HSBC Bank Middle East Limited

2005

Annual Report and Accounts

The world's local bank

HSBC

Annual Report and Accounts 2005

Contents

Presentation of Information

This document comprises the Annual Report and Accounts 2005 for HSBC Bank Middle East Limited and its subsidiary undertakings (together the 'group'). It contains the Directors' Report and Accounts, together with the Auditors' report, as required by the Companies (Jersey) Law 1991.

Notice of the Annual General Meeting

Notice is hereby given that the One-Hundred-and-Sixteenth Annual General Meeting of HSBC Bank Middle East Limited will be held at HSBC House, Esplanade, St Helier, Jersey, Channel Islands on Wednesday 12 April 2006 at 9.00 a.m. to transact the following ordinary business:

1 to receive and consider the Annual Accounts and the Reports of the Directors and of the Auditors for the year ended 31 December 2005;

2 to appoint Auditors and to fix their remuneration.

By Order of the Board
M J Seguss, *Secretary*
Jersey,

27 February 2006

Notes:

1 *By virtue of Article 13.6 of the Articles of Association, on a poll, votes may be given either personally, or by proxy.*
2 *By virtue of Article 13.8 of the Articles of Association, any instrument appointing a proxy shall be deposited at the Head Office of HSBC Bank Middle East Limited, or at such other place specified for that purpose in the notice of the meeting or an instrument of proxy issued by HSBC Bank Middle East Limited, before the time appointed for holding the meeting.*
3 *By virtue of Article 13.7 of the Articles of Association, any instrument appointing a proxy may be in any usual form, or as approved by the Directors.*
4 *By virtue of Article 14 of the Articles of Association, any corporation that is a Member of HSBC Bank Middle East Limited may, by Resolution of its Directors or other governing body, authorise such person as it thinks fit to act as its representative at any meeting of HSBC Bank Middle East Limited.*

Report of the Directors

Board of Directors

S K Green , *Chairman*

D H Hodgkinson, *Deputy Chairman*

E P Carton

J E Coverdale

Abdel Salam El Anwar

M M Hussain

C J M Keirle

I A Khan

C M Meares

R F Stock

J C Tibbo

The present Directors of HSBC Bank Middle East Limited are listed above.

During the year, I A Khan was appointed a Director with effect from 21 January 2005, C M Meares was appointed as a Director with effect from 10 May 2005, and J E Coverdale was appointed a Director with effect from 22 November 2005.

Also during the year, G P S Calvert resigned as a Director with effect from 22 November 2005.

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.

Profit and dividends

The profit attributable to the shareholders amounted to US$382,333,000, and has been dealt with as set out in the Consolidated Income Statement on page 6. No dividends were declared by the Directors during 2005, and the Directors recommend that no dividend be paid.

Share capital and debt securities

On 5 May 2005, HSBC Bank Middle East Limited issued, under the Debt Issuance Programme established in 2004 and providing for the issue of up to US$1,000,000,000 in debt securities in the form of medium-term Notes, a second tranche of US$700,000,000 Floating Rate Notes due 5 May 2010.

On 19 December 2005, the Directors allotted to HSBC Bank Middle East Limited's sole shareholder 100,000 cumulative redeemable preference shares of US$1.00 each at par and at a premium of US$999.00 per share, bearing a mandatory earliest redemption date of 19 December 2015 (deferrable at the request of the ordinary shareholders of HSBC Bank Middle East Limited to 10-yearly intervals thereafter), but redeemable at the option of HSBC Bank Middle East Limited on any date after 19 December 2010.

On 26 January 2006, the Directors allotted to HSBC Bank Middle East Limited's sole shareholder 100,000,000 ordinary shares of US$1.00 each at par.

Annual General Meeting

The 2006 Annual General Meeting of the Bank will be held on Wednesday 12 April 2006, in accordance with the Notice on page 2.

Report of the Directors (continued)

Auditors

The auditors, KPMG Channel Islands Limited, offer themselves for re-appointment, at fees to be agreed, and a resolution for their re-appointment will be proposed at the forthcoming Annual General Meeting.

On behalf of the Board
M J Seguss, *Secretary*
Jersey,

27 February 2006

Statement of Directors' Responsibilities 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.

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 company and of the profit or loss 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 applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company 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 company and enable them to ensure that the financial statements comply with the Companies (Jersey) Law 1991, the Banking Business (Jersey) Law 1991 and the Financial Services (Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2001. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Stephen Green, *Chairman*

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

We have audited the financial statements of HSBC Bank Middle East Limited for the year ended 31 December 2005 which comprise of the Consolidated Income Statement, the Consolidated Balance Sheet, the Consolidated Cash Flow Statement, the Consolidated Statement of Recognised Income and Expense and the related notes. These financial statements have been prepared under the accounting policies set out therein.

This report is made solely to the company's member, as a body, in accordance with Article 110 of the Companies (Jersey) Law 1991. Our audit work has been undertaken so that we might state to the company's members 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 company and the company'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 described in the Statement of Directors' Responsibilities on page 5, the company's Directors are responsible for preparation of the financial statements in accordance with applicable law and International Financial Reporting Standards.

Our responsibility is to audit the financial statements in accordance with the relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

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 and the Financial Services (Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2001. We also report to you if, in our opinion, the company has not kept proper accounting records or if we have not received all the information and explanations we require for our audit.

We read the Directors' Report accompanying the financial statements and consider the implications for our report if we become aware of any apparent misstatements within it.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

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

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

Opinion

In our opinion the financial statements:

— give a true and fair view, in accordance with International Financial Reporting Standards, of the state of the company's affairs as at 31 December 2005 and of its profit for the year then ended; and

— have been properly prepared in accordance with the Companies (Jersey) Law 1991, the Banking Business (Jersey) Law 1991 and the Financial Services (Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2001.

KPMG Channel Islands Limited
Chartered Accountants

5 St Andrew's Place
St Helier
Jersey

11 April 2006

Consolidated Income Statement for the Year Ended 31 December 2005

	Note	**2005 US$000**	2004 US$000
Interest income		**807,553**	484,894
Interest expense		**(288,523)**	(102,765)
Net interest income		**519,030**	382,129
Fee income		**237,074**	174,410
Fee expense		**(16,623)**	(13,162)
Net fee income		**220,451**	161,248
Trading income		**81,608**	55,206
Gains less losses from financial investments		**1,975**	1,281
Dividend income		**497**	15
Other operating income		**9,997**	5,573
Net operating income before loan impairment charges and other credit risk provisions		**833,558**	605,452
Loan impairment charges and other credit risk provisions		**(28,676)**	(40,223)
Net operating income		**804,882**	565,229
Employee compensation and benefits	*4*	**(210,813)**	(165,121)
General and administrative expenses	*5*	**(133,793)**	(100,798)
Depreciation of property, plant and equipment		**(10,445)**	(9,831)
Amortisation of intangible assets		**(687)**	(563)
Total operating expenses		**(355,738)**	(276,313)
Operating profit		**449,144**	288,916
Share of profits in associates		**26,916**	8,431
Profit before tax	*30*	**476,060**	297,347
Tax expense	*7*	**(91,765)**	(54,720)
Profit for the year		**384,295**	242,627
Attributable to shareholders		**382,333**	240,475
Attributable to minority interests		**1,962**	2,152

Consolidated Balance Sheet at 31 December 2005

	Notes	**2005**	2004
ASSETS		**US$000**	US$000
Cash and balances at central banks		**260,817**	246,455
Items in the course of collection from other banks		**132,752**	123,631
Trading assets	*11*	**202,963**	192,611
Derivatives	*12*	**146,569**	75,748
Loans and advances to banks	*13*	**4,845,167**	2,073,071
Loans and advances to customers	*14*	**11,372,418**	8,463,372
Financial investments	*15*	**992,540**	1,164,554
Interests in associates and joint ventures	*16*	**139,385**	132,124
Intangible assets	*17*	**1,319**	1,766
Property, plant and equipment	*18*	**78,014**	74,866
Other assets	*20*	**641,676**	71,922
Prepayments and accrued income		**97,882**	47,316
Total assets		**18,911,502**	12,667,436
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	*21*	**758,287**	1,709,781
Customer accounts	*22*	**14,174,426**	8,996,885
Items in the course of transmission to other banks		**89,493**	66,016
Derivatives	*12*	**136,486**	67,329
Debt securities in issue	*23*	**1,564,328**	698,364
Retirement benefits liabilities		**34,475**	29,623
Other liabilities	*24*	**821,181**	163,859
Accruals and deferred income		**70,824**	57,377
Provisions for liabilities and charges	*25*		
— deferred tax		**2,647**	2,688
— other provisions		**5,023**	5,707
Total liabilities		**17,657,170**	11,797,629
Equity			
Called up share capital	*28*	**331,055**	331,055
Other reserves	*29*	**15,538**	—
Retained earnings	*29*	**903,662**	534,513
Total shareholders' equity		**1,250,255**	865,568
Minority interests	*29*	**4,077**	4,239
Total equity		**1,254,332**	869,807
Total equity and liabilities		**18,911,502**	12,667,436

Stephen Green, *Chairman*

The accompanying notes are an integral part of the Consolidated Financial Statements.

Consolidated Statement of Recognised Income and Expense for the Year Ended 31 December 2005

	2005	2004
	US$000	US$000
Available-for-sale investments:		
— valuation gains taken to equity	**7,095**	—
Exchange differences arising on monetary items that form part of a net investment in a foreign operation	**94**	
Actuarial gains on post-employment benefits	**817**	—
	8,006	—
Profit for the year	**384,295**	242,627
Total recognised income for the year	**392,301**	242,627
Attributable to shareholders	**390,339**	240,475
Attributable to minority interests	**1,962**	2,152

Consolidated Cash Flow Statement for the Year Ended 31 December 2005

	Notes	**2005 US$000**	2004 US$000
Cash flows from operating activities			
Profit before tax		**476,060**	297,347
Adjustments for:			
— non-cash items included in net profit	*30*	**15,992**	11,565
— change in operating assets	*30*	**(3,589,116)**	(2,497,377)
— change in operating liabilities	*30*	**5,854,926**	2,007,484
— net gain from investing activities		**(12)**	(37)
— share of profits in associates		**(26,916)**	(8,431)
— dividends received from associates		**7,449**	6,747
— tax paid		**(56,869)**	(44,162)
Net cash from operating activities		**2,681,514**	(226,864)
Cash flows (used in)/from investing activities			
Purchase of financial investments		**(4,825,294)**	(3,141,351)
Proceeds from the sale of financial investments		**4,790,893**	2,878,467
Purchase of property, plant and equipment		**(14,014)**	(8,051)
Proceeds from the sale of property, plant and equipment		**261**	1,008
Purchase of intangible assets		**(215)**	(1,478)
Net cash outflow from acquisition of and increase in stake of associates		**(400)**	—
Net cash (used in)/from investing activities		**(48,769)**	(271,405)
Cash flows (used in)/from financing activities			
Subordinated loan capital issued		**100,000**	100,000
Dividends paid to shareholders		**—**	(35,000)
Dividends paid to minority interests			
— equity		**(2,124)**	(2,450)
Net cash (used in)/from financing activities		**97,876**	62,550
Net increase in cash and cash equivalents		**2,730,621**	(435,719)
Cash and cash equivalents at 1 January		**2,229,486**	2,519,389
Effect of IFRS transition on cash and cash equivalents		**(459,078)**	145,816
Cash and cash equivalents at 31 December	*30*	**4,501,029**	2,229,486

Notes on the Financial Statements

1 Basis of preparation

(a) For all periods up to and including the year ended 31 December 2004, HSBC Bank Middle East Limited prepared its consolidated financial statements in accordance with UK Generally Accepted Accounting Principles ('UK GAAP'). From 1 January 2005, HSBC Bank Middle East Limited has prepared its consolidated financial statements in accordance with International Financial Reporting Standards ('IFRSs') as endorsed by the EU and effective for HSBC Bank Middle East Limited's reporting for the year ended 31 December 2005. IFRSs comprise accounting standards issued by the International Accounting Standards Board ('IASB') and its predecessor body as well as interpretations issued by the International Financial Reporting Interpretations Committee ('IFRIC') and its predecessor body.

The Bank has adopted IFRS7 with effect from 1 January 2005, ahead of its effective date. As permitted for entities which apply this standard before 1 January 2006 the Bank has elected not to present comparative information for dislcosures required under this standard.

In preparing these consolidated financial statements, HSBC Bank Middle East Limited has elected to take advantage of certain transitional provisions within IFRS 1 'First-time Adoption of International Financial Reporting Standards' which offer exemption from presenting comparative information or applying IFRSs retrospectively. The most significant of these provisions is the exemption from presenting comparative information in accordance with IAS 32 'Financial Instruments: Disclosure and Presentation' ('IAS 32') and IAS 39 'Financial Instruments: Recognition and Measurement' ('IAS 39'). Comparative information for financial instruments has been prepared on the basis of HSBC Bank Middle East Limited's previous accounting policies. The accounting policies applied to financial instruments for 2004 and 2005 are disclosed separately below.

Transition to IFRSs

In addition to exempting companies from the requirement to restate comparatives for IAS 32 and IAS 39, IFRS 1 grants certain exemptions from the full requirements of IFRSs to companies adopting IFRSs for the first time in the transition period.

HSBC Bank Middle East Limited has elected to take the following exemptions affecting comparative financial data:

(i) *Business combinations*

HSBC Bank Middle East Limited has elected not to restate business combinations that took place prior to the 1 January 2004 transition date.

(ii) *Fair value or revaluation as deemed cost*

A first-time adopter may elect to measure individual items of property at fair value at the date of transition to IFRSs and use that fair value as deemed cost at that date. HSBC Bank Middle East Limited has made this election.

(iii) *Cumulative translation differences*

HSBC Bank Middle East Limited has set the cumulative translation differences for all foreign operations to zero at 1 January 2004.

HSBC Bank Middle East Limited has adopted the 'Amendment to IAS 39 Financial Instruments: Recognition and Measurement: The Fair Value Option' (the 'Amendment') with effect from 1 January 2005, ahead of its effective date (see Note 2(h)).

HSBC Bank Middle East Limited has also adopted the 'Amendment to IAS 19 Employee Benefits: Actuarial Gains and Losses, Group Plans and Disclosures' (Note 2(t)) and IFRIC 4 'Determining whether an Arrangement contains a Lease' (Note 2(r)), ahead of their required effective dates.

The balance sheets and income statements in this document are presented in accordance with IAS 1 'Presentation of Financial Statements'.

(b) The consolidated financial statements of HSBC Bank Middle East Limited comprise the financial statements of HSBC Bank Middle East Limited and its subsidiaries (together 'the group'). Entities that are controlled by HSBC Bank Middle East Limited are consolidated. Newly acquired subsidiaries are consolidated from the date control is transferred to HSBC Bank Middle East Limited until the date that control ceases.

The purchase method of accounting is used to account for the acquisition of subsidiaries by HSBC Bank Middle East Limited. The cost of an acquisition is measured at the fair value of the consideration at the date of exchange, together with costs directly attributable to that acquisition. The acquired identifiable assets, liabilities and contingent liabilities are measured at their fair values at the date of acquisition. The excess of the cost of acquisition over the fair value of HSBC Bank Middle East Limited's share of the identifiable assets, liabilities and contingent liabilities acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of HSBC Bank Middle East Limited's share of the identifiable assets, liabilities and contingent liabilities of the subsidiary acquired, the difference is recognised immediately in the income statement.

All intra-HSBC Bank Middle East Limited transactions are eliminated on consolidation.

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

(c) The preparation of financial information requires the use of estimates and assumptions about future conditions. Use of available information and application of judgement are inherent in the formation of estimates. Actual results in the future may differ from those reported. In this regard, management believes that the critical accounting policies where judgement is necessarily applied are those which relate to loan impairment, goodwill impairment and the valuation of financial instruments.

In the opinion of management, all normal and recurring adjustments considered necessary for a fair presentation of the group's net income, financial position and cash flows for the year have been made.

2 Principal accounting policies

(a) Interest income and expense

From 1 January 2005

Interest income and expense for all interest-bearing financial instruments except those classified as held-for-trading or designated at fair value are recognised in 'Interest income' and 'Interest expense' in the income statement using the effective interest rates of the financial assets or financial liabilities to which they relate.

The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments earned or paid on a financial asset or financial liability through its expected life or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, HSBC Bank Middle East Limited 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 HSBC Bank Middle East Limited that are an integral part of the effective interest rate, including transaction costs and all other premiums or discounts.

Interest on impaired financial assets is calculated by applying the original effective interest rate of the financial asset to the carrying amount as reduced by any allowance for impairment.

From 1 January 2004 to 31 December 2004

Interest income was recognised in the income statement as it accrued, except in the case of impaired loans and advances (see Note 2 (f)).

(b) Non interest income

(i) *Fee income*

From 1 January 2005

The group earns fee income from a diverse range of services it provides to its customers. Fee income is accounted for as follows:

— income earned on the execution of a discrete 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 the 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, loan commitment fees) and recorded in 'Interest income' (Note 2(a)).

From 1 January 2004 to 31 December 2004

Fee income was accounted for as follows:

— income earned on the execution of a discrete act was recognised as revenue when the act had been completed (for example, commission and fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement for the acquisition of shares or other securities);

— income earned from the provision of services was recognised as revenue as the services were provided (for example, asset management, portfolio and other management advisory and service fees)

— income which was interest in nature was recognised on an appropriate basis over the relevant period and recorded in 'Interest income' (Note 2(a)).

(ii) *Dividend income*

Dividend income is recognised when the right to receive payment is established. This is the ex-dividend date for equity securities.

(iii) *Net income from financial instruments designated at fair value*

From 1 January 2005

Net income from financial instruments designated at fair value comprises all gains and losses from changes in the fair value of financial assets and financial liabilities designated at fair value, together with interest income and expense and dividend income arising on those financial instruments.

(iv) *Trading income*

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.

(c) Segment reporting

The group's main operations are in the UAE, although it also has operations elsewhere in the Middle East, and manages its business through four customer groups: Personal Financial Services; Commercial Banking; Corporate Investment Banking and Markets; and Private Banking. Segment income and expenses include transfers between geographical regions and transfers between customer group segments. These transfers are conducted at arm's length.

(d) Cash and cash equivalents

For the purpose of the cash flow statement, 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, and certificates of deposit.

(e) Loans and advances to banks and customers

From 1 January 2005

Loans and advances to banks and customers include loans and advances originated by the group, which are not intended to be sold in the short term and have not been classified either as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to borrowers. 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.

From 1 January 2004 to 31 December 2004

Loans and advances to banks and customers included loans and advances originated by the group, which were not intended to be sold in the short term and had not been classified as held for trading. Loans and advances were recognised when cash was advanced to borrowers. They were measured at amortised cost less provisions for doubtful loans and advances.

Notes on the Financial Statements (continued)

2 Principal accounting policies *(continued)*

(f) Loan impairment

From 1 January 2005

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 loans assessed collectively. Losses expected from future events, no matter how likely, are not recognised.

(i) *Individually assessed loans*

At each balance sheet date, the group assesses on a case-by-case basis whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining impairment losses on these loans, the following factors are considered:

— the group's aggregate exposure to the customer;

— the viability of the customer's business model and 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 local currency; and

— where available, the secondary market price for the debt.

Impairment loss is 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 value. Any loss is charged in the income statement. The carrying amount of impaired loans on the balance sheet is reduced through the use of an allowance account.

(ii) *Collectively assessed loans*

Impairment is determined on a collective basis in two different scenarios:

— for loans subject to individual assessment (section (i)), to cover losses which have been incurred but have not yet been identified; 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 identified are grouped together according to their credit risk characteristics for the purpose of calculating an estimated collective loss. This arises from individual loan impairment at the balance sheet date which will only be identified in the future.

The collective impairment loss is determined after taking into account:

— historical loss experience in portfolios of similar 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 judgement as to 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.

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

Homogeneous groups of loans

For homogeneous groups of loans that are not considered individually significant, two alternative methods are used to calculate allowances on a portfolio basis.

— When appropriate empirical information is available, the group utilises roll rate methodology. This methodology employs a statistical analysis of historical trends of the probability of default and the amount of consequential loss, assessed at each time period for which the customer's contractual payments are overdue. 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 value of the portfolio. Other historical data and current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. In certain highly developed markets, sophisticated models also take into account behavioural and account management trends as revealed in, for example, bankruptcy and rescheduling statistics.

— In other cases, when the portfolio size is small or when information is insufficient or not sufficiently reliable to adopt a roll rate methodology, the group adopts a formulaic approach which allocates progressively higher loss rates in line with the period of time for which a customer's loan is overdue. Loss rates are based on the discounted expected future cash flows from a portfolio.

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

(iii) *Loan write-offs*

Loans (and the related impairment allowance accounts) are normally written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralised loans, when the proceeds from the realisation of security have been received.

(iv) *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.

(v) *Assets acquired in exchange for loans*

Non-financial assets acquired in exchange for loans in order to achieve 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 provided in respect of assets held for sale. Any subsequent write-down of the acquired asset to fair value less costs to sell is recorded as an impairment loss and included in the income statement. Any subsequent increase in the fair value less costs to sell,

2 Principal accounting policies *(continued)*

to the extent this does not exceed the cumulative impairment loss, is recognised in the income statement.

(vi) *Renegotiated loans*

Loans that have been individually identified as impaired and whose terms have been subsequently renegotiated are no longer considered to be impaired but are treated as new loans. All unamortised fees and costs are taken to the income statement with immediate effect.

From 1 January 2004 to 31 December 2004

It was the group's policy that each operating company would make provisions for impaired loans and advances when objective evidence of impairment existed and on a consistent basis, in accordance with the established group guidelines.

There were two basic types of provision, specific and general, each of which was considered in terms of the charge and the amount outstanding.

Specific provisions

Specific provisions represented the quantification of actual and inherent losses from homogeneous portfolios of assets and individually identified accounts. Specific provisions were deducted from loans and advances in the balance sheet. The majority of specific provisions were determined on a portfolio basis.

Portfolios

Where homogeneous groups of assets were reviewed on a portfolio basis, two alternative methods were used to calculate specific provisions:

— When appropriate empirical evidence was available, the group utilised roll rate methodology (a statistical analysis of historical trends of the probability of default and amount of consequential loss, assessed at the end of each time period for which payments were overdue), other historical data and an evaluation of current economic conditions to calculate an appropriate level of specific provision based on inherent loss. Additionally, in certain highly developed markets, sophisticated models taking into account behavioural and account management trends such as bankruptcy and rescheduling statistics were used. Roll rates were regularly benchmarked against actual outcomes to ensure they remained appropriate.

— In other cases, when information was insufficient or not sufficiently reliable to adopt a roll rate methodology, the group adopted a formulaic approach which allocated progressively higher loss rates in line with the period of time for which a customer's loan was overdue.

Individually assessed accounts

Specific provisions on individually assessed accounts were determined by an evaluation of the exposures on a case-by-case basis. This procedure was applied to all accounts that did not qualify for, or were not subject to a portfolio-based approach. In determining such provisions on individually assessed accounts, the following factors were considered:

— the group's aggregate exposure to the customer (including contingent liabilities);

— 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 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;

2 Principal accounting policies *(continued)*

— the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties were evident;

— the amount and timing of expected receipts and recoveries;

— the realisable value of security (or other credit mitigants) and likelihood of successful repossession;

— the 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 in local currency; and

— when available, the secondary market price of the debt.

Releases on individually calculated specific provisions were recognised whenever the group had reasonable evidence that the established estimate of loss had reduced.

Cross-border exposures

Specific provisions were established in respect of cross-border exposures to countries assessed by management to be vulnerable to foreign currency payment restrictions. This assessment included analysis of both economic and political factors.

Provisions were applied to all qualifying exposures within these countries unless these exposures:

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

— were mitigated by acceptable security cover which was, other than in exceptional cases, held outside the country concerned; or

— were represented by securities held for trading purposes for which a liquid and active market existed, and which were marked to market daily.

General provisions

General provisions augmented specific provisions and provided cover for loans that were impaired at the balance sheet date but which would not be individually identified as such until some time in the future. The group required operating companies to maintain a general provision, which was determined after taking into account:

— historical loss experience in portfolios of similar 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 a specific provision against that loss; and

— management's judgement as to whether the then economic and credit conditions were such that the actual level of inherent loss was likely to be greater or less than that suggested by historical experience.

The estimated period between a loss occurring and its identification (as evidenced by the establishment of a specific provision for that loss) was determined by local management for each identified portfolio.

Loans on which interest was being suspended and non-accrual loans

Loans were designated as non-performing as soon as management had doubts as to the ultimate collectibility of principal or interest or when contractual payments of principal or interest were 90 days overdue. When a loan was designated as non-performing, interest was not normally credited to the income statement and either interest accruals ceased ('non-accrual loans') or interest was credited to an interest suspense account in the

2 Principal accounting policies *(continued)*

balance sheet which was netted against the relevant loan ('suspended interest').

Within portfolios of low value, high volume, homogeneous loans, interest was normally suspended on facilities 90 days or more overdue. In certain operating subsidiaries, interest income on credit cards may have continued to be included in earnings after the account was 90 days overdue, provided that a suitable provision was raised against the portion of accrued interest which was considered to be irrecoverable.

The designation of a loan as non-performing and the suspension of interest could be deferred for up to 12 months in either of the following situations:

— cash collateral was held covering the total of principal and interest due and the right of set-off was legally sound; or

— the value of any net realisable tangible security was considered more than sufficient to cover the full repayment of all principal and interest due, and credit approval had been given to the rolling-up or capitalisation of interest payments.

Interest on non-performing loans was charged to the customer's account provided that there was a realistic prospect of interest being paid at some future date. However, the interest was not credited to the income statement but to an interest suspense account in the balance sheet, which was netted against the relevant loan.

When the probability of receiving interest payments was remote, interest was no longer accrued and any suspended interest balance was written off.

On receipt of cash (other than from the realisation of security), the overall risk was re-evaluated and, if appropriate, suspended or non-accrual interest was recovered and taken to the income statement. A specific provision of the same amount as the interest receipt was then raised against the principal balance. Amounts received from the realisation of security were applied to the repayment of outstanding indebtedness, with any surplus used to recover any specific provisions and then suspended interest.

Loans were not reclassified as accruing until interest and principal payments were up-to-date and future payments were reasonably assured.

Loan write-offs

Loans (and the related provisions) were normally written off, either partially or in full, when there was no realistic prospect of recovery of these amounts and when the proceeds from the realisation of security had been received.

(g) Trading assets and trading liabilities

From 1 January 2005

Treasury bills, debt securities, equity shares 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 initially at fair value using trade date accounting, with transaction costs taken to the income statement. Subsequently, their fair values are remeasured, and all gains and losses from changes therein, together with related interest income, interest expense and dividends, are recognised in the income statement in 'Trading income' as they arise.

From 1 January 2004 to 31 December 2004

Treasury bills, debt securities, equity shares and short positions in securities were included in 'Trading assets' or 'Trading liabilities' in the balance sheet at market value. Changes in the market value of these assets and liabilities were recognised in the income statement as 'Trading income' as they arose. For liquid portfolios, market values were determined by reference to independently sourced mid-market prices. In certain less liquid

2 Principal accounting policies *(continued)*

portfolios, securities were valued by reference to bid or offer prices as appropriate. When independent prices were not available, market values were estimated by discounting the expected future cash flows using a suitable interest rate adjusted for the counterparty's credit risk. Interest income, interest expense and dividends arising from trading assets and liabilities were aggregated in the income statement with similar amounts arising from other activities, as they arose separately from 'Trading income'.

(h) Financial instruments designated at fair value

From 1 January 2005

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:

— eliminates or significantly reduces valuation or recognition inconsistencies that would otherwise arise from measuring financial assets or financial liabilities, or recognising gains and losses on them, on different bases. Under this criterion, the group has designated unit-linked investment contracts, financial assets held to back certain insurance contracts, and certain portfolios of securities and debt issues that are managed in conjunction with financial assets or liabilities measured on a fair value basis; or

— 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. Under this criterion, the group has designated financial assets held to back certain insurance contracts, and certain asset-backed securities; or

— 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. Financial assets and financial liabilities so designated are recognised initially at fair value using trade date accounting, with transaction costs taken directly to the income statement. Subsequently, the fair values are remeasured, with gains and losses from changes therein recognised in the income statement as they arise, together with related interest income, interest expense and dividends, in 'Net income from financial instruments designated at fair value'.

Gains and losses arising from changes in the fair value of derivatives that are managed in conjunction with designated financial assets or financial liabilities are also included in 'Net income from financial instruments designated at fair value'.

(i) Financial instruments

From 1 January 2005

Treasury bills, debt securities and equity shares intended to be held on a continuing basis, other than those designated at fair value (Note 2(h)), are classified as 'available-for-sale' or 'held-to-maturity'.

(i) Available-for-sale securities 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 equity until the securities are either sold or impaired. When available-for-sale securities are sold, cumulative gains or losses previously recognised in equity are recognised in the income statement as 'Gains less losses from financial investments'.

Interest income is recognised on available-for-sale securities using the effective interest rate method, 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. Financial investments are recognised using trade date accounting.

2 Principal accounting policies *(continued)*

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 or group of assets. This usually arises when circumstances are such that an adverse effect on future cash flows from the asset or group of assets can be reliably estimated. If an available-for-sale security is impaired, the cumulative loss (measured as the difference between the asset's acquisition cost and its current fair value, less any impairment loss on that asset previously recognised in the income statement) is removed from equity and recognised in the income statement. Reversals of impairment losses are subject to contrasting treatments depending on the nature of the instrument concerned:

— if the fair value of a debt instrument classified as available-for-sale 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;

— impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

(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 rate method, less any impairment losses

From 1 January 2004 to 31 December 2004

Treasury bills, debt securities and equity shares intended to be held on a continuing basis were classified as financial investments and included in the balance sheet at cost less provision for any permanent diminution in value.

When dated financial investments had been purchased at a premium or discount, those premiums and discounts were amortised through the income statement over the period from the date of purchase to the date of maturity so as to give a constant rate of return. If the maturity was at the borrowers' option within a specified range of years, the earliest maturity was adopted. Those financial investments were included in the balance sheet at cost adjusted for the amortisation of premiums and discounts arising on acquisition. The amortisation of premiums and discounts was included in 'Interest income'. Any gain or loss on realisation of these securities was recognised in 'Gains less losses from financial investments' in the income statement as it arose.

(j) Determination of fair value

Fair values for trading instruments and available-for-sale securities that are quoted in active markets are based on bid/offer prices at the time. When independent prices are not available, fair values are determined by using valuation techniques which refer to observable market data. These include comparison with similar instruments where market observable prices exist, discounted cash flow analysis, option pricing models and other valuation techniques commonly used by market participants.

A number of factors such as bid-offer spread, credit profile, servicing costs of portfolios and model uncertainty are taken into account, as appropriate, when values are calculated using valuation techniques.

(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. The difference between the sale and repurchase price is treated as interest and recognised over the life of the agreement.

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.

2 Principal accounting policies *(continued)*

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 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, unless they are sold to third parties, in which case the obligation to return the securities is recorded as a trading liability and measured at fair value, and any gains or losses are included in 'Trading income'.

(l) Derivatives and hedge accounting

From 1 January 2005

Derivatives are recognised initially, and are subsequently remeasured, at fair value. Fair values are obtained from quoted market prices in active markets, or by using valuation techniques when an active market does not exist. All derivatives are classified as assets when their fair value is positive, or as liabilities when their fair value is negative.

In the normal course of business, the fair value of a derivative on initial recognition is the transaction price (i.e. 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 profit or loss on inception of the derivative. If observable market data are not available, and valuations are based on unobservable inputs, an initial increase in fair value indicated by the valuation model is not recognised immediately in the income statement. It is instead recognised over the life of the transaction on an appropriate basis, or is recognised in the income statement when the inputs become observable, or when the transaction matures or is closed out.

Certain derivatives embedded in other financial instruments, such as the conversion option in a convertible bond, are treated as separate derivatives if three circumstances apply: (i) their economic characteristics and risks are not clearly and closely related to those of the host contract; (ii) the terms of the embedded derivative are the same as those of a stand-alone derivative; and (iii) the combined contract is not designated at fair value through profit and loss. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

Derivative assets and liabilities on different transactions are only netted if the transactions are with the same counterparty, a legal right of set-off 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) hedges 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 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'.

2 Principal accounting policies *(continued)*

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 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 for which the effective interest rate method is used is amortised to the income statement over the residual period to maturity. An adjustment relating to the carrying amount of a hedged available-for-sale equity security remains in equity until the disposal of the equity security.

Cash flow hedge

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

Amounts accumulated in equity are recycled 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 deferred in equity are transferred 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 equity at that time remains 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 equity is immediately transferred to the income statement.

Net investment hedge

Hedges of net investments in foreign operations are accounted for similarly to cash flow hedges. Any gain or loss on the hedging instrument relating to the effective portion of the hedge is recognised in equity; the gain or loss relating to the ineffective portion is recognised immediately in the income statement. Gains and losses accumulated in equity are included in the income statement on the disposal of the foreign operation.

Hedge effectiveness testing

To qualify for hedge accounting, IAS 39 requires that at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness). Actual effectiveness (retrospective effectiveness) must also be demonstrated on an ongoing basis.

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method a group entity adopts for assessing hedge effectiveness will depend on its risk management strategy.

For fair value hedge relationships, group entities utilise the cumulative dollar offset method or regression analysis as effectiveness testing methodologies. For cash flow hedge relationships, group entities utilise the change in variable cash flow method or the cumulative dollar offset method using the hypothetical derivative approach.

For prospective effectiveness, the hedging instrument must be expected to be highly effective in achieving 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, the changes in fair value or cash flows must offset each other in the range of 80 per cent to 125 per cent for the hedge to be deemed effective.

Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair values of any derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in ‘Trading income’, except where derivatives are managed in conjunction with financial instruments designated at fair value, in which case gains and losses are reported in ‘Net income from financial instruments designated at fair value’.

2 Principal accounting policies *(continued)*

From 1 January 2004 to 31 December 2004

Derivative financial instruments comprised futures, forward, swap and option transactions undertaken by the group in the foreign exchange, interest rate, equity, credit derivative, and commodity markets that were held off-balance sheet. Netting was applied where a legal right of set-off existed.

Accounting for these instruments was dependent upon whether the transactions were undertaken for trading or non-trading purposes.

Trading transactions

Trading transactions included transactions undertaken for market-making, to service customers' needs and for proprietary purposes, as well as any related hedges.

Transactions undertaken for trading purposes were marked to market and the net present value of any gain or loss arising was recognised in the income statement as 'Trading income', after appropriate deferrals for unearned credit margins and future servicing costs. Derivative trading transactions were valued by reference to an independent liquid price when this was available. For those transactions with no readily available quoted prices, predominantly over the counter transactions, market values were determined by reference to independently sourced rates, using valuation models. If market observable data was not available, the initial increase in fair value indicated by the valuation model, but based on unobservable inputs, was not recognised immediately in the ncome statement. This amount was held back and recognised over the life of the transaction where appropriate, or released to the income statement when the inputs became observable, or when the transaction matured or was closed out. Adjustments were made for illiquid positions where appropriate.

Assets, including gains, resulting from derivative exchange rate, interest rate, equities, credit derivative and commodity contracts which were marked to market were included in 'Derivatives' on the assets side of the balance sheet. Liabilities, including losses, resulting from such contracts, were included in 'Derivatives' on the liabilities side of the balance sheet.

Non-trading transactions

Non-trading transactions, which were those undertaken for hedging purposes as part of the group's risk management strategy against cash flows, assets, liabilities or positions, were measured on an accrual basis. Non-trading transactions included qualifying hedges and positions that synthetically altered the characteristics of specified financial instruments.

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

To qualify as a hedge, a derivative was required effectively to reduce the price, foreign exchange or interest rate risk of the asset, liability or anticipated transaction to which it was linked and be capable of designation as a hedge at inception of the derivative contract. Accordingly, changes in the market value of the derivative were required to be highly correlated with changes in the market value of the underlying hedged item at inception of the hedge and over the life of the hedge contract. If these criteria were met, the derivative was accounted for on the same basis as the underlying hedged item. Derivatives used for hedging purposes included swaps, forwards and futures. Interest rate swaps were also used to alter synthetically the interest rate characteristics of financial instruments. In order to qualify for synthetic alteration, a derivative instrument had to be linked to specific individual, or pools of similar, assets or liabilities by the notional principal and interest rate risks of the associated instruments, and had to achieve a result that was consistent with defined risk management objectives. If these criteria were met, accruals-based accounting was applied, i.e. income or expense was recognised and accrued to the next settlement date in accordance with the contractual terms of the agreement.

Any gain or loss arising on the termination of a qualifying derivative was deferred and amortised to earnings over the original life of the terminated contract. When the underlying asset, liability or position was sold or terminated, the qualifying derivative was immediately marked-to-market and any gain or loss arising was taken to the income statement.

Notes on the Financial Statements (continued)

2 Principal accounting policies *(continued)*

(m)Derecognition of financial assets and liabilities

Financial assets are derecognised when the right to receive cash flows from the assets has expired; or when HSBC Bank plc has transferred its contractual right to receive the cash flows of the financial assets, and substantially all the risks and rewards of ownership; or where control is not retained. Financial liabilities are derecognised when they are extinguished, i.e. when the obligation is discharged, cancelled or expires.

(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.

(o) Associates

(i) Investments in associates are initially stated at cost and are adjusted thereafter for the post-acquisition change in the group's share of net assets.

(ii) Unrealised gains on transactions between the group and its associates are eliminated to the extent of the group's interest in the respective associates or joint ventures. Unrealised 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 relate to computer software and 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 have a finite useful life and 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 economic life.

(q) Property, plant and equipment

(i) 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, and land held under leases greater than 500 years (which are treated as finance leases), are not depreciated; and

— buildings are depreciated on cost or valuation at the greater of two per cent per annum on a straight-line basis or, if leasehold, over the unexpired terms of the leases, or over their remaining useful lives.

(ii) 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 accumulated useful lives, which run to a maximum of 35 years but are generally between five years and 20 years.

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

(r) Finance and operating leases

(i) Agreements which transfer to counterparties substantially all the risks and rewards associated with the ownership of assets, other than 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 customers'. Finance income receivable is recognised over the periods of the leases so as to give a constant rate of return on the net investment in the leases.

(ii) 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'. Leases of land exceeding 500 years to expiry at inception are recognised as finance leases. 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 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.

(iii) 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 equipment 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.

(s) Income tax

Income tax on the profit or loss for the year comprises current tax and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in shareholders' equity, in which case it is recognised in shareholders' equity.

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantially 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 set-off 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 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. 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 a legal right to set off exists in the entity.

From 1 January 2005, deferred tax relating to fair value remeasurement of available-for-sale investments and cash flow hedges which are charged or credited directly to equity, is also credited or charged directly to equity and is subsequently recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

(t) Post-employment benefits

The bank contributes to the Government pension and social security schemes in the countries in which it operates, as per local regulations. End of service benefits are calculated and paid in accordance with local law. The bank'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 obligation is calculated by a qualified actuary using the projected unit credit method (using an emerging cash flow model) allowing for assumed future experience. The discount rate used is the yield on a suitable index of US corporate bonds (Merill Lynch US Corporate AA 15+ Year Index). All actuarial gains or losses are recognised in shareholders' equity.

The bank also makes contributions to the HSBC International Staff Retirement Benefit Scheme in respect of a small number of International Managers being seconded to the bank by the HSBC Group. The bank

Notes on the Financial Statements (continued)

2 Principal accounting policies *(continued)*

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.

(u) Equity compensation plans

Shares 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 spread over the period to vesting.

The compensation expense of share options is recognised on a straight-line basis over the vesting period. Compensation expense is determined by reference to the fair value of the options on grant date, and the effect of any non-market vesting conditions such as option lapses. An option may lapse if, for example, an employee ceases to be employed by the group before the end of the vesting period. Estimates of future such employee departures are taken into account when accruing the cost during the service period.

The cost of guaranteed bonuses awarded in respect of service in the past, where an employee must complete a specified period of service until entitled to the award, is spread over the period of service rendered to the vesting date.

Discretionary bonuses awarded in respect of service in the past are expensed over the vesting period which, in this case, is the period from the date the bonus is announced until the award vests.

(v) Foreign currencies

(i) Items included in the financial statements of each of the 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 the group's presentation currency.

(ii) 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 in terms of 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.

(iii) The results of branches, subsidiaries and associates not reporting in US dollars 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 accounted for in a separate foreign exchange reserve. Exchange differences on a monetary item that is part of a net investment in a foreign operation are recognised in the income statement of the separate subsidiary financial statements. In consolidated financial statements these exchange differences are recognised in the foreign exchange reserve in shareholders' equity. In accordance with IFRS 1, the group has set the cumulative translation differences for all foreign operations to zero at the date of transition to IFRSs. On disposal of a foreign operation, exchange differences relating thereto and previously recognised in reserves are recognised in the income statement.

(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 as a result of past events, and a reliable estimate can be made of the amount of the obligation.

2 Principal accounting policies *(continued)*

(x) Debt securities in issue and subordinated liabilities

From 1 January 2005

Debt securities in issue are initially measured at fair value, which is the consideration received net of directly attributable transaction costs incurred. Subsequent measurement is at amortised cost, using the effective interest rate method to amortise the difference between proceeds net of directly attributable transaction costs and the redemption amount over the expected life of the debt, unless the securities are designated at fair value (Note 2(h)).

From 1 January 2004 to 31 December 2004

Debt securities in issue were initially measured at fair value, which was the consideration received net of transaction costs incurred. Premiums and discounts on the issue of debt and fair value adjustments to debt arising on acquisitions were amortised to interest payable so as to give a constant interest rate over the life of the debt. Where debt was callable, either by the group or the holder, the premium or discount was amortised over the period to the earliest call date.

(y) 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.

3 Net operating income

Net operating income for the year ended 31 December 2005 is stated after the following items of income, expense, gains and losses:

	2005 **US$000**
Income	
Fees earned on financial assets that are not held for trading or designated at fair value and that is not included in their effective interest rates	**116,292**
Fees earned on trust and other fiduciary activities where HSBC holds or invests assets on behalf of its customers	**10,602**
Expense	
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	**(269,636)**
Gains/(losses)	
Impairment losses on:	
— loans and advances	**28,676**

Notes on the Financial Statements (continued)

4 Employee compensation and benefits

	2005 US$000	2004 US$000
Wages and salaries	**188,904**	152,792
Social security costs	**3,068**	1,294
Post-employment benefits (Note 2(t))	**18,841**	11,035
	210,813	165,121

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

	2005 Number	2004 Number
Personal Banking	**1,369**	1,277
Commercial Banking	**662**	553
Corporate and Institutional Banking	**124**	106
Global Markets	**75**	85
Private Banking	**2**	—
Other	**1,504**	1,315
	3,736	3,336

5 General and administrative expenses

Auditors' remuneration

Auditors' remuneration in relation to statutory audit amounted to US$588 thousand (2004: US$513 thousand). The following remuneration was paid by the group to the group's principal auditor, KPMG Channel Islands Limited and its affiliated firms ('KPMG'):

	2005 US$000	2004 US$000
Audit services		
— statutory audit	**588**	513
— audit-related regulatory reporting	**297**	140
Total audit services	**885**	653
Further assurance services	**293**	208
Tax services	**21**	10
Other services		
— other services	**38**	43
Total other services	**352**	261
Total fees paid to KPMG	**1,237**	914

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

— Audit-related regulatory reporting services include services for assurance and other services that are reasonably related to the performance of the audit or review of financial statements, including comfort letters and interim reviews.

— Further assurance services include services for advice on accounting matters, reporting on internal controls not connected with the financial statements and due diligence work.

— Tax services include services for tax compliance and tax advice.

5 General and administrative expenses *(continued)*

— Other services include other assurance and advisory services such as translation services, review of financial models and advice on IT security.

6 Share-based payments

During 2005, US$1,806 thousand was charged to the income statement in respect of equity-settled share-based payment transactions (2004: Nil). This expense was based on the fair value of the share-based payment transactions when contracted. All of the expense arose under employee share awards made within HSBC'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/awards with vesting dependent on HSBC's Total Shareholder Return over a period, these 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 consistent with historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

The significant weighted average assumptions used to estimate the fair value of the options granted in 2005 were as follows:

	Group Share Option Plan	3-year Savings Related Share Option Schemes	5-year Savings Related Share Option Schemes
Risk-free interest rate (%)[1]	**4.6**	**4.3**	**4.3**
Expected life (years)[2]	**7.8**	**3.0**	**5.0**
Expected volatility (%)[3]	**20.0**	**20.0**	**20.0**
Expected dividend yield (US$ per share)[4]	**0.7**	**0.7**	**0.7**

1 *The risk-free rate was determined from the UK gilts yield curve for Group Share Option Plan awards and UK Savings-Related Share Option Schemes. 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.*
4 *Expected dividend yield was based on historic levels of dividend growth.*

HSBC Share Plan

The HSBC Share Plan was adopted by HSBC in 2005. This Plan comprises Performance Share Awards, Restricted Share Awards and Achievement Share Awards. The aim of the HSBC Share Plan is to align the interests of executives to 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 made to Senior Executives taking into account individual performance in the prior year. Performance Share Awards are divided into two equal parts for testing attainment against pre-determined benchmarking. One half is subject to a Total Shareholder Return 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 would be released to the employee according to a sliding scale from 30 to 100 per cent of the award, dependent upon the scale of achievement against the benchmarks. Shares will be released after three years to the extent that the performance conditions are satisfied. These awards are forfeited in total if HSBC performance fails to meet the minimum criteria.

Notes on the Financial Statements (continued)

6 Share-based payments *(continued)*

	2005 Number (000's)
Outstanding at 1 January	222
Granted in the year	57
Expensed in the year	(33)
Outstanding at 31 December	246

The weighted average fair value of shares awarded by HSBC for Performance Share Awards in 2005 was **£2,295 thousand.**

Restricted Share Awards

Restricted Share Awards are made to eligible employees for recruitment and retention purposes or as part of deferral of annual bonus. The awards vest between one and three years from date of award.The bank granted Restricted Share Awards to certain executives in the years 2002, 2003, 2004 and 2005. These awards confer the right to the employees concerned to own shares of HSBC Holdings plc upon completion of a minimum number of years of service from the date of award. Should the employee not satisfy this condition, subject to certain exceptions, the award would lapse. The cost of the restricted shares is determined by HSBC Holdings plc and is paid by the bank up-front. The cost is thereafter spread over the vesting period of the award.

Achievement Share Awards

Achievement shares are utilised to promote widespread interest in HSBC shares among employees and are awarded to eligible employees after taking into account the employee's performance in the prior year. Shares are awarded without corporate performance conditions and are released to employees after three years providing the employees have remained continuously employed by HSBC for this period.

	2005		
	Number of employees	Number of shares (000's)	Average award (000's)
Forfeited in the year[1]	118	181	2
Outstanding at 31 December	118	181	2

The weighted average fair value of shares awarded by HSBC for Achievement Share Awards in 2005 was **£1,689 thousand.**

Savings-related share option plans

The savings-related share option plans invite eligible employees to enter into savings contracts to save up to £250 per month, with the option to use the savings to acquire shares. The aim of the plan is to align the interests of all employees to the creation of shareholder value. The options are exercisable within six months following either the third or the fifth anniversary of the commencement of the savings contract depending on conditions set at grant. The exercise price is set at a 20 per cent (2004: 20 per cent) discount to the market value at the date of grant.

6 Share-based payments *(continued)*

	2005		2004	
	Number (000's)	**Weighted average exercise price £**	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	**2,069**	**5.98**	2,375	5.88
Granted in the year	**652**	**6.66**	511	6.47
Exercised in the year	**(818)**	**6.08**	(607)	6.00
Forfeited in the year	**(162)**	**6.18**	—	—
Expired in the year	**(9)**	**5.10**	(210)	5.99
Outstanding at 31 December[1]	**1,732**	**6.18**	2,069	5.98

The weighted average fair value of options granted in the year as at the date of grant was £6,083 thousand (2004: £4,492 thousand). The number of options and the weighted average exercise price outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	2005	2004
Exercise price range (£)	**£5.35-£6.75**	£5.35-£6.75
Number (000's)	1,732	2,069
Weighted average exercise price (£)	6.18	5.98

Restricted Share Plan

Conditional awards under the Restricted Share Plan

Conditional awards under the Restricted Share Plan were granted to Senior Executives from 1996 to 2004. The aim of the plan was to align the interests of executives to the creation of shareholder value. This was achieved by setting certain Total Shareholder Return targets against a peer group of major banks which must normally be attained in order for the awards to vest. No further awards will be made under this Plan following adoption of the HSBC Share Plan in 2005.

Other awards made under the Restricted Share Plan

Other awards were made under the Restricted Share Plan as part deferral of annual bonus. Awards were also made for recruitment and retention purposes. The awards generally vest from one to three years from the date of award. Awards made under this plan ceased in 2004. Awards of restricted shares in 2005 were made under the Rules of the HSBC Share Plan.

Group Share Option Plan

The Group Share Option Plan was a long-term incentive plan available to certain HSBC employees between 2000 and 2005. The aim of the plan was to align the interests of those higher performing employees to the creation of shareholder value. This was achieved by setting certain Total Shareholder Return targets which must normally 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.

Notes on the Financial Statements (continued)

6 Share-based payments *(continued)*

	2005	
	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	**1, 844**	**7.79**
Granted in the year	**125**	**6.68**
Exercised in the year	**(167)**	**7.06**
Expired in the year	**(4)**	**7.81**
Outstanding at 31 December	**1,798**	**7.78**

The weighted average fair value of options granted in the year as at the date of grant was £3.09 (2004: £2.96) The number of options and weighted average exercise price outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	2005
Exercise price range (£)	**£5.35-£6.75**
Number (000's)	**1,798**
Weighted average exercise price (£)	**7.78**

Executive Share Option Scheme

The Executive Share Option Scheme was a long-term incentive scheme available to certain senior HSBC employees with grants made each year until the adoption of the 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 1999

7 Tax expense

The charge for taxation comprises:

	2005 US$000	2004 US$000
Current tax		
Overseas tax — current year	**98,046**	55,660
Overseas tax — adjustment in respect of prior years	**(734)**	(1,457)
	97,312	54,203
Deferred tax		
Origination and reversal of temporary differences	**(5,547)**	517
Effect of write-downs / reversal of write-downs of deferred tax assets	**(5,547)**	517
Tax expense	**91,765**	54,720

The bank is not resident in the United Kingdom for taxation purposes. The bank and subsidiary undertakings provide for taxation at the appropriate rates in the countries in which they operate.

7 Tax expense *(continued)*

	2005	2004
	US$000	US$000
Analysis of overall tax charge		
Taxation at UAE tax rate of 20 per cent (2004: 20 per cent)	**89,829**	58,989
Impact of overseas profits in principal locations taxed at different rates[1]	**9,247**	3,664
Income not subject to tax	**(10,173)**	(7,592)
Expenses not deductible for tax purposes	**2,215**	3,108
Prior period adjustments	**(809)**	(5,046)
Other items	**1,456**	1,597
Overall tax charge	**91,765**	54,720

1 *Overseas profits taxed at different rates to that which applies in the UAE contributed to an increase in the effective tax rate of 1.13 per cent (2004: decrease of 0.26 per cent). The increase in the effective tax rate was more in 2005 than in 2004 because of the greater proportion of group profits arising in Qatar, where they are subject to a higher rate of tax than in the UAE, in 2005.*

8 Dividends

	2005		2004	
	US$ per share	**US$000**	US$ per share	US$000
First interim	—	—	0.060	20,000
Second interim	—	—	0.045	15,000

9 Segment analysis

The allocation of earnings reflects the benefit of shareholders' funds to the extent that these costs are actually allocated to businesses in the segment by way of intra-group capital and funding structures.

(a) By geographical region

Geographical information has been classified by the location of the principal operations of the subsidiary or associate undertaking or, in the case of the bank, by the location of the branch responsible for reporting the results or for advancing the funds.

	Middle East	*Europe*	*Total*
2005	**US$000**	**US$000**	**US$000**
Gross income			
Interest receivable	**773,981**	**33,572**	**807,553**
Dividend income	**497**	**—**	**497**
Fees and commissions receivable	**237,074**	**—**	**237,074**
Dealing profits	**84,079**	**(496)**	**83,583**
Other operating income	**9,844**	**153**	**9,997**
Total gross income	**1,105,475**	**33,229**	**1,138,704**
Profit on ordinary activies before tax	**473,787**	**2,273**	**476,060**
Attributable profit	**382,230**	**103**	**382,333**
Depreciation and amortisation	**(11,078)**	**(54)**	**(11,132)**
Provisions	**(28,676)**	**—**	**(28,676)**
Cost to acquire property, plant and equipment	**(14,009)**	**(5)**	**(14,014)**
Cost to acquire intangibles	**(215)**	**—**	**(215)**
Net assets	**1,130,595**	**123,737**	**1,254,332**
Total assets	**18,864,764**	**46,738**	**18,911,502**
Total liabilities	**17,652,728**	**4,442**	**17,657,170**

Notes on the Financial Statements (continued)

9 Segment analysis *(continued)*

2004	*Middle East* US$000	*Europe* US$000	*Total* US$000
Gross income			
Interest receivable	484,077	817	484,894
Dividend income	15	—	15
Fees and commissions receivable	174,408	2	174,410
Dealing profits	55,932	555	56,487
Other operating income	5,456	117	5,573
Total gross income	719,888	1,491	721,379
Profit on ordinary activies before tax	297,138	209	297,347
Attributable profit/(loss)	241,669	(1,194)	240,475
Depreciation and amortisation	(10,214)	(180)	(10,394)
Provisions	(40,223)	—	(40,223)
Cost to acquire property, plant and equipment	(8,107)	(40)	(8,147)
Cost to acquire intangibles	(1,478)	—	(1,478)
Net assets	741,218	128,589	869,807
Total assets	12,578,998	88,438	12,667,436
Total liabilities	11,791,067	6,562	11,797,629

(b) By customer group

The bank's operations include a number of support services and head office functions. The costs of these functions are allocated to business lines, where it is appropriate, on a systematic and consistent basis. In addition, there are a number of income and expense items between customer groups and the following analysis includes inter-segment amounts within each customer group.

(c) By class of business

	2005 **US$000**	2004 US$000
Profit on ordinary activities before tax		
Personal Banking	**100,622**	67,433
Commercial Banking	**226,250**	149,605
Corporate and Institutional Banking	**75,529**	43,499
Investment Banking	**72,445**	54,470
Private Banking	**1,214**	—
Other	**—**	(17,660)
Net assets		
Personal Banking	**137,555**	127,956
Commercial Banking	**450,488**	326,994
Corporate and Institutional Banking	**253,181**	130,667
Investment Banking	**131,248**	57,599
Other	**281,860**	226,591
Total assets		
Personal Banking	**5,386,055**	4,551,024
Commercial Banking	**7,517,841**	4,995,614
Corporate and Institutional Banking	**3,890,758**	2,223,461
Investment Banking	**8,024,896**	5,983,476
Private Banking	**1,174,772**	—
Other	**2,634,915**	947,774

10 Analysis of financial assets and liabilities by measurement bases

	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 fair value hedging instruments US$000*	*Total US$000*
ASSETS						
Cash and balances at central banks	—	—	—	**260,817**	—	**260,817**
Items in the course of collection from other banks	—	—	—	**132,752**	—	**132,752**
Trading assets	**202,963**	—	—	—	—	**202,963**
Derivatives	**145,312**	—	—	—	**1,257**	**146,569**
Loans and advances to banks	—	**4,845,167**	—	—	—	**4,845,167**
Loans and advances to customers	—	**11,372,418**	—	—	—	**11,372,418**
Financial investments	—	—	**992,540**	—	—	**992,540**
Other assets	—	—	—	**641,676**	—	**641,676**
Total financial assets	**348,275**	**16,217,585**	**992,540**	**1,035,245**	**1,257**	**18,594,902**
Total non-financial assets						**316,600**
Total assets						**18,911,502**
LIABILITIES						
Deposits by banks	—	—	—	**758,287**	—	**758,287**
Customer accounts	—	—	—	**14,174,426**	—	**14,174,426**
Items in the course of transmission to other banks	—	—	—	**89,493**	—	**89,493**
Derivatives	**135,065**	—	—	—	**1,421**	**136,486**
Debt securities in issue	—	—	—	**1,564,328**	—	**1,564,328**
Other liabilities	—	—	—	**821,181**	—	**821,181**
Total financial liabilities	**135,065**	—	—	**17,407,715**	**1,421**	**17,544,201**
Total non-financial liabilities						**112,969**
Total liabilities						**17,657,170**

11 Trading assets

	2005 US$000	2004 US$000
Trading assets:		
— not subject to repledge or resale by counterparties	202,963	192,611
Debt securities	25,902	44,411
Equity securities	177,061	148,200
	202,963	192,611

In accordance with IFRS 1, the group's consolidated balance sheet at 31 December 2004 does not reflect the adoption of IAS 32 and IAS 39. The analysis in the above note is therefore not applicable for 2004.

12 Derivatives

Fair values of derivatives open positions by product contract type held by the group[1]

	At 31 December 2005					
		Assets			*Liabilities*	
	Trading	*Hedging*	*Total*	*Trading*	*Hedging*	*Total*
	US$000	*US$000*	*US$000*	*US$000*	*US$000*	*US$000*
Exchange rate	**119,415**	**—**	**119,415**	**(111,653)**	**—**	**(111,653)**
Interest rate	**25,897**	**1,257**	**27,154**	**(23,412)**	**(1,421)**	**(24,833)**
Total	**145,312**	**1,257**	**146,569**	**(135,065)**	**(1,421)**	**(136,486)**

	At 31 December 2004	
	Total assets	Total liabilities
	US$000	US$000
Exchange rate	70,181	(63,711)
Interest rate	5,567	(3,618)
Total	75,748	(67,329)

1 *In accordance with IFRS 1, the group's consolidated balance sheet at 31 December 2004 does not reflect the adoption of IAS 32 and IAS 39. The analysis in the above note is therefore not applicable for 2004.*

Derivatives are financial instruments that derive their value from the price of an underlying item such as equities, bonds, interest rates, foreign exchange, credit spreads, commodities and equity or other indices. Derivatives enable users to increase, reduce or alter exposure to credit or market risks. The group makes markets in derivatives for its customers and uses derivatives to manage its exposure to credit and market risks.

Derivatives are carried at fair value and shown in the balance sheet as separate totals of assets and liabilities. Asset values represent the cost to the group of replacing all transactions with a fair value in the group's favour assuming that all group's relevant counterparties default at the same time, and that transactions can be replaced instantaneously. Liability values represent the cost to the group counterparties of replacing all their transactions with the group with a fair value in their favour if the group were to default. Derivative assets and liabilities on different transactions are only netted if the transactions are with the same counterparty, a legal right of set-off exists and the cash flows are intended to be settled on a net basis. Changes in the values of derivatives are recognised in 'Trading income' unless they qualify as hedges for accounting purposes.

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. For accounting purposes, derivative instruments are classified as held either for trading or hedging. Derivatives that are held as hedging instruments are formally designated as hedges as defined in IAS 39. All other derivative instruments are classified as held-for-trading. The held-for-trading classification includes two types of derivative instruments: those used in sales and trading activities, and those instruments that are used for risk management purposes but which for various reasons do not meet the qualifying criteria for hedge accounting. The second type of held-for-trading 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 offsetting deals being utilised 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 as 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

12 Derivatives *(continued)*

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 changes in currency 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. Ineffective hedging derivatives were previously designated as hedges, but no longer meet the criteria for hedge accounting.

Gains and losses from changes in the fair value of derivatives that do not qualify for hedge accounting are reported in 'Trading income'.

Contract amounts of derivatives held-for-trading purposes by product type

	2005	2004
	US$000	US$000
Exchange rate	**13,285,433**	5,641,645
Interest rate	**5,696,039**	1,281,808
Total derivatives	**18,981,472**	6,923,453

Hedging Instruments

The group uses 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.

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, as described below.

The following table summarises the contract amounts of derivatives held for hedging purposes by product type:

	At 31 December 2005
	Fair value hedge US$000
Interest rate	**61,007**

With respect to interest rate contracts, 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.

Fair value hedges

The group's fair value hedges 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 income. 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 income as a yield

Notes on the Financial Statements (continued)

12 Derivatives *(continued)*

adjustment over the remainder of the hedging period.

The fair values of outstanding derivatives designated as fair value hedges at 31 December 2005, were assets of US$1,257 thousand and liabilities of US$1,421 thousand.

Gains or losses arising from the change in fair value of fair value hedges

	2005 US$000
Gains arising from the change in fair value of fair value hedges:	
— on hedged items attributable to the hedged risk	**92**

13 Loans and advances to banks

	2005 Book value US$000	**Fair value[1] US$000**	2004 Book value US$000
Loans and advances to banks	**4,845,167**	**4,842,183**	2,073,071

1 *In accordance with IFRS 1, the group's consolidated balance sheet at 31 December 2004 does not reflect the adoption of IAS 32 and IAS 39. The analysis in the above note is therefore not applicable for 2004.*

14 Loans and advances to customers

	2005 Book value US$000	**Fair value[1] US$000**	2004 Book value US$000
Loans and advances to customers	**11,372,418**	**11,420,230**	8,463,372

1 *In accordance with IFRS 1, the group's consolidated balance sheet at 31 December 2004 does not reflect the adoption of IAS 32 and IAS 39. The analysis in the above note is therefore not applicable for 2004.*

Loans and advances to customers include finance leases with a present value amounting to US$121,363 thousand (2004: US$93,559 thousand).

15 Financial investments

	2005 US$000	2004 US$000
Financial investments:		
— not subject to repledge or resale by counterparties	**992,540**	1,164,554

	2005 Book value and fair value[1] US$000	2004 Book value US$000
Treasury and other eligible bills:		
— available-for-sale	**145,451**	168,580
Debt securities:		
— available-for-sale	**835,964**	990,292
Equity securities:		
— available-for-sale	**11,125**	5,682
Total financial investments	**992,540**	1,164,554

15 Financial investments *(continued)*

1 *In accordance with IFRS 1, the group's consolidated balance sheet at 31 December 2004 does not reflect the adoption of IAS 32 and IAS 39. The analysis in the above note is therefore not applicable for 2004.*

16 Interests in associates

Principal associates of the bank

	At 31 December 2005			
Name of associate	***Country of incorporation***	***Principal activity***	***The bank's interest in equity capital***	***Issued equity capital***
Arabian Real Estate Investment Trust Management Limited	Cayman Islands	Real estate	40.00%	US$1 million of which US$0.8 million is fully paid
British Arab Commercial Bank Limited	England	Banking	46.51%	US$81 million and £32 million fully paid £5 million nil paid
Rewards Management Middle East Free Zone Limited Liability Company	Dubai, UAE	Multi-participant loyalty programmes	40.00%	AED0.5 million

On 12 December 2005, the bank purchased 40% of the equity share capital of Arabian Real Estate Investment Trust Management Limited at a cost of US$400 thousand.

British Arab Commercial Bank Limited has issued US$44,478 thousand of subordinated unsecured loan stock in which the group has a 34.66% interest.

The bank's share of associates' contingent liabilities amounted to US$435,509 thousand at 31 December 2005 (2004: US$398,002 thousand).

The associates are unlisted.

Arabian Real Estate Investment Trust Management Limited operates in Dubai.

British Arab Commercial Bank Limited operates in North Africa and the Eastern Mediterranean.

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

Movement in investments in associates:

	2005
	US$000
At 1 January 2005	**132,124**
IFRSs transition adjustment at 1 January 2005	**10,368**
Additions	**400**
Retained profits and losses	**19,467**
Exchange and other movements	**(22,974)**
At 31 December 2005	**139,385**

Notes on the Financial Statements (continued)

16 Interests in associates *(continued)*

Summarised aggregated financial information of associates is as follows:

	2005	2004
	US$000	US$000
Assets	**1,756,930**	1,691,650
Liabilities	**1,618,093**	1,566,279
Revenues	**51,004**	24,443
Profit	**37,084**	11,960

17 Intangible assets

The analysis of the movement of intangible assets for the year ended 31 December 2005 is as follows:

	Software			
	2005		2004	
	Cost	***Accumulated depreciation***	*Cost*	*Accumulated depreciation*
	US$000	**US$000**	US$000	US$000
At 1 January	**4,862**	**(3,096)**	3,940	(2,696)
Additions	**215**	**—**	1,478	—
Disposals	**(244)**	**248**	(561)	178
Charge for the year[1]	**—**	**(687)**	—	(563)
Exchange translation differences	**1**	**(1)**	—	—
Other changes	**(24)**	**45**	5	(15)
At 31 December	**4,810**	**(3,491)**	4,862	(3,096)
Net book value at 31 December	**1,319**		1,766	

1 *The amortisation charge for the year is recognised within the income statement under 'Amortisation of intangible assets'.*

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

Computer software which is capitalised as an intangible asset is amortised over its useful life, but no longer than five years. When amortising the cost of the software, the residual value is always assumed to be zero as the bank does not sell the software once its useful life has expired.

18 Property, plant and equipment

	Freehold land and buildings	***Short leasehold land and buildings***	***Equipment, fixtures and fittings***	***Total***
	US$000	**US$000**	**US$000**	**US$000**
Cost or fair value				
At 1 January 2005	**38,577**	**41,734**	**64,450**	**144,761**
Additions at cost	**90**	**3,107**	**10,817**	**14,014**
Disposals	**—**	**(1,575)**	**(4,671)**	**(6,246)**
Transfers	**—**	**—**	**(20)**	**(20)**
Exchange translation differences	**(104)**	**11**	**5**	**(88)**
Other changes	**(21)**	**—**	**(39)**	**(60)**
At 31 December 2005	**38,542**	**43,277**	**70,542**	**152,361**

18 Property, plant and equipment *(continued)*

Accumulated depreciation				
At 1 January 2005	**—**	**(20,117)**	**(49,778)**	**(69,895)**
Depreciation charge for the year	**(882)**	**(2,512)**	**(7,051)**	**(10,445)**
Disposals	**—**	**1,579**	**4,478**	**6,057**
Transfers	**—**	**(9)**	**(30)**	**(39)**
Exchange translation differences	**12**	**(10)**	**(14)**	**(12)**
Other changes	**45**	**(42)**	**(16)**	**(13)**
At 31 December 2005	**(825)**	**(21,111)**	**(52,411)**	**(74,347)**
Net book value at 31 December 2005	**37,717**	**22,166**	**18,131**	**78,014**

	Freehold land and buildings	*Short leasehold land and buildings*	*Equipment, fixtures and fittings*	*Total*
	US$000	US$000	US$000	US$000
Cost or fair value				
At 1 January 2004	39,721	40,450	63,586	143,757
Additions at cost	262	2,227	5,658	8,147
Disposals	(1,006)	(947)	(4,811)	(6,764)
Transfers	—	—	1,488	1,488
Exchange translation differences	121	4	26	151
Other changes	(521)	—	(1,497)	(2,018)
At 31 December 2004	38,577	41,734	64,450	144,761
Accumulated depreciation				
At 1 January 2004	—	(18,624)	(45,906)	(64,530)
Depreciation charge for the year	(826)	(2,285)	(6,720)	(9,831)
Disposals	315	794	3,242	4,351
Transfers	—	—	(1,185)	(1,185)
Exchange translation differences	(10)	(2)	(18)	(30)
Other changes	521	—	809	1,330
At 31 December 2004	—	(20,117)	(49,778)	(69,895)
Net book value at 31 December 2004	38,577	21,617	14,672	74,866

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:

	2005		2004	
	Cost	***Accumulated depreciation***	*Cost*	*Accumulated depreciation*
	US$000	**US$000**	US$000	US$000
At 1 January	**41,699**	**(20,085)**	39,789	(18,561)
Additions	**3,107**	**—**	2,072	—
Disposals	**(1,575)**	**1,579**	(188)	164
Transfers	**—**	**(9)**	77	(64)
Depreciation charge for the year	**—**	**(2,512)**	—	(2,285)
Exchange translation differences	**11**	**(8)**	5	—
Other changes	**—**	**(42)**	(56)	661
At 31 December	**43,242**	**(21,077)**	41,699	(20,085)
Net book value at 31 December	**22,165**		21,614	

Notes on the Financial Statements (continued)

19 Investments

The principal subsidiary undertakings of the bank are:

	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%

All the above make their financial statements up to 31 December.
The subsidiary undertakings are directly owned and are included in the consolidation.
The countries of operation are the same as the countries of incorporation.
The subsidiary undertakings are unlisted.

20 Other assets

	2005 US$000	2004 US$000
Assets held for resale	**2,394**	2,786
Deferred taxation (Note 25)	**29,109**	24,745
Endorsements and acceptances	**560,364**	—
Other accounts	**49,809**	44,391
	641,676	71,922

The composition of the assets held for sale is as follows:

	2005 US$000	2004 US$000
Repossessed property	**2,394**	2,786

The intent to sell repossessed properties is published in two daily newspapers, bi-annually. Once the pricing has been agreed, the relevant documentation and registration is completed and a sale is recorded.

No fair value is calculated for repossessed properties.

21 Deposits by banks

	2005		2004
	Book value US$000	**Fair value[1] US$000**	Book value US$000
Deposits by banks	**758,287**	**758,095**	1,709,781

1 *In accordance with IFRS 1, the group's consolidated balance sheet at 31 December 2004 does not reflect the adoption of IAS 32 and IAS 39. The analysis in the above note is therefore not applicable for 2004.*

22 Customer accounts

	2005		2004
	Book value	**Fair value**[1]	Book value
	US$000	**US$000**	US$000
Customer accounts	**14,174,426**	**14,178,515**	8,996,885

1 *In accordance with IFRS 1, the group's consolidated balance sheet at 31 December 2004 does not reflect the adoption of IAS 32 and IAS 39. The analysis in the above note is therefore not applicable for 2004.*

23 Debt securities in issue

	2005		2004
	Book value	**Fair value**[1]	Book value
	US$000	**US$000**	US$000
Medium term notes, by remaining maturity			
— between 2 and 5 years	**1,064,328**	**1,060,658**	298,364
Non-equity preference shares	**500,000**	**500,000**	400,000
Debt securities in issue	**1,564,328**	**1,560,658**	698,364

1 *In accordance with IFRS 1, the group's consolidated balance sheet at 31 December 2004 does not reflect the adoption of IAS 32 and IAS 39. The analysis in the above note is therefore not applicable for 2004.*

Medium term notes

On 11 October 2004, the bank established a Debt Issuance Programme providing for the issue of up to US$1,000,000,000 in debt securities in the form of medium-term notes. On 14 December 2004, the bank issued, under the Programme, a first tranche of US$300,000,000 floating rate notes due 14 December 2009. On 5 May 2005, the bank issued, under the Programme, a second tranche of US$700,000,000 floating rate notes due 5 May 2010. The costs of the issue have been amortised over the life of the notes.

Non-equity preference shares

Authorised

At 31 December 2005 and 2004, the authorised non-equity preference share capital of the bank was 750,000 cumulative redeemable preference shares of US$1 each.

Issued

The issued preference shares comprise a first issue on 29 October 1997 of 50,000 perpetual cumulative redeemable preference shares of nominal value US$1 each at a premium of US$999 per share, a second issue on 1 April 1998 of 25,000 perpetual cumulative redeemable preference shares of nominal value US$1 each at a premium of US$999 per share, a third issue on 17 December 2003 of 225,000 dated cumulative redeemable preference shares of nominal value US$1 each at a premium of US$999 per share, a fourth issue on 26 August 2004 of 100,000 dated cumulative redeemable preference shares of nominal value US$1 each at a premium of US$999 per share and a fifth issue on 19 December 2005 of 100,000 dated cumulative redeemable preference shares of nominal value US$1 each at a premium of US$999 per share

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

On the first issue, cumulative redeemable preference dividends of 12 month US dollar LIBOR + 0.35% on the issue price of each perpetual share are payable annually.

The first issue perpetual cumulative redeemable preference shares bear no mandatory redemption date but are redeemable at the option of the bank on any date after 31 October 2002. 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.

23 Debt securities in issue *(continued)*

On the second issue, cumulative redeemable preference dividends of 12 month US dollar LIBOR + 0.70% on the issue price of each perpetual share are payable annually.

The second issue perpetual cumulative redeemable preference shares bear no mandatory redemption date but are redeemable at the option of the bank on any date after 2 April 2003. 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.

On the third issue, cumulative redeemable preference dividends of 12 month US dollar LIBOR + 0.50% on the issue price of each dated share are payable annually.

The redemption of the third issue dated cumulative redeemable preference shares, other than at the option of the bank as described below, will be subject to the approval of the ordinary shareholders of the bank. The earliest date for redemption will be 17 December 2013 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 on any date after 17 December 2008, 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.

On the fourth issue, cumulative redeemable preference dividends of 12 month US dollar LIBOR + 0.48% on the issue price of each dated share are payable annually.

The redemption of the fourth issue dated cumulative redeemable preference shares, other than at the option of the bank as described below, will be subject to the approval of the ordinary shareholders of the bank. The earliest date for redemption will be 26 August 2014 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 on any date after 26 August 2009, 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.

On the fifth issue, cumulative redeemable preference dividends of 12 month US dollar LIBOR + 0.30% on the issue price of each dated share are payable annually.

The redemption of the fifth issue dated cumulative redeemable preference shares, other than at the option of the bank as described below, will be subject to the approval of the ordinary shareholders of the bank. The earliest date for redemption will be 19 December 2015 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 on any date after 19 December 2010, 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.

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.

24 Other liabilities

	2005	2004
	US$000	US$000
Current taxation	**105,769**	65,604
Obligations under finance leases	**6,169**	6,495
Endorsements and acceptances	**560,364**	—
Other liabilities	**148,879**	91,760
	821,181	163,859
Obligations under finance leases falling due:		
— over 5 years	**6,169**	6,495

25 Provisions for liabilities and charges

(a) Deferred tax

	Amount of deferred tax asset recognised in the balance sheet		*Amount of deferred tax liability recognised in the balance sheet*	
	2005	2004	**2005**	2004
	US$000	US$000	**US$000**	US$000
Temporary difference:				
— loan impairment provisions	**25,024**	23,214	—	—
— relief for losses	—	601	—	—
— revaluation of non-investment property	—	—	**2,647**	2,688
— other	**4,085**	930	—	—
At 31 December 2005	**29,109**	24,745	**2,647**	2,688

(b) Other provisions for liabilities and charges

	Provisions for contingent liabilities and commitments	*Other Provisions*	*Total*
	US$000	**US$000**	**US$000**
At 1 January 2005	**3,690**	**2,017**	**5,707**
Additional provisions/increase in provisions	**118**	**5,516**	**5,634**
Provisions utilised	**(1,127)**	**(4,256)**	**(5,383)**
Amounts reversed	**(921)**	—	**(921)**
Exchange and other movements	**(167)**	**153**	**(14)**
At 31 December 2005	**1,593**	**3,430**	**5,023**

Included within "provisions for contingent liabilities and commitments" is an amount of US$939 thousand (2004: US$1,487 thousand) relating to the "HSBC In The Community Middle East Foundation". This is a charitable trust established by the bank, whose aim is to provide funding to Middle East nationals, primarily for educational and environmental purposes. Funding is provided on a case by case basis, throughout the year.

Notes on the Financial Statements (continued)

26 Maturity analysis of liabilities

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

	On demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*Total*
	US$000	*US$000*	*US$000*	*US$000*	*US$000*	*US$000*
Deposits by banks	**44,518**	**243,841**	**29,461**	**19,829**	**—**	**337,649**
Customer accounts	**5,840,550**	**7,349,540**	**983,292**	**230,503**	**2,917**	**14,406,802**
Debt securities in issue	**—**	**34,035**	**102,104**	**1,608,883**	**922,444**	**2,667,466**
Other financial liabilities	**8,048**	**499,142**	**132,010**	**13,623**	**3,203**	**656,026**
Total at 31 December 2005	**5,893,116**	**8,126,558**	**1,246,867**	**1,872,838**	**928,564**	**18,067,943**

	At 31 December 2005		
	Due within 1 year	**Due after more than 1 year**	**Total**
Assets	**US$000**	**US$000**	**US$000**
Loans and advances to banks	**4,820,908**	**24,259**	**4,845,167**
Loans and advances to customers	**7,537,303**	**3,835,115**	**11,372,418**
Financial investments	**508,308**	**484,232**	**992,540**
Other financial assets	**549,213**	**11,151**	**560,364**
	13,415,732	**4,354,757**	**17,770,489**
Liabilities			
Deposits by banks	**742,701**	**15,586**	**758,287**
Customer accounts	**13,990,639**	**183,787**	**14,174,426**
Debt securities in issue	**—**	**1,564,328**	**1,564,328**
Other financial liabilities	**549,707**	**16,826**	**566,533**
	15,283,047	**1,780,527**	**17,063,574**

	At 31 December 2004		
	Due within 1 year	Due after more than 1 year	Total
Assets	US$000	US$000	US$000
Loans and advances to banks	2,043,888	29,183	2,073,071
Loans and advances to customers	5,581,087	2,882,285	8,463,372
Financial investments	750,330	414,224	1,164,554
	8,375,305	3,325,692	11,700,997
Liabilities			
Deposits by banks	1,679,554	30,227	1,709,781
Customer accounts	8,952,351	44,534	8,996,885
Debt securities in issue	—	698,364	698,364
Other financial liabilities	494	6,001	6,495
	10,632,399	779,126	11,411,525

27 Foreign currency exposures

(a) Assets and liabilities denominated in foreign currency

	2005 US$000	2004 US$000
Assets		
Denominated in US dollars	**7,732,169**	4,482,572
Denominated in currencies other than US dollars	**11,179,333**	8,184,864
Total assets	**18,911,502**	12,667,436
Equity and liabilities		
Denominated in US dollars	**10,578,443**	4,812,528
Denominated in currencies other than US dollars	**8,333,059**	7,854,908
Total equity and liabilities	**18,911,502**	12,667,436

(b) Structural currency exposures

The group's structural foreign currency exposure is represented by the net asset value of its foreign currency equity investments in subsidiary undertakings, branches and associates. Gains or losses on structural foreign currency exposures are taken to reserves.

The group's management of structural foreign currency exposures is discussed in the 'Market risk' section on pages 60 to 65.

The group's structural currency exposures as at the year-end were as follows:

Net structural currency exposures

Currency of structural exposure	2005 US$000	2004 US$000
Bahraini dinar	**61,755**	46,579
Jordanian dinar	**73,057**	64,316
Kuwaiti dinar	**49,505**	—
Lebanese pound	**40,429**	36,169
Omani rial	**77,416**	64,074
Qatari rial	**98,228**	72,655
Sterling	**246**	292
UAE dirham	**1,109,224**	759,198
Total	**1,509,860**	1,043,283

28 Called up share capital

Authorised

The authorised ordinary share capital of the bank at 31 December 2005 and 2004 was 1,000,000,000 ordinary shares of US$1 each.

Issued and fully paid	Number of ordinary shares	US$000
At 1 January and 31 December 2005	**331,055,000**	**331,055**
At 1 January and 31 December 2004	331,055,000	331,055

Notes on the Financial Statements (continued)

29 Reserves

	2005							
			Other reserves					
	Called up share capital US$000	*Retained earnings US$000*	*Available-for-sale fair value reserve US$000*	*Foreign exchange reserve US$000*	*Share-based payment reserve US$000*	*Total share-holders' equity US$000*	*Minority interests US$000*	*Total equity US$000*
At 1 January	**331,055**	**534,513**	—	—	—	**865,568**	**4,239**	**869,807**
IFRSs transition adjustment at 1 January 2005	—	**8,806**	**6,239**	—	**834**	**15,879**	—	**15,879**
Profit for the year attributable to shareholders	—	**382,333**	—	—	—	**382,333**	—	**382,333**
Share of changes recognised directly in equity in the associate's equity	—	**(30,422)**	—	—	—	**(30,422)**	—	**(30,422)**
Actuarial gains on post-employment benefits schemes	—	**817**	—	—	—	**817**	—	**817**
Exchange differences arising on monetary items that form part of a net investment in a foreign operation	—	—	—	**94**	—	**94**	—	**94**
Fair value gains taken to equity	—	—	**7,095**	—	—	**7,095**	—	**7,095**
Charge to the income statement in respect of equity settled share-based payment transactions	—	—	—	—	**1,276**	**1,276**	—	**1,276**
Exchange and other movements	—	**7,615**	—	—	—	**7,615**	—	**7,615**
Profit attributable to minority interests	—	—	—	—	—	—	**1,962**	**1,962**
Dividends to minority interests	—	—	—	—	—	—	**(2,124)**	**(2,124)**
At 31 December	**331,055**	**903,662**	**13,334**	**94**	**2,110**	**1,250,255**	**4,077**	**1,254,332**

29 Reserves *(continued)*

	2004							
			Other reserves					
	Called up share capital US$000	*Retained earnings US$000*	*Available-for-sale fair value reserve US$000*	*Foreign exchange reserve US$000*	*Share-based payment reserve US$000*	*Total share-holders' equity US$000*	*Minority interests US$000*	*Total equity US$000*
At 1 January	331,055	315,819	—	—	—	646,874	4,537	651,411
Profit for the year attributable to shareholders	—	240,475	—	—	—	240,475	—	240,475
Dividends to shareholders of the parent company	—	(35,000)	—	—	—	(35,000)	—	(35,000)
Share of changes recognised directly in equity in the associate's equity	—	10,667	—	—	—	10,667	—	10,667
Exchange and other movements	—	2,552	—	—	—	2,552	—	2,552
Profit attributable to minority interests	—	—	—	—	—	—	2,152	2,152
Dividends to minority interests	—	—	—	—	—	—	(2,450)	(2,450)
At 31 December	331,055	534,513	—	—	—	865,568	4,239	869,807

Notes on the Financial Statements (continued)

30 Reconciliation of profit before tax to net cash flow from operating activities

(a) Non-cash items included in profit and loss	2005	2004
	US$000	US$000
Depreciation and amortisation	**13,638**	10,594
Loan impairment losses	**28,676**	40,455
Loans written off net of recoveries	**(25,651)**	(38,902)
Provisions for liabilities and charges	**4,712**	14,373
Provisions utilised	**(5,383)**	(14,310)
Accretion of discounts and amortisation of premiums	**—**	(645)
	15,992	11,565

(b) Change in operating assets		
Change in prepayments and accrued income	**(50,566)**	(5,234)
Change in net trading securities and net derivatives	**(46,418)**	(109,005)
Change in loans and advances to banks	**50,034**	(91,263)
Change in loans and advances to customers	**(2,914,139)**	(2,249,441)
Change in other assets	**(628,027)**	(42,434)
	(3,589,116)	(2,497,377)

(c) Change in operating liabilities		
Change in accruals and deferred income	**13,447**	15,406
Change in deposits by banks	**(784,640)**	125,847
Change in customer accounts	**5,173,841**	1,521,087
Change in debt securities in issue	**765,964**	298,364
Change in other liabilities	**686,314**	46,780
	5,854,926	2,007,484

(d) Cash and cash equivalents comprise		
Cash and balances at central banks	**260,817**	246,455
Items in the course of collection from other banks	**132,752**	123,631
Loans and advances to banks of one month or less	**4,177,196**	1,576,331
Treasury bills, other bills and certificates of deposit less than three months	**19,757**	349,085
Less: items in the course of transmission to other banks	**(89,493)**	(66,016)
	4,501,029	2,229,486

31 Risk management

All of the group's activities involve analysis, evaluation and management of some degree of risk or combination of risks. The most important types of risk are market risk (which includes foreign exchange, interest rate, equity and commodity price risks), liquidity risk, operational risk and credit risk (which includes cross-border risk).

(a) Credit risk management

Credit risk is the risk that financial loss arises from the failure of a customer or counterparty to meet its obligations under a contract. It arises principally from lending, trade finance, treasury and leasing activities. HSBC has standards, policies and procedures dedicated to controlling and monitoring all such risks.

HSBC Holdings plc is responsible for the formulation of high-level credit policies. It also reviews the application of the HSBC Group's universal facility grading system. Historically, HSBC's risk rating framework has consisted of a minimum of seven grades, taking into account the risk of default and the availability of security or other credit risk mitigation. The first three of which are applied to differing levels of satisfactory risk. Accounts in grade 4 and 5 require different degrees of special attention and grades 6 and 7 indicate non-performing status. A more sophisticated risk rating framework for banks and other customers, based on default probability and loss estimates and comprising up to 22 categories, is being progressively implemented across the HSBC Group and is already operative in most major business units.

This new approach will increasingly allow a more granular analysis of risk and trends. Rating methodology is based upon a wide range of financial analytics together with market data-based tools which are core inputs to the assessment of counterparty risk. Although automated risk rating processes are increasingly in use, for the larger facilities ultimate responsibility for setting risk grades rests with the final approving executive in each case. Risk grades are reviewed frequently and amendments, where necessary, are implemented promptly.

The HSBC Group's credit risk limits to counterparties in the financial and government sectors are managed centrally to optimise the use of credit availability and to avoid excessive risk concentration. Cross-border risk is controlled through the imposition of country limits, which are determined by taking into account economic and political factors, and local business knowledge, with sub-limits by maturity and type of business. Transactions with counterparties in higher risk countries are considered on a case-by-case basis.

Within the overall framework of the HSBC Group policy, the bank has an established risk management process encompassing credit approvals, the control of exposures (including those to borrowers in financial difficulty), credit policy direction to business units and the monitoring and reporting of exposures both on an individual and a portfolio basis. Local management is responsible for the quality of its credit portfolios and follows a credit process involving delegated approval authorities and credit procedures, the objective of which is to build and maintain risk assets of high quality. Regular reviews are undertaken to assess and evaluate levels of risk concentration, including those to individual industry sectors and products.

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

Maximum exposure to credit risk

Maximum exposure to credit risk, collateral held or other credit enhancements

	At 31 December 2005		
	Carrying value US$000	***Off-balance sheet exposure US$000***	***Maximum exposure US$000***
Trading assets:			
— debt securities	**25,902**	**—**	**25,902**
Derivatives	**146,569**	**—**	**146,569**
Loans and advances to banks	**4,330,201**	**—**	**4,330,201**
Loans and advances to customers	**11,371,503**	**—**	**11,371,503**
Financial investments:			
— treasury and other similar bills	**145,451**	**—**	**145,451**
— debt securities	**835,964**	**—**	**835,964**
Other assets:			
— endorsements and acceptances	**560,364**	**—**	**560,364**
Financial guarantees and other credit related contingent liabilities	**—**	**16,528,736**	**16,528,736**
	17,415,954	**16,528,736**	**33,944,690**

Notes on the Financial Statements (continued)

31 Risk management *(continued)*

Collateral and other credit enhancements

Loans and advances

Where appropriate, the bank is required to implement guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and determine valuation parameters. Such parameters are expected to be conservative, reviewed regularly and be supported by empirical evidence. Security structures and legal covenants are subject to regular review to ensure that they continue to fulfil their intended purpose and remain in line with local market practice. While collateral is an important mitigant to credit risk, it is the HSBC Group's policy to establish that loans are within the customer's capacity to repay rather than to over rely on security. In certain cases, depending on the customer's standing and the type of product, facilities may be unsecured. The principal collateral types 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.

Other securities

Collateral held as security for financial assets other than loans and advances is determined by the structure of the instrument. Debt securities, treasury and other eligible bills are generally unsecured with the exception of asset backed securities and similar instruments, which are secured by pools of financial assets.

Concentrations of exposure

	2005	2004
	%	%
Middle East	**47.20**	63.90
United Kingdom	**13.40**	14.10
Rest of Continental Europe	**21.10**	13.80
Asia	**16.20**	0.10
United States	**2.10**	8.10
	100.00	100.00

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 highly diversified with no exposures to individual industries or economic groupings totalling more than 10 per cent of consolidated total assets, except as follows:

— the majority of the bank's exposure to credit risk is concentrated in the Middle East. Within the Middle East, the bank's credit risk is diversified over a wide range of industrial and economic groupings; and

— the bank'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 2005 and 31 December 2004 was concentrated in mainland Europe and the Middle East.

— 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.

31 Risk management *(continued)*

Credit quality

Loans and advances

Distribution of loans and advances, by facility grade, that are neither past due nor impaired as at 31 December 2005:

	At 31 December 2005	
	Loans and advances to customers	***Loans and advances to banks***
	US$000	***US$000***
Grade 1 — low risk	**1,821,748**	**3,077,034**
Grade 2 — satisfactory risk	**3,187,205**	**1,474,001**
Grade 3 — fair risk	**5,808,119**	**236,371**
Grade 4 — watch list	**445,895**	**51,251**
Grade 5 — sub-standard but not impaired	**72,831**	**—**
	11,335,798	**4,838,657**

Other securities

Debt securities and other bills by rating agency designation

The following table presents an analysis of debt and similar securities, other than loans, by rating agency designation at 31 December 2005, based on Standard and Poor's ('S&P') ratings or their equivalent:

	At 31 December 2005		
	Treasury bills	***Debt securities***	***Total***
	US$000	**US$000**	**US$000**
AAA	**94,888**	**8,998**	**103,886**
AA - to AA +	**—**	**18,629**	**18,629**
A - to A +	**—**	**317,106**	**317,106**
Lower than A -	**—**	**99,476**	**99,476**
Unrated	**50,563**	**417,657**	**468,220**
Total	**145,451**	**861,866**	**1,007,317**
Of which issued by:			
— governments	**138,587**	**615,945**	**754,532**
— corporates	**6,864**	**245,922**	**252,786**
Of which classified as:			
— held-for-trading debt securities	**—**	**25,902**	**25,902**
— available-for-sale securities	**145,451**	**835,965**	**981,416**

Impairment assessment

It is HSBC's policy that each operating company makes allowance for impaired loans promptly when required and on a consistent basis in accordance with established HSBC Group guidelines.

HSBC's rating process for credit facilities extended by members of the HSBC Group is designed to highlight exposures requiring greater management attention based on a higher probability of default and potential loss. Management particularly focuses on facilities to those borrowers and portfolio segments classified below satisfactory grades. Amendments to risk grades, where necessary, are required to be undertaken promptly. Management also regularly evaluates the adequacy of the established allowances for impaired loans by conducting a detailed review of the loan portfolio, comparing performance and delinquency statistics with historical trends and assessing the impact of current economic conditions.

Notes on the Financial Statements (continued)

31 Risk management *(continued)*

Two types of impairment allowance are in place: individually assessed and collectively assessed. These are discussed in Note 2.

HSBC Group policy requires a review of the level of impairment allowances on individual facilities that are above materiality thresholds at least half-yearly, and more regularly where individual circumstances require. This will normally include a review of collateral held (including re-confirmation of its enforceability) and an assessment of actual and anticipated receipts. For significant commercial and corporate debts, specialised loan 'work-out' teams with experience in insolvency and specific market sectors are used. This expertise enables likely losses on significant individual exposures to be assessed more accurately. Reversals on individually calculated impairment allowances are recognised whenever the HSBC Group has reasonable objective evidence that the established estimate of loss has been reduced.

Portfolio allowances are generally reassessed monthly and charges for new allowances, or releases of existing allowances, are calculated for each separately identified portfolio.

In relevant cases, impairment allowances will include an element in respect of cross-border exposures to countries assessed by management to be vulnerable to foreign currency payment restrictions. This assessment includes analysis of both economic and political factors existing at the time. Economic factors include the level of external indebtedness, the debt service burden and access to external sources of funds to meet the debtor country's financing requirements. Political factors taken into account include the stability of the country and its government, threats to security and the quality and independence of the legal system.

Non-performing loans

For individually assessed accounts, loans are designated as non-performing as soon as there is objective evidence that an impairment loss has been incurred. Objective evidence of impairment includes observable data such as when contractual payments of principal or interest are 90 days overdue. Portfolios of homogeneous loans are designated as non-performing if facilities are 90 days or more overdue.

Charge-offs

Loans (and the related impairment allowances) are normally charged off, either partially or in full, when there is no realistic prospect of recovery of these amounts and when the proceeds from the realisation of security have been received. Unsecured consumer facilities are normally charged off between 150 and 210 days overdue. There are no cases where the charge-off period exceeds 360 days except where certain consumer finance accounts are still deemed collectible beyond this point. In the case of bankruptcy, charge-off can occur earlier.

31 Risk management *(continued)*

Impaired loans

Individually impaired loans by industry sector

	At 31 December 2005	
	Gross loans and advances to customers	*Gross loans by industry sector as a % of total gross loans*
	US$000	*%*
Personal		
Residential mortgages	**1,277**	**0.01**
Other personal	**52,400**	**0.45**
Total personal	**53,677**	**0.46**
Corporate and commercial		
Commercial, industrial and international trade	**108,823**	**0.94**
Other property-related	**22,498**	**0.19**
Government	**5**	**0.00**
Other commercial	**71,263**	**0.61**
Total corporate and commercial	**202,589**	**1.74**
Financial		
Non-bank financial institutions	**1,437**	**0.01**
Total impaired loans and advances to customers	**257,703**	**2.21**

Impairment allowances

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

Movement in allowance accounts for total loans and advances

	At 31 December 2005		
	Individually assessed	*Collectively assessed*	*Total*
	US$000	*US$000*	*US$000*
At 1 January	**217,548**	**37,614**	**255,162**
Amounts written off	**(1,927)**	**(45,228)**	**(47,155)**
Recoveries of loans and advances written off in previous years	**6,190**	**—**	**6,190**
Charge to income statement	**(8,205)**	**36,881**	**28,676**
Exchange and other movements	**(47,184)**	**62,726**	**15,542**
At 31 December	**166,422**	**91,993**	**258,415**

Notes on the Financial Statements (continued)

31 Risk management *(continued)*

Impairment allowances against loans and advances to customers

	2005 %	2004 %
Total impairment allowances to gross lending[1]		
Individually assessed impairment allowances	**(0.06)**	0.40
Collectively assessed impairment allowances	**0.32**	0.07
Total provisions to gross lending		
Specific provisions	**1.42**	2.46
General provisions	**0.79**	0.43
Total	**2.47**	3.36

1 *Net of settlement accounts.*

Net impairment charge to income statement by geographical region

	Year ended 31 December 2005 *Middle East* *US$000*
Individually assessed impairment allowances	
New allowances	**16,084**
Release of allowances no longer required	**(18,100)**
Recoveries of amounts previously written off	**(6,190)**
	(8,206)
Collectively assessed impairment allowances	
New allowances	**59,398**
Release of allowances no longer required	**(7,206)**
Recoveries of amounts previously written off	**(15,310)**
	36,882
Total charge for impairment losses:	
— bank	**(1,740)**
— customer	**30,416**
Customer charge for impairment losses as a percentage of closing gross loans and advances	**0.26%**
31 December 2005	
Customer balances outstanding	
Non-performing loans	**294,323**
Impairment allowances	**257,703**

Net charge to the profit and loss account for bad and doubtful debts by geographical region

31 Risk management *(continued)*

	Year ended 31 December 2004 *Middle East* *US$000*
Specific provisions	
New provisions	65,197
Release of provisions no longer required	(18,053)
Recoveries of amounts previously written off	(12,634)
	34,510
General provisions	5,945
Total bad and doubtful debt charge:	
— bank	14
— customer	40,441
Customer bad and doubtful debt charge as a percentage of closing gross loans and advances	0.46%
31 December 2004	
Non-performing loans	327,430
Provisions	252,490

Renegotiated loans

Restructuring activity is designed to manage customer relationships, maximise collection opportunities and avoid foreclosure or repossession, if possible. Following restructuring, an overdue consumer account will normally be reset from delinquent to current status. Restructuring policies and practices are based on indicators or criteria which, in the judgement of local management, evidence the probability that payment will continue. These policies are continually reviewed and their application varies depending upon the nature of the market, the product and the availability of empirically based data. Where empirical evidence indicates an increased propensity to default on restructured accounts, the use of roll rate methodologies for the calculation of impairment allowances results in the increased default propensity being reflected in impairment allowances.

Renegotiated loans that would otherwise be past due or impaired

	2005 **US$000**
Loans and advances to customers	**23,965**
Loans and advances to banks	**1,299**
	25,264

(b) Liquidity and funding management

The bank maintains a diversified and stable funding base of core retail and corporate customer deposits as well as portfolios of highly liquid assets. The objective of the bank's liquidity and funding management is to ensure that all foreseeable funding commitments and deposit withdrawals can be met when due.

The Group's liquidity and funding management process includes:
- projecting cash flows by major currency and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity 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;
- 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

Notes on the Financial Statements (continued)

31 Risk management *(continued)*

— 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.

Core retail deposits (current accounts and savings deposits payable on demand or at short notice) form a significant part of the group's overall funding. Considerable importance is attached to this core deposit base which, over the years, has been stable and predictable. The HSBC Group prefers to grow its balance sheet through increasing core retail deposits where possible.

HSBC Global Markets is an important player in the money markets and debt capital markets. As a leading market maker in loans and deposits, the bank routinely accepts deposits, often of a short-term nature, from banks and other institutions and makes advances to similar organisations. In addition, the funding of capital markets activities, by repo arrangements for example, will often result in funding directly in the wholesale market.

It is, however, HSBC Group's policy that on an all-currency basis all professional deposits with residual maturities up to 30 days, plus 5 per cent of deposit liabilities should be backed by liquid assets. This means that, in a crisis, the group would be able to meet its obligations as they fall due for at least 30 days without recourse to the wholesale markets.

Throughout the group's operations, sufficient liquidity is maintained to meet their day-to-day needs and local regulatory requirements unless specific arrangements are made for Global Markets in Dubai or London to provide the necessary support.

Minimum liquidity ratio limits are set for each operating entity. Limits reflect the local market place, the diversity of funding sources available, and the concentration risk of large depositors.

(c) Market risk management

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.

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

Each operating entity is required to assess the market risks which arise 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 auspices 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 professionally manage such risks.

Value at risk ('VAR')

One of the principal tools used by HSBC to monitor and limit market risk exposure is 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 (for HSBC, 99 per cent). HSBC calculates VAR daily. The VAR model used by HSBC is predominantly based on historical simulation. The historical simulation model derives plausible future scenarios from historical market rates time series, taking account of inter-relationships between different markets and rates, for example between interest rates and foreign exchange rates. Potential movements in market prices are calculated with reference to market data from the last two years. HSBC has changed the assumed holding period from a 10-day period to a 1-day period as this reflects the way the risk positions are managed. Comparative VAR numbers have been re-stated to reflect this change.

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

— the use of historic data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;

31 Risk management *(continued)*

— the use of a 1-day holding period assumes that all positions can be liquidated or hedged in 1 day. This may not fully reflect the market risk arising from times of severe illiquidity, when a 1-day holding period may be insufficient to liquidate or hedge all positions fully;

— the use of a 99 per cent confidence level, by definition, does not take into account losses that might occur beyond this level of confidence; and

— VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

HSBC recognises these limitations by augmenting its VAR limits with other position and sensitivity limit structures. Additionally, HSBC applies a wide range of stress testing, both on individual portfolios and on the Group's consolidated positions. HSBC's stress-testing regime provides senior management with an assessment of the financial impact of identified extreme events on the market risk exposures of HSBC.

The VAR, both trading and non-trading, for Global Markets was as follows:

Total	**US$000**
At 31 December 2005	**2,535**
At 31 December 2004	2,284

	Average	Minimum	Maximum
	US$000	**US$000**	**US$000**
2005	**2,438**	**2,010**	**2,767**
2004	2,071	877	3,340

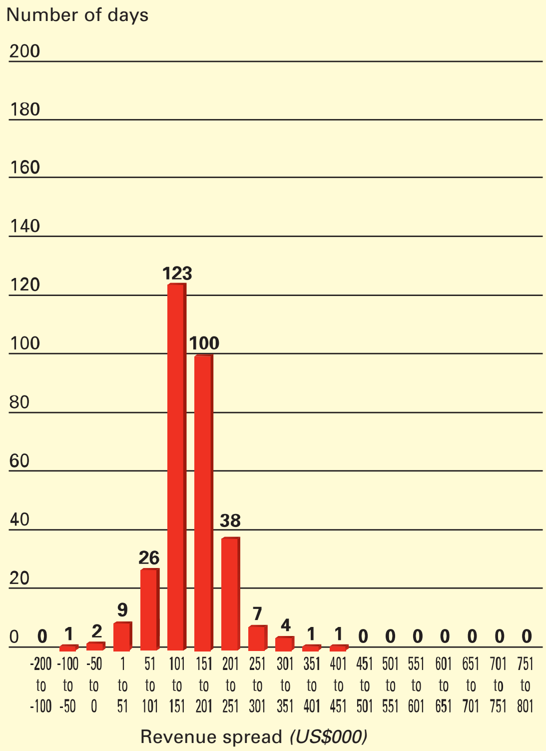
The daily revenue earned from market risk-related treasury activities includes accrual book net interest income and funding related to dealing positions. The histogram below illustrates the frequency of daily revenue arising from such market risk-related activities.

The average daily revenue earned from market risk-related treasury activities in 2005, including accrual book net interest income and funding of dealing positions, was US$152 thousand compared with US$153 thousand in 2004. The standard deviation of these daily revenues was US$58 thousand compared with US$46 thousand in 2004. The standard deviation measures the variation of daily revenues about the mean value of those revenues.

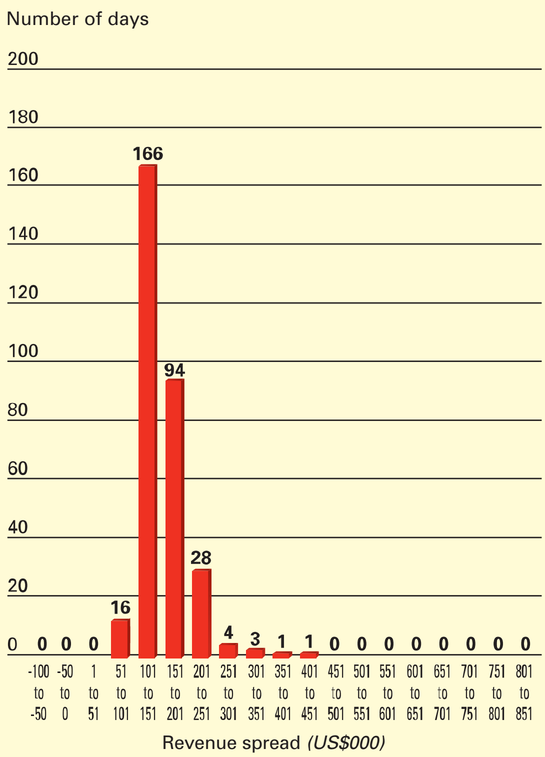
An analysis of the frequency distribution of daily revenues shows that there were 3 days with negative revenues during 2005 compared with no days in 2004. The most frequent result was a daily revenue of between US$101 thousand and US$151 thousand, with 123 occurrences.

Notes on the Financial Statements (continued)

Daily distribution of market risk revenues 2005
HSBC Bank Middle East Limited Treasury



Daily distribution of market risk revenues 2004
HSBC Bank Middle East Limited Treasury



Fair value and price verification control

Where certain financial instruments are carried on the group's balance sheet at fair values, the valuation and the related price verification processes are subject to careful governance across the group. Financial instruments which are accounted for on a fair value basis include assets held in the trading portfolio, financial instruments designated at fair value, obligations related to securities sold short and all derivative financial instruments.

The determination of fair values is therefore a significant element in the reporting of the group's Global Markets activities.

The responsibility for the determination of accounting policies and procedures governing valuation and validation ultimately rests with the HSBC Group Finance and the Corporate, Investment Banking and Markets Finance functions, which report to the HSBC Group Finance Director. All significant valuation policies, and any changes thereto, must be approved by senior finance management. HSBC's governance of financial reporting requires that:

Financial Control departments across the Group are independent of the risk-taking businesses, with the Finance functions having ultimate responsibility for the determination of fair values included in the financial statements, and for ensuring that the Group's policies and relevant accounting standards are adhered to. Both senior management and the HSBC Group Audit Committee assess the resourcing and expertise of Finance functions within the Group on a regular basis to ensure that the Group's financial control and price verification processes are properly staffed to support the required control infrastructure.

Trading

Market risk in trading portfolios is monitored and controlled at both portfolio and position levels using a complementary set of techniques, such as VAR and present value of a basis point, together with stress and sensitivity testing and concentration limits. These techniques quantify the impact on capital of defined market movements.

Other controls include restricting individual operations to trading within a list of permissible instruments authorised for each site by Traded Markets Development and Risk, and enforcing rigorous new product approval procedures. In particular, trading in the more complex derivative products is concentrated in offices with appropriate levels of product expertise and robust control systems.

31 Risk management *(continued)*

Total trading VAR by risk type

	Foreign US$000	Interest rate trading US$000	Total trading US$000
At 31 December 2005	**195**	**4**	**197**
At 31 December 2004	54	230	235
Average			
2005	**173**	**108**	**216**
2004	56	169	183
Minimum			
2005	**65**	**2**	**134**
2004	24	23	44
Maximum			
2005	**284**	**687**	**850**
2004	167	383	394

Non-trading

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

Market 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 optionality in certain product areas, for example, mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand, for example, current accounts. This prospective change in future net interest income from non-trading portfolios will be reflected in the current realisable value of these positions should they be sold or closed prior to maturity. In order to manage this risk optimally, market risk in non-trading portfolios is transferred to Global Markets or to separate books managed under the auspices of the local ALCO.

The transfer of market risk to trading books managed by Global Markets or ALCO is usually achieved by a series of internal deals between the business units and these trading books. When the behavioural characteristics of a product differ from its contractual characteristics, the behavioural characteristics are assessed to determine the true underlying interest rate risk. Local ALCOs regularly monitor all such behavioural assumptions and interest rate risk positions, to ensure they comply with interest rate risk limits established by the HSBC Group Management Board.

As noted above, in certain cases, the non-linear characteristics of products cannot be adequately captured by the risk transfer process. For example, both the flow from customer deposit accounts to more attractive investment products and the precise repayment levels of mortgages will vary at different interest rate levels. In such circumstances simulation modelling is used to identify the impact of varying scenarios on valuations and net interest income.

Once market risk has been consolidated in Global Markets or ALCO-managed books, the net exposure is typically managed through the use of interest rate swaps within agreed limits.

Net interest income

Future net interest income is affected by movements in interest rates. A principal part of the group's management of market risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). The group aims, through its management of market risk in non-trading portfolios, to mitigate the impact of prospective interest rate movements which could reduce future net interest income, whilst balancing the cost of such hedging activities on the current net revenue stream. For simulation modelling, businesses use a combination of scenarios relevant to local businesses and local markets as

31 Risk management *(continued)*

well as standard scenarios required to be used across the group. The standard scenarios are consolidated to illustrate the combined pro forma impact on the group's consolidated portfolio valuations and net interest income.

The impact on future net interest income of a 25 basis points parallel fall or rise in all yield curves worldwide in each quarter during the 12 month period from 1 January 2006 would decrease or increase planned net interest income by US$6,707 thousand ($2,683 thousand from 1 January 2005). These scenarios differ from those disclosed in the Annual Report and Accounts 2004 which assumed an immediate 100 basis points parallel rise or fall in all yield curves on the first day of the 12 month period. The revised scenarios, although still simplified, are considered more relevant.

The figures represent the effect of the pro forma movements in net interest income based on the projected yield curve scenarios and the group's current interest rate risk profile. This effect, however, does not incorporate actions that could be taken by Global Markets or in the business units to mitigate the impact of this interest rate risk. In reality, Global Markets would seek to proactively change the interest rate risk profile to minimise losses and optimise net revenues. The projections above also assume that interest rates of all maturities move by the same amount and, therefore, do not reflect the potential impact on net interest income of some rates changing while others remain unchanged. The projections also make other simplifying assumptions, including that all positions run to maturity.

The group's core exposure to changes in its net interest income arising from movements in interest rates falls into two areas: core deposit franchises and Global Markets.

— Core deposit franchises: these are exposed to changes in the value of the deposits raised and spreads against wholesale funds; in a low interest rate environment, the value of core deposits increases as interest rates rise and decreases as interest rates fall. This risk is, however, asymmetrical in a very low interest rate environment as there is limited room to lower deposit pricing in the event of interest rate reductions.

— Global Markets: the residual interest rate risk is managed within Global Markets. This reflects the group's policy of transferring all interest rate risk, other than structural risk, to Global Markets to be managed within defined limits and with flexibility as to the instruments used.

The major drivers of the changes shown in the projected effect of interest rate moves are set out below.

— Reinvestment rates — for the purpose of the sensitivity projections, it has been assumed maturing interest earning assets and interest bearing liabilities replenish at the prevailing market rates and on similar terms.

— The projected movements from rate changes are computed assuming simultaneous change in customer rates.

— Economic environment — the projected effect of interest rate moves assumes no significant changes in the existing economic environment, interest rate and exchange rate policies of the regions where the group operates.

It can be seen from the above that projecting the movement in net interest income from prospective changes in interest rates is a complex interaction of structural and managed exposures. In a rising rate environment, the most critical exposures are those managed within Global Markets.

Additionally, the group considers a principal risk to future net interest income to be a general flattening of yield curves at a low level of interest rates, as this reduces the value of the deposit franchise and limits the opportunities within Global Markets.

Following the adoption of IFRS, the group monitors the sensitivity of reserves to interest rate movements on a monthly basis by assessing the expected reduction in valuation of available-for-sale portfolios and cashflow hedges due to parallel movements of plus or minus 100bps in all yield curves. The table below describes the sensitivity to these movements at 31 December 2005 and the maximum and minimum month figures during the year then ended:

31 Risk management *(continued)*

	At 31 December 2005 US$000	Maximum impact US$000	Minimum impact US$000
+ 100 basis point parallel move all in yield curves	**(3,552)**	**(5,183)**	**(3,552)**
As a percentage of shareholders funds at 31 December 2005	**(0.28) %**	**(0.41) %**	**(0.28) %**
- 100 basis point parallel move all in yield curves	**3,552**	**5,183**	**3,552**
As a percentage of shareholders funds at 31 December 2005	**0.28 %**	**0.41 %**	**0.28 %**

Structural foreign exchange exposures

Structural foreign exchange exposures represent net investments in subsidiaries, branches or associated undertakings, the functional currencies of which are currencies other than the US dollar or Gulf currencies linked to the US dollar.

Revaluation gains and losses on structural exposures are recorded in the statement of total consolidated recognised income and expenses. The main operating (or functional) currencies of the group are UAE dirhams and other Gulf currencies linked to the US dollar.

The group's structural foreign currency exposures are managed with the primary objective of ensuring, where practical, that the group's tier 1 capital ratio is protected from the effect of changes in exchange rates. This is usually achieved by holding qualifying tier 1 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 tier 1 capital ratio or the US dollar value of capital invested. Such hedging would be undertaken using forward foreign exchange contracts or by financing with borrowings in the same currencies as the functional currencies involved.

As the group is generally able to balance adequately foreign currency tier 1 capital with foreign currency risk-weighted assets, the group's foreign currency structural exposures are usually unhedged, including exposures due to foreign-currency-denominated profits arising during the year.

(d) Operational risk management

Operational risk is the risk of loss arising from fraud, unauthorised activities, error, omission, inefficiency, systems failure or external events. It is inherent to every business organisation and covers a wide spectrum of issues.

The group manages this risk through a controls-based environment in which processes are documented, authorisation is independent and transactions are reconciled and monitored. This is supported by an independent programme of periodic reviews undertaken by Internal Audit, and by monitoring external operational risk events, which ensure that the group stays in line with best practice and takes account of lessons learned from publicised operational failures within the financial services industry.

The HSBC Group has codified its operational risk management process by issuing a high level standard, supplemented by more detailed formal guidance issued in January 2005. This explains how the HSBC Group manages operational risk by identifying, assessing, monitoring, controlling and mitigating the risk, rectifying operational risk events, and implementing any additional procedures required for compliance with local regulatory requirements. The processes undertaken to manage operational risk are determined by reference to the scale and nature of each HSBC Group operation. The HSBC Group standard covers the following:

— Operational risk management responsibility is assigned at senior management level within the business operation;

— Information systems are used to record the identification and assessment of operational risks and generate appropriate, regular management reporting;

— Operational risks are identified by assessments covering operational risks facing each business and risks

31 Risk management *(continued)*

inherent in processes, activities and products. Risk assessment incorporates a regular review of identified risks to monitor significant changes;

— Operational risk loss data is collected and reported to senior management. Aggregate operational risk losses are recorded and details of incidents above a materiality threshold are reported to the Group Audit Committee and the Risk Management Meeting; and

— Risk mitigation, including insurance, is considered where this is cost-effective.

Local management is responsible for implementing the HSBC Group standard on operational risk throughout their operations and, where deficiencies are evident, rectifying them within a reasonable timeframe.

The group maintains and tests contingency facilities to support operations in the event of disasters. Additional reviews and tests are conducted in the event that any HSBC office is affected by a business disruption event to incorporate lessons learned in the operational recovery from those circumstances.

(e) Capital management

The Jersey Financial Services Commission (JFSC) supervises the group on a consolidated basis and, as such, receives information on the capital adequacy of, and sets capital requirements for, the group 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 and banking group to maintain a ratio of total capital to risk-weighted assets taking into account both balance sheet assets and off-balance sheet transactions.

The group's capital is divided into two tiers:

— Tier 1 capital comprises shareholders' funds and minority interests in tier 1 capital, 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 (previously, general provisions) and reserves arising from the revaluation of properties.

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 per cent 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.

Following the implementation of IFRS, there will be changes to the measurement of banks' capital adequacy in a number of ways. The most significant of these changes for the group is that under IFRS, dividends are not recognised on the balance sheet until they are declared. This gives rise to an increase in shareholders' funds at the reporting date compared with the previous accounting, which is reversed when the relevant dividend is subsequently declared. Banks reflect the benefit of this increase in their regulatory capital until the dividend declaration, in line with the accounting treatment.

The group complied during the period with the JFSC's capital adequacy requirements, with one exception. A short-term substantial long US dollar position arose in the UAE as a result of demand for UAE dirhams required by foreign investors for subscription in a major regional IPO in which the group was a receiving bank. Such positions are not risk-weighted in the UAE, but are risk weighted under the JFSC's regulations. The UAE

31 Risk management *(continued)*

dirhams/US$ peg means that such positions have minimal economic risk, however this position caused the JFSC's regulatory minimum capital adequacy ratio to be temporarily breached. This breach was taken very seriously and after advising the JFSC, consequential capital injections totalling US$200 million were made and enhanced monitoring and changes to internal operational guidelines were agreed and implemented to address the deficiencies which caused this exception.

(f) Reputational risk management

The safeguarding of HSBC's reputation is of paramount importance to its continued prosperity and is the responsibility of every member of staff. Reputational risks can arise from social, ethical or environmental issues, or as a consequence of operational risk events. As a banking group, HSBC's good reputation depends upon the way in which it conducts its business, but it can also be affected by the way in which clients, to whom it provides financial services, conduct themselves.

Reputational risks are considered and assessed by the HSBC Board, the HSBC Group Management Board, the HSBC Risk Management Meeting, subsidiary company boards, board committees and/or senior management during the formulation of policy and the establishment of HSBC standards. Standards on all major aspects of business are set for HSBC and for individual subsidiaries, businesses and functions. These policies, which are an integral part of the internal control systems, are communicated through manuals and statements of policy and are promulgated through internal communications and training. The policies set out operational procedures in all areas of reputational risk, including money laundering deterrence, environmental impact, anti-corruption measures and employee relations.

Management in all operating entities is required to establish a strong internal control structure to minimise the risk of operational and financial failure, and to ensure that a full appraisal of reputational implications is made before strategic decisions are taken. The HSBC Group internal audit function monitors compliance with policies and standards.

32 Contingent liabilities and contractual commitments

(a) Contingent liabilities and commitments

Contract amounts	**2005** **US$000**	2004 US$000
Contingent liabilities:		
Acceptances and endorsements	**—**	532,324
Guarantees and assets pledged as collateral security:		
— guarantees and irrevocable letters of credit	**4,251,725**	2,456,505
Other contingent liabilities	**—**	700
	4,251,725	2,989,529
Commitments:		
Documentary credits and short-term trade-related transactions	**925,191**	845,956
Undrawn formal standby facilities, credit lines and other commitments to lend:		
— over 1 year	**653,783**	937,284
— 1 year and under	**11,118,332**	5,335,470
	12,697,306	7,118,710

The above table discloses the nominal principal amounts of off-balance sheet transactions.

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

Notes on the Financial Statements (continued)

32 Contingent liabilities and contractual commitments *(continued)*

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

	2005	2004
	US$000	US$000
Guarantees and assets pledged by the bank as collateral security	**420,295**	162,964
Documentary credits and short-term trade-related transactions	**3,301**	42,510
	423,596	205,474

(b) 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 2005 were as follows:

	At 31 December 2005		At 31 December 2004	
	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				
Acceptances and endorsements[1]	**—**	**—**	532,324	—
Financial guarantees[2]	**318,081**	**108,120**	235,098	24,180
Standby letters of credit which are financial guarantees[3]	**350,091**	**—**	257,150	—
Other direct credit substitutes[4]	**119,945**	**—**	60,835	—
Performance bonds[5]	**1,603,520**	**176,717**	816,016	77,670
Bid bonds[5]	**253,671**	**70,985**	189,264	18,407
Other transaction-related guarantees[5]	**1,186,122**	**64,473**	735,178	42,707
Total	**3,831,430**	**420,295**	2,825,865	162,964

1 *Acceptances and endorsements arise when the group agrees to guarantee payment on a negotiable instrument drawn up by a customer. The accepted instrument is then sold into the market on a discounted basis. From 1 January 2005, acceptances and endorsements are recognised on-balance sheet in 'Other assets' and 'Other liabilities' as a result of the adoption of IAS 32.*

2 *Financial guarantees include undertakings to fulfill the obligations of customers or group entities should the obligated party fail to do so. Intra-group financial guarantees include a guarantee of a capital nature issued by the group to a group entity for inclusion as capital support by the latter's regulator.*

3 *Standby letters of credit which are financial guarantees are irrevocable obligations on the part of the bank to pay a third party when a customer fails to meet a commitment.*

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

5 *Performance bonds, bid bonds and other transaction-related guarantees are undertakings by which the requirement to make payment under the guarantee depends on the outcome of a future event which is unconnected to the creditworthiness of the customer.*

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. Approximately 90 per cent of the above guarantees have a term of less than one year. Guarantees with terms of more than one year are subject to the group's annual credit review process.

32 Contingent liabilities and contractual commitments *(continued)*

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. At 31 December 2005, the group held collateral of US$98,657 thousand (2004: US$126,502 thousand) from which amounts paid under the guarantees disclosed above could be recovered.

The group had commitments to purchase from a number of suppliers within one year, land and buildings and other fixed assets for a value of US$8,018 thousand at 31 December 2005 (2004: US$10,735 thousand).

(c) 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 while it is impossible to ascertain the ultimate legal and financial liability with respect to these contingencies, their eventual outcome is not expected to materially affect the group's financial position and operations.

33 Lease commitments

(a) Finance lease commitments

	2005			2004		
	Total future payments US$000	***Interest charges US$000***	***Present value US$000***	*Total future payments US$000*	*Interest charges US$000*	*Present value US$000*
No later than one year	**494**	**—**	**494**	494	—	494
Later than one year and no later than five years	**2,472**	**—**	**2,472**	2,472	—	2,472
Later than five years	**3,203**	**—**	**3,203**	3,529	—	3,529
	6,169	**—**	**6,169**	6,495	—	6,495

(b) Operating lease commitments

At 31 December 2005, 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.

	2005	2004
Annual commitments under non-cancellable operating leases were:	**US$000**	US$000
Land and buildings expiring:		
— no later than one year	**319**	323
— later than one year and no later than five years	**6,253**	4,102
— later than five years	**2,538**	928
	9,110	5,353

In 2005, US$9,752 thousand (2004: US$6,533 thousand) was charged to 'General and administrative expenses' in respect of lease agreements related to minimum lease payments.

(c) Lease receivables

	2005			2004		
	Total future payments US$000	***Interest charges US$000***	***Present value US$000***	*Total future payments US$000*	*Interest charges US$000*	*Present value US$000*
No later than one year	**9,361**	**(3,311)**	**6,050**	7,127	(252)	6,875
Later than one year and no later than five years	**117,525**	**(9,266)**	**108,259**	83,179	(3,642)	79,537
Later than five years	**7,848**	**(794)**	**7,054**	7,828	(680)	7,148
	134,734	**(13,371)**	**121,363**	98,134	(4,574)	93,560

Notes on the Financial Statements (continued)

33 Lease commitments *(continued)*

Amounts receivable under operating leases

	2005	2004
Future minimum lease payments under non-cancellable operating leases were:	**US$000**	US$000
Land and buildings expiring:		
— no later than one year	**90**	87

34 Litigation

The bank, through a number of its branches, is named in and is defending legal actions in various jurisdictions arising from its normal business. None of these proceedings is regarded as material litigation.

35 Related party transactions

(a) Transactions, arrangements and agreements involving Directors and others

	2005			2004		
	Number of persons US$000	***Highest balance during the year[1] US$000***	***Balance at year end[1] US$000***	*Number of persons US$000*	*Highest balance during the year[1] US$000*	*Balance at year end[1] US$000*
Directors and connected persons and companies controlled by them						
Loans	**1**	**144**	**144**	1	65	48
Credit card transactions	**1**	**13**	**13**	1	11	5
	2	**157**	**157**	2	76	53

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.

35 Related party transactions *(continued)*

(b) Transactions with other related parties

	2005		2004	
	Highest balance during the year [1]	***Balance at the year end*** [1]	*Highest balance during the year* [1]	*Balance at the year end* [1]
Amounts due from associates:	***US$000***	***US$000***	*US$000*	*US$000*
— Subordinated	**15,415**	**15,415**	15,415	15,415
— Unsubordinated	**10**	**—**	24	24
	15,425	**15,415**	15,439	15,439
Amounts due to associates	**31,005**	**4,095**	2,736	864

	2005		2004	
	Highest balance during the year [1]	***Balance at the year end*** [1]	*Highest balance during the year* [1]	*Balance at the year end* [1]
Subsidiaries	***US$000***	***US$000***	*US$000*	*US$000*
Assets:				
Cash and balances at central banks	**15**	**15**	22	12
Trading assets	**176,759**	**176,759**	173,390	148,056
Loans and advances to banks	**105**	**45**	1,342	1,342
Loans and advances to customers	**509,297**	**508,685**	423,937	423,937
Financial investments	**17,613**	**17,613**	5,414	5,414
Intangible assets	**836**	**672**	984	878
Property, plant and equipment	**141**	**119**	529	141
Other assets	**64,271**	**42,432**	44,205	40,981
Prepayments and accrued income	**4,038**	**3,837**	3,412	2,812
Liabilities:				
Items in the course of transmissionto other banks	**3,224**	**3,224**	2,618	2,566
Other liabilities	**701,984**	**701,984**	579,050	579,050
Accruals and deferred income	**2,662**	**1,127**	3,359	3,167
Provisions for liabilities and charges	**24**	**—**	81	24
Income Statement:				
Interest income	**10,346**	**36,780**	7,741	27,782
Interest expense	**(4,853)**	**(15,519)**	(2,447)	(7,455)
Trading income	**230**	**11**	34	34
Gains less losses from financial investments	**1,857**	**1,975**	1,336	1,414
Dividend income	**285**	**496**	—	—
Fee income	**1,462**	**5,132**	3,576	8,032
Fee expense	**(1,007)**	**(2,988)**	(768)	(2,472)
Other operating income	**383**	**916**	236	578
Loan impairment charges and other credit risk provisions	**1,409**	**1,237**	1,074	2,450
General and administrative expenses	**3,668**	**(13,603)**	(6,214)	(15,877)

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.*

Notes on the Financial Statements (continued)

36 Ultimate holding company

The group's ultimate holding company is HSBC Holdings plc, which is registered in England.

The largest and smallest group in which the financial statements of the bank are consolidated is that headed by HSBC Holdings plc. Copies of the HSBC Holdings plc Annual Review 2005 and/or Annual Report and Accounts 2005 may be obtained by writing to Group Corporate Affairs, HSBC Holdings plc, 8 Canada Square, London E14 5HQ, United Kingdom; or from the HSBC web site, www.hsbc.com

37 Events after the balance sheet date

On 26 January 2006, the Directors allotted to HSBC Bank Middle East Limited's sole shareholder 100,000,000 ordinary shares of US$1.00 each at par.

On 27 February 2006, the Board of Directors authorised the financial statements for issue.

38 Transition to IFRSs

Key impact analysis on the opening balance sheet as at 1 January 2005

HSBC Bank Middle East Limited previously prepared its primary financial statements under UK GAAP, which differs in certain significant respects from IFRS. The following is a summary of the main differences applicable to HSBC Bank Middle East Limited:

IAS 19 'Employee Benefits' ('IAS 19')

IAS 19 requires pension fund assets to be assessed at fair value and liabilities on the basis of current actuarial assumptions using the projected unit credit method. As permitted by an amendment to IAS 19 approved by the IASB and expected to be endorsed by the EU, HSBC Bank Middle East Limited has elected to recognise all actuarial gains and losses directly in retained earnings.

IAS 10 'Events after the Balance Sheet Date' ('IAS 10')

Under IAS 10, equity dividends declared after the balance sheet date are not included as a liability at the balance sheet date. Accordingly, HSBC Bank Middle East Limited has reversed the liability for proposed dividends at each balance sheet date.

IAS 17 'Leases' ('IAS 17')

IAS 17 requires that unearned income on finance leases be taken to income at a rate calculated to give a constant rate of return on the net investment in the lease, with no account taken in calculating the net investment of the tax effects of the lease. In general, this leads to a deferral of finance income compared with the pattern of recognition under UK GAAP, where income is recognised at a constant rate of return on the net cash investment in the lease including the effect of tax.

Under UK GAAP, assets leased out under operating leases are depreciated over their useful lives so that, for each asset, rentals less depreciation are recognised at a constant periodic rate of return on the net cash invested in that asset. Under IFRS, operating leased assets are depreciated to ensure that in each period the depreciation charge is at least equal to that which would have arisen on a straight-line basis.

Under UK GAAP, leasehold land was separately identified within the valuation of land and buildings. IFRS generally requires leasehold land to be treated as held under an operating lease unless title is expected to pass to the lessee at the end of the lease. No revaluation is permitted in respect of such owner-occupied operating lease assets. HSBC Bank Middle East Limited has classified as operating leases all land and buildings held under leases whose unexpired portion is less than 500 years.

IFRS 2 'Share-based Payment' ('IFRS 2')

IFRS 2 requires companies to adopt a fair-value-based method of accounting for share-based compensation plans which takes into account vesting conditions related to market performance, for example total shareholder return. Under this method, compensation cost is measured at the date of grant based on the assessed value of the award and is recognised over the service period, which is usually the vesting period.

In respect of other vesting conditions, an estimate of the number of options that will lapse before they vest is made at grant date and adjustments to this estimate are made over the service period. Accordingly, the expense recognised reflects, over time, the actual number of lapsed options for non-market performance-related conditions.

There is no exemption under IFRS 2 for Save-As-You-Earn schemes, as existed under UK GAAP.

IAS 12 'Income Taxes' ('IAS 12')

Under IAS 12, deferred tax liabilities and assets are generally recognised in respect of all temporary differences except where expressly prohibited by the Standard, subject to an assessment of the recoverability of deferred tax assets. Deferred tax assets are recognised to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilised.

In addition, unremitted earnings from subsidiaries and associates operating in lower tax jurisdictions result in a deferred tax liability unless the reporting entity is able to control the timing of the reversal of temporary differences and it is probable that the temporary differences will not reverse in the foreseeable future.

Under IFRS, fair value adjustments made on acquisition are tax-effected in order to present profitability on a tax-equalised basis: under UK GAAP no tax adjustments were required for items which did not affect the amount of tax payable or recoverable.

IAS 38 'Intangible Assets' ('IAS 38')

Where intangible assets have an indefinite useful life, or are not yet ready for use, they are tested for impairment annually. This impairment test may be performed at any time during an annual period, provided it is performed at the same time every year. An intangible asset recognised during the current period is tested before the end of the current annual period.

IAS 38 further requires costs incurred in the development phase of a project to produce application software for internal use to be capitalised and amortised over the software's estimated useful life if the software will generate probable future economic benefits, and such costs can be measured reliably. Under UK GAAP these costs were expensed as incurred. The capitalisation of software previously expensed in full results in a decrease in general and administrative expenses and an increase in depreciation and amortisation charged in respect of capitalised software in the form of regular, ongoing amortisation and any impairment charge.

IAS 16 'Property, Plant and Equipment' ('IAS 16')

HSBC Bank Middle East Limited has adopted the 'cost' model by which assets are carried at cost less any accumulated depreciation and impairment losses. HSBC Bank Middle East Limited has also applied the exemption in IFRS 1 which allows fair value at the date of transition to IFRS to be used as deemed cost for the value of property in most circumstances.

IAS 21 'The Effects of Changes in Foreign Exchange Rates' ('IAS 21')

IAS 21 states that in consolidated financial statements, all exchange differences arising on the retranslation of foreign operations with functional currencies which differ from the entity's reporting currency should be recognised as a separate component of equity, in the foreign exchange reserve.

On disposal of a foreign operation, the exchange differences previously recognised in reserves in relation to that operation are recognised in the income statement for the period.

As permitted by IFRS 1, HSBC Bank plc has deemed cumulative translation differences at 1 January 2004 to be zero.

Notes on the Financial Statements (continued)

38 Transition to IFRSs *(continued)*

Reconciliation of previously reported profit attributable to shareholders under UK GAAP to profit attributable to shareholders under IFRSs for the year ended 31 December 2004

	Year ended 31 December 2004 US$000
Profit before tax under UK GAAP	310,185
Interest payable	(6,944)
Employee compensation	912
Retirement benefits	(1,402)
Share of income in associates	(1,876)
Share of tax in associates	(3,528)
Profit before tax under IFRSs	297,347
Tax — UK GAAP	(58,141)
Tax — IFRSs adjustments	(107)
Share of tax in associates	3,528
Minority interests — UK GAAP	(2,152)
Profit attributable to shareholders under IFRSs	240,475

Reconciliation of previously reported shareholders' funds under UK GAAP to total shareholders' equity under IFRSs at 31 December 2004

	At 31 December 2004 US$000	At 1 January 2004 US$000
Shareholders' funds as previously reported under UK GAAP	1,270,377	927,443
Non-equity share capital and non-equity share premium reclassification	(400,000)	(300,000)
Dividends	—	20,000
Other	(2,121)	2,134
Tax	(2,688)	(2,703)
Total shareholders' equity under IFRSs	865,568	646,874

39 Key Impact Analysis on Opening Balance Sheet as at 1 January 2005

The opening balance sheet has been prepared in accordance with the parts of the Basis of preparation and Accounting polices notes set out in pages 12 to 29 which were applicable as at 1 January 2005.

Reconciliation of previously reported shareholders' funds under UK GAAP to total shareholders' equity under IFRSs at 1 January 2005

	At 1 January 2005 US$000
Shareholders' funds as previously reported under UK GAAP	1,270,377
Non IAS 32, IAS 39 and IFRS 4 adjustments	(404,809)
Total shareholders' equity under IFRSs excluding IAS 32, IAS 39 and IFRS 4	865,568
IAS 32, IAS 39 and IFRS 4 adjustments	
Investment securities	16,161
Tax	(282)
Total shareholders' equity under IFRSs	**881,447**

39 Key Impact Analysis on Opening Balance Sheet as at 1 January 2005 *(continued)*

Explanation of differences

Investment securities

Debt securities and equity shares intended to be held on a continuing basis under UK GAAP were disclosed as investment securities and included in the balance sheet at cost less provision for any permanent diminution in value. Other debt securities and equity shares held for trading purposes were included in the balance sheet at market value.

Under IAS 39, all investment securities (debt securities and equity shares) are classified and disclosed within one of the following three categories: 'held-to-maturity'; 'available-for-sale'; or 'at fair value through profit or loss'. Securities previously classified as held-for-trading purposes remain so classified. The accounting treatment for each of the categories above under IFRSs is described in Note 2, Principal accounting policies. On transition to IFRSs, under IAS 39 HSBC Bank plc classified most of its investment securities as available-for-sale. This resulted in an available-for-sale reserve of US$6,239 thousand, representing the cumulative unrealised gain on these securities being recorded within shareholders' equity.

Non-equity share capital and non-equity share premium reclassification

Preference shares were previously classified in the balance sheet as non-equity share capital and non-equity share premium with preference share dividends recorded as non-equity dividends in the income statement. Under IAS 32, preference shares are generally classified in the balance sheet as liabilities. This had the impact of increasing liabilities by US$400,000 thousand at 1 January 2005.

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Manama *Main Office*
Adliya
Muharraq
Manama *Offshore Banking Unit*

Iran
Tehran *Representative Office*

Jordan
Western Amman *Main Office*
Jebel Hussein

Kuwait
Kuwait City *Main Office*

Lebanon
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Deira
Jebel Ali

Fujairah
Fujairah

Ras Al Khaimah
Ras Al Khaimah

Sharjah
Sharjah

PRINCIPAL SUBSIDIARY COMPANIES

HSBC Financial Services (Middle East) Limited
Dubai

HSBC Middle East Finance Company Limited
Dubai *Main Office*
Abu Dhabi
Al Ain
Ras Al Khaimah

ASSOCIATED COMPANIES

Arabian Real Estate Investment Trust Management Limited
Cayman Islands

British Arab Commercial Bank Limited*
London

Rewards Management Middle East Free Zone Limited Liability Company*
Dubai

SPECIAL CONNECTIONS EXIST WITH

Dar Es Salaam Investment Bank
Baghdad *Head Office*
and 13 branches

HSBC Bank plc
Cyprus

HSBC Bank Egypt S.A.E
Cairo *Head Office,* 22 other branches
and 8 mini-bank units

Gibbs Gulf Insurance Consultants Limited

HSBC Insurance Brokers Limited

HSBC Bank International Limited

HSBC Investment Company (Egypt) S.A.E

HSBC Securities (Egypt) S.A.E.

The Hongkong and Shanghai Banking Corporation Limited
Muharraq *Offshore Banking Unit*

The Saudi British Bank*
Riyadh *Head Office,* 72 other branches
including 12 sections or branches for
ladies

** HSBC Group associated company.*

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