties include the parent, fellow subsidiaries, associates, joint ventures, post-employment benefit plans for HSBC employees, key management personnel, close family members of Key Management Personnel and entities which are controlled, jointly controlled or significantly influenced by Key Management Personnel or their close family members.

Key Management Personnel are defined as those persons having authority and responsibility for planning, directing and controlling the activities of the group and includes members of the Board of Directors of HSBC Bank Middle East Limited.

Transactions, arrangements and agreements including Directors and other Key Management Personnel

The table below set out transactions which fall to be disclosed under IAS 24 'Related Party Disclosures' between the group and the Key Management Personnel of both the bank and its parent company, HSBC Holdings plc, and their connected persons or controlled companies.

	2010		2009	
	Highest balance during the year[1]	**Balance at 31 December[1]**	Highest balance during the year[1]	Balance at 31 December[1]
	£000	**£000**	£000	£000
Key Management Personnel and connected persons and companies controlled by them				
Loans	**3,872**	**3,463**	1,471	410
Credit cards	**84**	**84**	45	9
Guarantees	**3**	**–**	–	–

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

The above transactions were made in the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with persons of a similar standing or, where applicable, with other employees. The transactions did not involve more than the normal risk of repayment or present other unfavourable features.

Notes on the Financial Statements (continued)

34 Related party transactions *(continued)*

Transactions with other related parties

Associates

	2010		2009	
	Highest balance during the year[1]	**Balance at 31 December[1]**	Highest balance during the year[1]	Balance at 31 December[1]
	US$000	**US$000**	US$000	US$000
Amounts due from associates	**127,254**	**456**	16,152	15,709
Amounts due to associates	**32,102**	**31,434**	23,649	22,081

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Transactions of the group with HSBC Holdings plc and fellow subsidiaries of HSBC Holdings plc

Transactions detailed below include amounts due to/from HSBC Holdings plc

	2010		2009	
	Highest balance during the year[1]	**Balance at 31 December[1]**	Highest balance during the year[1]	Balance at 31 December[1]
	US$000	**US$000**	US$000	US$000
Assets				
Loans and advances to customers	**88**	**71**	3	3
Liabilities				
Customer accounts	**21,625**	**10,396**	23,261	9,465
Subordinated amounts due	**300,000**	**300,000**	300,000	300,000

	For the year ended 31 December 2010	For the year ended 31 December 2009
	US$000	US$000
Income Statement		
Interest expense	**20,100**	20,100
Other operating income	**195**	–
General and administrative expenses	**27,173**	26,787

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

34 Related party transactions *(continued)*

Transactions detailed below include amounts due to/from fellow subsidiaries of HSBC Holdings plc

	2010		2009	
	Highest balance during the year[1]	**Balance at the year end[1]**	Highest balance during the year[1]	Balance at the year end[1]
	US$000	**US$000**	US$000	US$000
Assets				
Derivatives	**331,498**	**314,157**	284,295	191,853
Loans and advances to banks	**1,127,495**	**1,127,495**	1,515,792	1,342,479
Liabilities				
Deposits by banks	**476,900**	**250,722**	858,592	283,357
Derivatives	**797,623**	**739,427**	750,693	556,924
Subordinated amounts due	**1,050,000**	**1,050,000**	1,050,000	1,050,000
Guarantees	**215,621**	**185,811**	182,397	135,502

	For the year ended 31 December 2010	For the year ended 31 December 2009
	US$000	US$000
Income Statement		
Interest income	**1,255**	1,463
Interest expense	**37,527**	34,189
Fee income	**63,348**	49,803
Fee expense	**20,982**	16,742
Other operating income	**26,958**	13,354
General and administrative expenses	**125,469**	128,126

1 *The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.*

The above outstanding balances arose from the ordinary course of business and on substantially the same terms, including interest rates and security, as for comparable transactions with third party counterparties.

Transactions between HSBC Bank Middle East Limited and its subsidiaries

Transactions detailed below include amounts due to/from HSBC Bank Middle East Limited and its subsidiaries

	2010		2009	
	Highest balance during the year[1]	**Balance at the year end[1]**	Highest balance during the year[1]	Balance at the year end[1]
	US$000	**US$000**	US$000	US$000
Assets				
Loans and advances to customers	**560,252**	**425,671**	773,779	560,252
Liabilities				
Customer accounts	**125,426**	**125,426**	112,844	73,254

1 The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent transactions during the year.

34 Events after the balance sheet date

These accounts were approved by the Board of Directors on 16 February 2011 and authorised for issue.

HSBC Bank Middle East Limited and other Group Offices in the Region

HSBC Bank Middle East Limited

Head Office
HSBC House, Esplanade,
St. Helier, Jersey JE4 8UB,
Channel Islands
Tel: (44–1534) 606512
Fax: (44–1534) 606149

Middle East Management Office
HSBC Building,
Emaar Square
P O Box 66
Dubai
United Arab Emirates
Tel: (971–4) 4235168
Fax: (971–4) 4267397

ALGERIA
El Mohammadia branch
Hydra branch

BAHRAIN
Seef – Main Branch
Adliya
Manama – Batelco Building
Sanad
2 Customer Service Units

JORDAN
Amman (Western Amman Main Branch)
Amman (Jebel Hussein Branch)
Amman (Abdoun Branch)
Amman (Khalda Branch)
Amman (Madinah Munawarah Branch)
Amman (Swefieh Branch)

KUWAIT
Kuwait City - Qibla Area

LEBANON
Beirut – St. Georges Bay
Beirut – Ras–Beirut Branch Rbeiz Building
Beirut – Verdun – Farid Trad St
Beirut – Ashrafieh Branch
Greater Beirut – Dora Branch
Zouk – La Vega Center

LIBYA
Tripoli Representative Office

OMAN
Bait Al Falaj – HSBC Building
Muscat City Centre
Qurum – Roundabout
Salalah – Al Salam St
Sohar – Al Tareef St
3 Customer Service Units

PAKISTAN
Faisalabad– Jail Road
Islamabad– F–6 Markaz
Islamabad– F–11
Karachi– Shaheen Commercial Complex
Karachi–Clifton
Karachi–Defence
Karachi–Citi Tower
Lahore–Gulberg
Lahore–Model Town
Rawalpindi–Bank Road Saddar
Sialkot—Qayyum Trade Centre

PALESTINIAN AUTONOMOUS AREA
Ramallah – Jafa St

QATAR
Doha – Al Sadd Area
Doha – Umm Ghuwailina (Main Branch and Head Office)
Doha – Mesaieed
Doha – West Bay
Doha – Salwa Road

UNITED ARAB EMIRATES
Abu Dhabi – HSBC Bank ME ltd
Al Ain – Sheikh Khalifa St
Dubai – Deira Al Muraqqabat
Dubai – Bur Dubai
Jebel Ali – Free Trade Zone
Fujairah – Hamad Bin Abdulla St
Ras Al Khaimah – Corniche Rd
Sharjah – King Faisal Road
12 Customer Service Units and 4 Management Offices

PRINCIPAL SUBSIDIARY COMPANIES

HSBC Financial Services (Middle East) Limited
Dubai

HSBC Middle East Securities LLC
Dubai

HSBC Middle East Finance Company Limited
Abu Dhabi – Al Salam St
Al Ain – Sanayya
Dubai – Sheikh Zayed Road
Ras Al Khaimah – HSBC Building – Corniche Rd

ASSOCIATED COMPANIES

Arabian Real Estate Investment Trust Management Limited
Cayman Islands

Rewards Management Middle East Free Zone Limited Liability Company
Dubai

MENA Infrastructure Fund (GP) Limited
Dubai

MENA Holdings Limited
Cayman Islands

HSBC Middle East Leasing Partnership
Dubai

SPECIAL CONNECTIONS WITH THESE MEMBERS OF THE HSBC GROUP

Dar Es Salaam Investment Bank
Iraq, Baghdad Head Office and 14 branches

HSBC Bank Egypt S.A.E.
Cairo, Head Office, 87 other branches and 13 Units serving specialised companies

HSBC Bank International Limited

HSBC Insurance Brokers Limited

HSBC Securities (Egypt) S.A.E.

HSBC Saudi Arabia Limited

The Hongkong and Shanghai Banking Corporation Limited
Seef, Bahrain – Wholesale (Offshore)

The Saudi British Bank
Riyadh Head Office, 81 branches and 30 exclusive ladies' sections

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