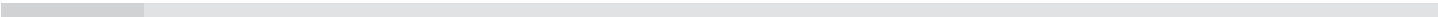


# 2008

HSBC Bank Middle East Limited  
Annual Report and Accounts

HSBC   
The world's local bank





## Annual Report and Accounts 2008

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### Presentation of Information

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This document comprises the Annual Report and Accounts 2008 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.

## Report of the Directors

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### Board of Directors

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Y A Nasr, <i>Chairman and Chief Executive</i>	M M Hussain
W A Boustany	C J M Keirle
J B Blanthorne	C M Meares
J E Coverdale	J C Perry
Abdel Salam El Anwar	J C Tibbo

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

During the year, W A Boustany was appointed as a Director with effect from 18 February 2008, and J C Perry was appointed as a Director with effect from 1 December 2008.

Also during the year, D H Hodgkinson resigned as a Director and as Chairman with effect from 1 December 2008, and Y A Nasr was appointed as Chairman, also with effect from 1 December 2008.

### Principal activities

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

### New branch network

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With effect from 16 May 2008, the bank purchased, at net book value, the entire branch network in Pakistan from The Hongkong and Shanghai Banking Corporation Limited for US\$62,853 thousand.

### Profit and dividends

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The profit attributable to the shareholders amounted to US\$ 965,610 thousand (2007: 703,967 thousand), and has been dealt with as set out in the Consolidated Income Statement on page 7.

A second interim equity dividend for the year 2007 of US\$100,000 thousand was declared, but subsequently rescinded, during the year. Also during the year, a first interim equity dividend for 2008 of US\$250,000 thousand (2007: US\$150,000 thousand) was declared and paid.

### Total share capital

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On 21 July 2008, the Bank's authorised share capital was increased from US\$1,001,250 thousand, divided into 1,000,000 thousand ordinary shares of US\$1.00 each and 1,250 thousand cumulative redeemable preference shares of US\$1.00 each, to US\$1,502,500 thousand, divided into 1,500,000 thousand ordinary shares of US\$1.00 each and 2,500 thousand cumulative redeemable preference shares of US\$1.00 each.

### Equity share capital

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On 27 June 2008, the Bank issued 200,000 thousand ordinary shares of US\$1.00 each, fully paid, at par.

### Debt securities and non-equity preference share capital

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On 8 January 2008, the Bank established a Sukuk Issuance Programme, providing for the issue of up to US\$5,000,000,000 in securities in the form of Shari'a-compliant Trust Certificates. No such Trust Certificates were issued during the year.

On 17 January 2008, the Bank's Debt Issuance Programme, originally established in 2004 and providing for the issue of up to US\$1,000,000 thousand in debt securities in the form of medium-term Notes, and extended in 2006 to provide for the issue of up to US\$3,000,000 thousand in debt securities in similar form, was extended to provide for the issue of up to US\$7,000,000 thousand in debt securities in similar form.

On 28 April 2008, the Bank issued 200,000 cumulative redeemable preference shares of US\$1.00 each, fully paid and at a premium of US\$999.00 per share.

On 30 April 2008, the Bank issued AED2,250,000 thousand Floating Rate Notes due 30 April 2013, under its Debt Issuance Programme.

On 17 July 2008, also under its Debt Issuance Programme, the Bank completed a re-opening and tap, amounting to an additional AED750,000 thousand, to its AED2,250,000 thousand Floating Rate Notes due 30 April 2013 originally issued on 30 April 2008.

On 31 July 2008, the Bank issued 300,000 cumulative redeemable preference shares of US\$1.00 each, fully paid and at a premium of US\$999.00 per share.

On 22 December 2008, also under its Debt Issuance Programme, the Bank issued SAR542,500 thousand Floating Rate Notes due December 2010.

Since the year-end, on 28 January 2009, the Bank has executed a buy-back of AED295,000 thousand of the AED3,000,000 thousand Floating Rate Notes due 30 April 2013, originally issued under its Debt Issuance Programme on 30 April 2008 and 17 July 2008, respectively.

### **Annual General Meeting**

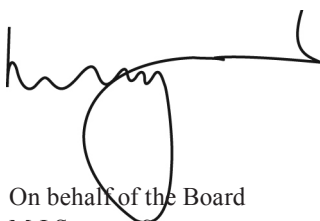
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On 3 November 2008, the Bank's shareholders agreed, in accordance with the powers conferred by Article 87(4) of the Companies (Jersey) Law 1991, as amended, to dispense in future with the necessity for the Bank to hold Annual General Meetings.

### **Auditors**

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The auditors, KPMG Channel Islands Limited, are, the Bank's shareholders having agreed to dispense with the necessity for the Bank to hold Annual General Meetings, deemed to be re-appointed, and continue in office at fees to be agreed by the Directors.



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

16 February 2009

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

The following statement, which should be read in conjunction with the Auditors' statement of their responsibilities set out in their report on page 4, is made with a view to distinguishing for shareholders the respective responsibilities of the Directors and of the Auditors in relation to the financial statements.

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

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

- select suitable accounting policies and apply them consistently;
- make judgments and estimates which are reasonable and prudent;
- state whether they have been prepared in accordance with International Financial Reporting Standards as adopted by the EU;
- 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, the Financial Services (Trust Company and Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2007 and the Financial Services (Fund Services Business (Accounts, Audits and Reports)) (Jersey) Order 2007. 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.



Y A Nasr, *Chairman and Chief Executive*

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

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We have audited the group financial statements ("the financial statements") of HSBC Bank Middle East Limited for the year ended 31 December 2008 which comprise the Consolidated Income Statement, the Consolidated Balance Sheet, the Consolidated Statement of Recognised Income and Expense, the Consolidated Cash Flow Statement 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 members, 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**

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As described in the Statement of Directors' Responsibilities on page 4, 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, the Financial Services (Trust Company and Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2007 and the Financial Services (Fund Services Business (Accounts, Audits and Reports)) (Jersey) Order 2007.

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**

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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

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In our opinion the financial statements:

- give a true and fair view, in accordance with International Financial Reporting Standards, of the state of the groups affairs as at 31 December 2008 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, the Financial Services (Trust Company and Investment Business (Accounts, Audits and Reports)) (Jersey) Order 2007 and the Financial Services (Fund Services Business (Accounts, Audits and Reports) (Jersey)) Order 2007.

*KPMG Channel Islands Limited*

KPMG Channel Islands Limited  
*Chartered Accountants*

5 St Andrew's Place  
Charing Cross  
St Helier  
Jersey  
JE4 8WQ

31 March 2009

#### Notes:

- The maintenance and integrity of the HSBC Bank Middle East Limited's, or other HSBC Group websites are the responsibility of the directors; the work carried out by the auditors does not involve consideration of these matters and, accordingly, the auditors accept no responsibility for any changes that may have occurred to the financial statements or audit report since they were initially presented on the website.*
- Legislation in Jersey governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.*

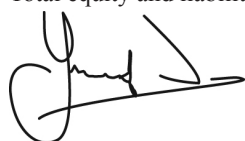


## Consolidated income statement for the year ended 31 December 2008

	<i>Notes</i>	<b>2008</b> US\$000	2007 US\$000
Interest income		1,944,169	1,751,198
Interest expense		(630,542)	(811,600)
<b>Net interest income</b>		<b>1,313,627</b>	939,598
Fee income		658,076	434,045
Fee expense		(42,228)	(32,218)
<b>Net fee income</b>		<b>615,848</b>	401,827
Trading income excluding net interest income		310,927	207,268
Net interest income on trading activities		15,729	16,464
<b>Net trading income</b>		<b>326,657</b>	223,732
Gains less losses from financial investments		7,418	2,673
Dividend income		1,215	1,085
Other operating income		10,575	19,620
<b>Net operating income before loan impairment charges</b>		<b>2,275,340</b>	1,588,535
Loan impairment charges and other credit risk provisions		(284,924)	(53,651)
<b>Net operating income</b>		<b>1,990,416</b>	1,534,884
Employee compensation and benefits	5	(468,121)	(394,515)
General and administrative expenses	6	(329,308)	(251,223)
Depreciation of property, plant and equipment		(16,878)	(13,996)
Amortisation of intangible assets		(5,665)	(3,710)
<b>Total operating expenses</b>		<b>(819,972)</b>	(663,444)
<b>Operating profit</b>		<b>1,170,444</b>	871,440
Share of profits in associates		22,033	15,569
<b>Profit before tax</b>		<b>1,192,477</b>	887,009
Tax expense	8	(213,459)	(167,975)
<b>Profit for the year</b>		<b>979,018</b>	719,034
Profit attributable to shareholders of the parent company		965,610	703,967
Profit attributable to minority interests		13,408	15,067

## Consolidated balance sheet at 31 December 2008

<b>ASSETS</b>	<i>Notes</i>	<b>2008</b> US\$000	2007 US\$000
Cash and balances at central banks		960,721	861,247
Items in the course of collection from other banks		229,480	297,440
Trading assets	12	365,351	1,503,766
Derivatives	13	980,162	396,026
Loans and advances to banks	24	7,111,613	6,384,369
Loans and advances to customers	24	23,685,672	18,614,547
Financial investments	14	6,288,010	7,403,279
Interests in associates	15	152,429	157,756
Intangible assets	16	9,111	8,207
Property, plant and equipment	17	112,800	86,070
Other assets	19	1,357,868	1,202,158
Deferred taxation	23	39,717	33,240
Prepayments and accrued income		235,733	205,020
<b>Total assets</b>		<b><u>41,528,668</u></b>	<b><u>37,153,125</u></b>
<b>LIABILITIES AND EQUITY</b>			
<b>Liabilities</b>			
Deposits by banks	24	1,811,408	3,425,491
Customer accounts	24	28,745,291	25,648,194
Items in the course of transmission to other banks		174,219	188,860
Trading liabilities	25	54,319	84,061
Derivatives	13	982,522	401,112
Debt securities in issue	20	4,441,277	2,981,754
Retirement benefit liabilities		58,285	46,320
Other liabilities	21	1,481,795	1,661,864
Current tax liabilities		238,333	193,843
Accruals and deferred income		200,667	145,600
Provisions	22	6,252	6,406
Deferred taxation	23	3,045	3,557
<b>Total liabilities</b>		<b><u>38,197,412</u></b>	<b><u>34,787,062</u></b>
<b>Equity</b>			
Called up share capital	29	631,055	431,055
Other reserves	30	46,891	60,468
Retained earnings	30	2,401,324	1,739,413
<b>Total equity attributable to shareholders of the parent company</b>		<b><u>3,079,270</u></b>	<b><u>2,230,936</u></b>
Minority interests	30	251,985	135,127
<b>Total equity</b>		<b><u>3,331,255</u></b>	<b><u>2,366,063</u></b>
<b>Total equity and liabilities</b>		<b><u>41,528,668</u></b>	<b><u>37,153,125</u></b>



Y A Nasr, Chairman and Chief Executive

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 2008

	2008 US\$000	2007 US\$000
Available-for-sale investments:		
– fair value gains taken to equity	1,991	51,282
– fair value transferred to income statement on disposal	(13,899)	(2,923)
Cash flow hedges:		
– fair value losses taken to equity	(11,040)	(6,170)
– fair value losses transferred to income statement	6,435	838
Exchange differences arising on net investment in foreign operations	(3,551)	3,625
Actuarial losses on defined benefit plans	(6,005)	(5,251)
	<u>(26,070)</u>	<u>41,401</u>
Net deferred taxation on items taken directly to equity	3,597	(616)
	<u>(22,473)</u>	<u>40,785</u>
Total income and expense taken directly to equity during the year	979,018	719,034
Profit for the year	<u>956,545</u>	<u>759,819</u>
Total recognised income and expense for the year	<u>956,545</u>	<u>759,819</u>
Total recognised income and expense for the year attributable to:		
– shareholders of the parent company	943,137	744,752
– minority interests	<u>13,408</u>	<u>15,067</u>

## Consolidated cash flow statement for the year ended 31 December 2008

	<i>Notes</i>	<b>2008</b> US\$000	2007 US\$000
<b>Cash flows from operating activities</b>			
Profit before tax		1,192,477	887,009
Adjustments for:			
– non-cash items included in profit before tax	31	172,806	14,887
– change in operating assets	31	(5,483,767)	(6,629,421)
– change in operating liabilities	31	2,874,519	11,089,625
– elimination of exchange differences <sup>1</sup>		11,294	34,326
– net gain from investing activities		(7,212)	(3,231)
– share of profits in associates		(22,033)	(15,569)
– dividends received from associates		6,138	8,470
– tax paid		(177,766)	(116,374)
Net cash (used in)/generated from operating activities		<u>(1,433,544)</u>	<u>5,269,722</u>
<b>Cash flows from investing activities</b>			
Purchase of financial investments		(1,707,888)	(24,592,968)
Proceeds from the sale of financial investments		404,374	23,573,567
Purchase of property, plant and equipment		(39,868)	(17,337)
Proceeds from the sale of property, plant and equipment		1,487	6,709
Purchase of intangible assets		(6,735)	(4,616)
Proceeds from the sale of intangible assets		97	–
Net cash outflow from acquisition of and increase in stake of associates		(27,595)	(1,500)
Net cash used in investing activities		<u>(1,376,128)</u>	<u>(1,036,145)</u>
<b>Cash flows from financing activities</b>			
Issue of ordinary share capital		200,000	–
Non equity preference share capital issued		500,000	100,000
Dividends paid to shareholders		(250,000)	(150,000)
Dividends paid to minority interests		(816)	(1,962)
Net cash generated from/(used in) financing activities		<u>449,184</u>	<u>(51,962)</u>
<b>Net (decrease)/increase in cash and cash equivalents</b>		<b>(2,360,488)</b>	<b>4,181,615</b>
Cash and cash equivalents at 1 January		12,359,846	8,127,907
Effect of exchange rate changes on cash and cash equivalents		66,897	50,324
Cash and cash equivalents at 31 December	31	<u>10,066,255</u>	<u>12,359,846</u>

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

## Notes on the Financial Statements

### 1 Basis of preparation

#### (a) Compliance with International Financial Reporting Standards

The consolidated financial statements of HSBC Bank Middle East Limited ('Group') have been prepared in accordance with International Financial Reporting Standards ('IFRSs') as endorsed by the EU. EU-endorsed IFRSs may differ from IFRSs as published by the International Accounting Standards Board ('IASB') if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2008, there were no unendorsed standards effective for the year ended 31 December 2008 affecting these consolidated financial statements, and there was no difference between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to Group. Accordingly, Group's financial statements for the year ended 31 December 2008 are prepared in accordance with IFRSs as issued by the IASB.

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

During 2008, the group adopted the following amendments to standards and interpretations:

- IFRIC 14 'IAS 19 - The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction' had no significant effect on the consolidated financial statements of the group.
- An amendment to IAS 39 'Financial Instruments: Recognition and Measurement' ('IAS 39') and to IFRS 7 'Financial Instruments: Disclosures' ('IFRS 7') - 'Reclassification of Financial Assets' ('Reclassification Amendment') had no significant effect on the consolidated financial statements of the group.
- IFRIC 11 'Group and Treasury Share Transactions' ('IFRIC 11'). Application of this interpretation has resulted in the group treating all share based payment transactions as equity settled.
- This change in accounting policy was made in accordance with the transitional provisions of IFRIC 11, which require that the interpretation be applied retrospectively in accordance with IAS 8 'Accounting Policies, changes in Accounting Estimates and Errors', subject to the transitional provisions of IFRS 2 'Share-based Payments'.

#### (b) Consolidation

The consolidated financial statements of HSBC Bank Middle East Limited comprise the financial statements of the bank and its subsidiaries made up to 31 December. Newly acquired subsidiaries are consolidated from the date that the group gains control. The purchase method of accounting is used to account for the acquisition of subsidiaries by the group. The cost of an acquisition is measured at the fair value of the consideration given 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. Any excess of the cost of acquisition over the fair value of the group'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 the group's share of the identifiable assets, liabilities and contingent liabilities of the business required, the difference is recognised immediately in the income statement. Entities that are controlled by the group are consolidated until the date that control ceases.

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

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

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

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

It is the group's policy to transfer HSBC intragroup entities at net asset value.

## Notes on the Financial Statements (continued)

### (c) *Future accounting developments*

Standards and interpretations issued by the IASB and endorsed by the EU

IFRS 8 'Operating Segments' ('IFRS 8'), which replaces IAS 14 'Segment Reporting' ('IAS 14'), was issued on 30 November 2006 and is effective for annual periods beginning on or after 1 January 2009. This standard specifies how an entity should disclose information about its segments which enables users to evaluate the nature and financial effects of its business activities and the economic environments in which it operates, based on information about the components of the entity that the chief operating decision maker uses to make operating decisions. The group will adopt IFRS 8 with effect from 1 January 2009, and will accordingly present financial information for segments whose operating segments are regularly reviewed by the chief operating decision maker in order to make decisions about allocating resources and assessing performance. The group currently presents two sets of segments in accordance with IAS 14, one geographical and one based on customer groups, which reflect the way the businesses of the Group are managed. Under IFRS 8, the group will continue to provide information on financial performance by customer group alongside the geographical operating segment information.

A revised IAS 1 'Presentation of Financial Statements', which is applicable for annual periods beginning on or after 1 January 2009, was issued on 6 September 2007. The revised standard aims to improve users' ability to analyse and compare information given in financial statements. The adoption of the revised standard will have no effect on the results reported in the group's consolidated financial statements. It will, however, result in certain presentational changes in the primary statements of the group.

The IASB issued an amendment to IFRS 2 'Share-based Payment' - 'Vesting Conditions and Cancellations' on 17 January 2008. The amendment, which is applicable for annual periods beginning on or after 1 January 2009, clarifies that vesting conditions comprise only service conditions and performance conditions. It also specifies the accounting treatment for a failure to meet a non-vesting condition. The group does not expect adoption of the amendment to have a significant effect on the group's consolidated financial statements.

The IASB issued a revised IAS 23 'Borrowing Costs' on 29 March 2007, which is applicable for annual periods beginning on or after 1 January 2009. The revised standard eliminates the option of recognising borrowing costs immediately as an expense, to the extent that they are directly attributable to the acquisition, construction or production of a qualifying asset. The group does not expect adoption of the revised standard to have a significant effect on the consolidated financial statements.

IFRIC 13 'Customer Loyalty Programmes' ('IFRIC 13') was issued on 28 June 2007 and is effective for annual periods beginning on or after 1 July 2008. IFRIC 13 addresses how companies that grant their customers loyalty award credits (often called 'points') when buying goods or services should account for their obligation to provide free or discounted goods and services, if and when the customers redeem the points. IFRIC 13 requires companies to allocate some of the proceeds of the initial sale to the award credits and recognise these proceeds as revenue only when they have fulfilled their obligations to provide goods or services. Adoption of this interpretation is not expected to have a significant impact on the group.

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

At 31 December 2008, the following interpretations, effective for these consolidated financial statements, were issued by the IASB but not endorsed by the EU. These interpretations have no significant effect on the consolidated financial statements:

- an amendment to IAS 39 and to IFRS 7 - 'Reclassification of Financial Assets - Effective Date and Transition' was issued on 27 November 2008. The amendment, which clarifies the effective date of the Reclassification Amendment, will have no effect on the group's consolidated financial statements.
- IFRIC 12 'Service Concession Arrangements' ('IFRIC 12') was issued on 30 November 2006 and is effective for annual periods beginning on or after 1 January 2008. IFRIC 12 provides guidance on service concession arrangements by which a government or other public sector entity grants contracts for the supply of public services to private sector operators. IFRIC 12 addresses how service concession operators should apply existing IFRSs to account for the obligations they undertake and the rights they receive in service concession arrangements. IFRIC 12 is unlikely to have a material effect on the group.

A revised IFRS 3 'Business Combinations' and an amended IAS 27 'Consolidated and Separate Financial Statements', were issued on 10 January 2008. The revisions to the standards apply prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual financial reporting period beginning on or after 1 July 2009. The main changes under the standards are that:

- acquisition-related costs are recognised as expenses in the income statement in the period they are incurred;
- equity interests held prior to control being obtained are re-measured to fair value at the time control is obtained, and any gain or loss is recognised in the income statement;
- changes in a parent’s ownership interest in a subsidiary that do not result in a change of control are treated as transactions between equity holders and reported in equity; and
- an option is available, on a transaction-by-transaction basis, to measure any non-controlling interests (previously referred to as minority interests) in the entity acquired either at fair value, or at the non-controlling interest’s proportionate share of the net identifiable assets of the entity acquired.

The effect that the changes will have on the results and financial position of the group will depend on the incidence and timing of business combinations occurring on or after 1 January 2010.

IFRIC 15 ‘Agreements for the Construction of Real Estate’ (‘IFRIC 15’) was issued on 3 July 2008 and is effective for annual periods beginning on or after 1 January 2009. IFRIC 15 provides guidance on the recognition of revenue among real estate developers for sales of units. The group does not expect adoption of IFRIC 15 to have a significant effect on the group’s consolidated financial statements.

IFRIC 16 ‘Hedges of a Net Investment in a Foreign Operation’ (‘IFRIC 16’) was issued on 3 July 2008 and is effective for annual periods beginning on or after 1 October 2008. IFRIC 16 provides guidance on accounting for the hedge of a net investment in a foreign operation in an entity’s consolidated financial statements. The main change introduced by IFRIC 16 is to eliminate the possibility of an entity applying hedge accounting for a hedge of foreign exchange differences between the functional currency of a foreign operation and the presentation currency of the parent’s consolidated financial statements. The adoption of IFRIC 16 will have no effect on the group’s consolidated financial statements.

IFRIC 17 ‘Distributions of Non-cash Assets to Owners’ (‘IFRIC 17’) was issued on 27 November 2008 and is effective for annual periods beginning on or after 1 July 2009. IFRIC 17 provides guidance on how distributions of assets other than cash as dividends to shareholders should be accounted for. The adoption of IFRIC 17 will have no effect on the group’s consolidated financial statements.

IFRIC 18 ‘Transfer of Assets from Customers’ (‘IFRIC 18’) was issued on 29 January 2009 and is required to be applied prospectively to transfers of assets from customers received on or after 1 July 2009. IFRIC 18 clarifies the requirements of IFRSs for agreements in which an entity receives from a customer an item of property, plant, and equipment that the entity must then use either to connect the customer to a network or to provide the customer with ongoing access to a supply of goods and services (such as a supply of electricity, gas or water). The group does not expect adoption of IFRIC 18 to have an effect on the group’s consolidated financial statements.

The IASB issued amendments to IAS 32 ‘Financial Instruments: Presentation’ and IAS 1 ‘Presentation of Financial Statements’ – ‘Puttable Financial Instruments and Obligations Arising on Liquidation’, on 14 February 2008. The amendments are applicable for annual periods beginning on or after 1 January 2009. The group does not expect the adoption of this amendment to have a significant effect on the group’s consolidated financial statements.

The IASB issued ‘Improvements to IFRSs’ on 22 May 2008, which comprises a collection of necessary, but not urgent, amendments to IFRSs. The amendments are primarily effective for annual periods beginning on or after 1 January 2009, with earlier application permitted. The group does not expect adoption of the amendments to have a significant effect on the consolidated financial statements.

The IASB issued amendments to IFRS 1 ‘First-time Adoption of International Financial Reporting Standards’ and IAS 27 ‘Consolidated and Separate Financial Statements’ – ‘Determining the cost of an Investment in the Separate Financial Statements’, on 22 May 2008. The amendment is effective for annual periods beginning on or after 1 January 2009. These amendments are not expected to have a significant effect on the group’s consolidated financial statements.

The IASB issued an amendment to IAS 39 ‘Financial Instruments: Recognition and Measurement’ – ‘Eligible Hedged Items’ on 31 July 2008, which is applicable for annual periods beginning on or after 1 July 2009. The amendment clarifies how the existing principles underlying hedge accounting should be applied. This amendment will have no effect on the group’s consolidated financial statements.



## Notes on the Financial Statements (continued)

### 2 Summary of significant accounting policies

#### (a) Interest income and expense

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

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

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

#### (b) Non interest income

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

- income earned on the execution of a significant act is recognised as revenue when the act is completed (for example, fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as 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, certain loan commitment fees) and recorded in 'Interest income' (Note 2(a)).

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

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

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

#### (c) Segment reporting

The Group's main operations are in the UAE and Qatar, although it also has operations elsewhere in the Middle East, and manages its business through four customer groups: Personal Financial Services; Commercial Banking; Corporate, Global Banking and Markets; and Private Banking. The 'Other' segment comprises activities, operations and sources of income and expense which are not allocated to any of the other business segments. This includes movements in fair value on debt securities issued by the group designated at fair value and exchange movements on foreign-currency denominated equity instruments issued by the group. Segment income and expenses include transfers between geographical regions and transfers between customer group segments. These transfers are conducted on arm's length terms and conditions.

#### (d) Determination of fair value

All financial instruments are recognised initially at fair value. In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (that is, the fair value of the consideration given or received). In certain circumstances, however, the initial fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose



variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, the group recognises a trading gain or loss at inception of the financial instrument. When unobservable market data have a significant impact on the valuation of financial instruments, the entire initial difference in fair value indicated by the valuation model from the transaction price is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis, or when the inputs become observable, or the transaction matures or is closed out, or when the group enters into an offsetting transaction.

Subsequent to initial recognition, the fair values of financial instruments quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. 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. For financial instruments, fair values may be determined in whole or in part using valuation techniques based on assumptions that are not supported by prices from current market transactions or observable market data.

Factors such as bid-offer spread, credit profile and model uncertainty are taken into account, as appropriate, when fair values are calculated using valuation techniques. Valuation techniques incorporate assumptions that other market participants would use in their valuations, including assumptions about interest rate yield curves, exchange rates, volatilities, and prepayment and default rates. Where a portfolio of financial instruments has quoted prices in an active market, the fair value of the instruments are calculated as the product of the number of units and quoted price and no block discounts are made.

If the fair value of a financial asset measured at fair value becomes negative, it is recorded as a financial liability until its fair value becomes positive, at which time it is recorded as a financial asset.

The fair values of financial liabilities are measured using quoted market prices where available, or using valuation techniques. These fair values include market participants' assessments of the appropriate credit spread to apply to the group's liabilities. The amount of change during the period, and cumulatively, in the fair value of designated financial liabilities and loans and advances that is attributable to changes in their credit spread is determined as the amount of change in the fair value that is not attributable to changes in market conditions that give rise to market risk.

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

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

**(f) Loan impairment**

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

*Individually assessed loans and advances*

For all loans that are considered individually significant, the group assesses on a case-by-case basis at each balance sheet date whether there is any objective evidence that a loan is impaired. For those loans where objective evidence of impairment exists, impairment losses are determined considering the following factors:

- the group's aggregate exposure to the customer;
- the viability of the customer's business model and its capability to trade successfully out of financial difficulties and generate sufficient cash flow to service its debt obligations;
- the amount and timing of expected receipts and recoveries;

## Notes on the Financial Statements (continued)

- 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 mitigations) 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 losses are calculated by discounting the expected future cash flows of a loan at its original effective interest rate, and comparing the resultant present value with the loan's current carrying amount.

### *Collectively assessed loans and advances*

Impairment is assessed on a collective basis in two circumstances:

- for loans subject to individual assessment, 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, where there is objective evidence of impairment.

### *Incurring but not yet identified impairment*

Individually assessed loans for which no evidence of loss has been specifically identified on an individual basis are grouped together according to their credit risk characteristics for the purpose of calculating an estimated collective loss. This reflects impairment losses that the group has incurred as a result of events occurring before the balance sheet date, which the group is not able to identify on an individual loan basis, and that can be reliably estimated. These losses will only be individually identified in the future. As soon as information becomes available which identified losses on individual loans within the group, those loans are removed from the group and assessed on an individual basis for impairment.

The collective impairment loss is determined after taking into account:

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

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

### *Homogeneous groups of loans and advances*

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

- When appropriate empirical information is available, the group utilises roll rate methodology. This methodology employs statistical analyses of historical data and experience of delinquency and default to estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date which the group is not able to identify on an individual loan basis, and that can be reliably estimated. Under this methodology, loans are grouped into ranges according to the number of days past due, and statistical analysis is used to estimate the likelihood that loans in each range will progress through the various stages of delinquency and ultimately prove

irrecoverable. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. 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 reliable enough to adopt a roll rate methodology, the group adopts a formulaic approach which allocates progressively higher percentage loss rates the longer a customer's loan is overdue. Loss rates are based on historical experience.

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

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

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

#### *Write-offs of loans and advances*

A loan (and the related impairment allowance account) is normally written off, either partially or in full, when there is no realistic prospect of recovery of the principal amount and, for a collateralised loan, when the proceeds from realising the security have been received.

#### *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.

#### *Assets acquired in exchange for loans*

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

#### *Renegotiated loans*

Loans subject to collective impairment assessment whose terms have been renegotiated are no longer considered past due, but are treated as new loans for measurement purposes once the minimum numbers of payments required under the new arrangements have been received. Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or should be considered past due. The carrying amount of loans that have been classified as renegotiated retain this classification until maturity or de-recognition.

#### **(g) Trading assets and trading liabilities**

Treasury bills, debt securities, equity shares, loans 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-

## Notes on the Financial Statements (continued)

term profit-taking. These financial assets or financial liabilities are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase or sell securities, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently their fair values are remeasured and all gains and losses from changes therein are recognised in the income statement in 'Net trading income' as they arise.

### (h) *Financial instruments designated at fair value*

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

- 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 main classes of financial instruments designated by the group are:

Long-term debt issues. The interest payable on certain fixed rate long-term debt securities issued has been matched with the interest on 'receive fixed/pay variable' interest rate swaps as part of a documented interest rate risk management strategy. An accounting mismatch would arise if the debt securities issued were accounted for at amortised cost, because the related derivatives are measured at fair value with changes in the fair value recognised in the income statement. By designating the long-term debt at fair value, the movement in the fair value of the long-term debt will also be recognised in the income statement.

Financial assets and financial liabilities under investment contracts. Liabilities to customers under linked contracts are determined based on the fair value of the assets held in the linked funds, with changes recognised in the income statement. If no designation was made for the assets relating to the customer liabilities they would be classified as available-for-sale and the changes in fair value would be recorded directly in equity. These financial instruments are managed on a fair value basis and management information is also prepared on this basis.

Designation at fair value of the financial assets and liabilities under investment contracts allows the changes in fair values to be recorded in the income statement and presented in the same line.

- 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.
- Relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, including certain debt issues and debt securities held.

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

### (i) *Financial investments*

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'. Financial investments are recognised on trade date, when the group enters into contractual arrangements with counterparties to purchase securities, and are normally derecognised when either the securities are sold or the borrowers repay their obligations.

(i) Available-for-sale securities are initially measured at fair value plus direct and incremental transaction costs. They are subsequently re-measured at fair value, and changes therein are recognised in equity in the 'Available-for-sale fair value reserve' 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.

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 financial assets. Impairment losses are recognised if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the asset that can be reliably estimated.

If the available-for-sale security is impaired, the difference between the asset's acquisition cost (net of any principal repayments and amortisation) and the current fair value, less any previous impairment loss recognised in the income statement, is removed from equity and recognised in the income statement. Any subsequent reduction in the fair value of an impaired asset is taken to the income statement.

Impairment losses for available-for-sale debt securities are recognised within 'Loan impairment charges and other credit risk provisions' in the income statement and impairment losses for available-for-sale equity securities are recognised within 'Gains less losses from financial investments' in the income statement.

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.

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

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

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

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

**(k) Derivatives and hedge accounting**

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

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative would meet the definition of a stand-alone derivative if they were contained in a separate contract; and the combined contract is not held for trading or designated at fair value. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

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

The method of recognising fair value gains or losses depends on whether derivatives are held for trading or are designated as hedging instruments, and if the latter, the nature of the risks being hedged. All gains and losses from changes in the fair value of derivatives held for trading are recognised in the income statement. When derivatives are

## Notes on the Financial Statements (continued)

designated as hedges, the group classifies them as either: (i) hedges of the change in fair value of recognised assets or liabilities or firm commitments ('fair value hedges'); (ii) hedges of the variability in highly probable future cash flows attributable to a recognised asset or liability, or a forecast transaction ('cash flow hedges'); or (iii) a hedge of net investments in a foreign operation ('net investment hedges'). Hedge accounting is applied to derivatives designated as hedging instruments in a fair value, cash flow or net investment hedge provided certain criteria are met.

### *Hedge accounting*

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

### *Fair value hedge*

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

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

### *Cash flow hedge*

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

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 in a similar way to cash flow hedges. A gain or loss on the effective portion of the hedge is recognised in equity; a gain or loss on 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 the group requires that, at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness) and demonstrate actual effectiveness (retrospective effectiveness) on an ongoing basis.

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

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

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

### *Derivatives that do not qualify for hedge accounting*

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in 'Net trading income', except



where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives managed in conjunction with debt securities issued by the group), in which case gains and losses are reported in ‘Net income from financial instruments designated at fair value’. The interest on derivatives managed in conjunction with debt securities issued by the group which are designated at fair value is recognised in ‘Interest expense’. All other gains and losses on these derivatives are reported in ‘Net income from financial instruments designated at fair value’.

**(l) De-recognition of financial assets and liabilities**

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

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

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

**(m) 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.

**(n) Subsidiaries and associates**

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

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

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

**(o) Intangible assets**

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

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

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

**(p) Property, plant and equipment**

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

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

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

## Notes on the Financial Statements (continued)

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

### (q) *Finance and operating leases*

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

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

All other leases are classified as operating leases. When acting as lessor, the group includes the assets subject to operating leases in 'Property, plant and equipment' and accounts for them accordingly. Impairment losses are recognised to the extent that residual values are not fully recoverable and the carrying value of the 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.

### (r) *Income tax*

Income tax comprises current tax and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantively enacted by the balance sheet date, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are offset when the group intends to settle on a net basis and the legal right to 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 based on tax rates and laws enacted, or substantively enacted, by the balance sheet date. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when a legal right to set off exists in the entity.

Deferred tax relating to actuarial gains and losses on post-employment benefits is recognised directly in equity. Deferred tax relating to fair value re measurement of available-for-sale investments and cash flow hedging instruments which are charged or credited directly to 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.

### (s) *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 long term, high quality corporate bonds or Central Bank certificate of deposits, where appropriate. Actuarial gains and losses are recognised in 'Shareholders' equity' and presented in the Statement of Recognised Income and Expense in the period in which they arise.

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 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.



**(t) Equity compensation plans**

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

Share options granted by HSBC Holdings to group employees are accounted for as equity-settled share-based payment transactions. The expense is recognised in the income statement over the vesting period and is determined by reference to the fair value of the award on grant date.

If awards of shares and options lapse during the vesting period due to an employee leaving employment with the group, the charge to date is reversed to the income statement. If an award lapses due to an employee leaving a plan but not employment with the group, this is accounted for as an acceleration of vesting with full immediate recognition of the outstanding charge in the income statement. No accounting entries are made if awards of share options lapse after they have fully vested.

**(u) Foreign currencies**

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.

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

The assets, including related goodwill where applicable, and liabilities of branches and associates whose functional currency is not US dollars, are translated into the group's presentational currency at the rate of exchange ruling at the balance sheet date. The results of branches, subsidiaries and associates whose function currency is not US 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 recognised in equity in the 'foreign exchange reserve'.

**(v) 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.

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

**(w) Debt securities in issue, non-equity preference share capital and deposits by customers and banks**

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

## Notes on the Financial Statements (continued)

### (x) *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.

### (y) *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, items in the course of collection from or in transmission to other banks and certificates of deposit.

## 3 Use of assumptions and estimates

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

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

The accounting policies that are deemed critical to the group's results and financial position, in terms of the materiality of the items to which the policy is applied, or which involve a high degree of judgement including the use of assumptions and estimation, are disclosed below:

### **Impairment of loans and advances**

The group's accounting policy for losses arising from the impairment of customer loans and advances is described in Note 2(f) on the financial statements. Further information can be found in Note 32 'Risk Management'. Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at balance sheet date.

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

The group uses two alternative methods to calculate collective impairment allowances on homogeneous groups of loans that are not considered individually significant, both of which are subject to estimation uncertainty, in part because it is not practical to identify losses on an individual loan basis because of the large number of individually significant loans in the portfolio:

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

On individually assessed loans for which no evidence of loss has been specifically identified, the collective impairment loss is determined by taking into account historical loss experience in portfolios of similar credit characteristics, the estimated period between impairment occurring and the loss being identified and management's experienced judgement as to whether current economic and credit conditions are such that the actual level of inherent losses at the balance sheet date is likely to be greater or less than that suggested by historical experience.

The use of statistically assessed historical information is supplemented with significant management judgement to assess whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience. In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio. In certain circumstances, historical loss experience provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, where there have been changes in economic, regulatory or behavioural conditions such that the

most recent trends in the portfolio risk factors are not fully reflected in the statistical models. In these circumstances, such risk factors are taken into account when calculating the appropriate levels of impairment allowances, by adjusting the impairment allowances derived solely from historical loss experience.

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

The total amount of the group's impairment allowances on homogeneous groups of loans is inherently uncertain because it is highly sensitive to changes in economic and credit conditions across a large number of geographical areas. Economic and credit conditions within geographical areas are influenced by many factors with a high degree of interdependency so that there is no one single factor to which the group's loan impairment allowances as a whole are particularly sensitive.

### **Valuation of financial instruments**

The best evidence of fair value is a quoted price in an actively traded market. If the market for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are not observable. Valuation techniques that rely to a greater extent on non-observable inputs require a higher level of management judgement to calculate a fair value than those based wholly on observable inputs.

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

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

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

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

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

**Notes on the Financial Statements** (continued)*Pensions*

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

*Share-based payments*

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

**4 Net operating income**

Net operating income for the year ended 31 December 2008 is stated after the following items of income, expense, gains and losses:	<b>2008</b> US\$000	2007 US\$000
<b>Income</b>		
Interest on financial instruments, excluding interest on financial assets held for trading or designated at fair value	<b>1,944,169</b>	1,751,198
Interest recognised on impaired financial assets	<b>2,359</b>	17,379
Fees earned on financial assets or liabilities not held for trading or designated at fair value other than fees included in effective interest rates calculations on these types of assets and liabilities	<b>538,785</b>	370,609
Fees earned relating to trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	<b>55,317</b>	37,522
<b>Expense</b>		
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	<b>(630,542)</b>	(811,600)
Fees payable on financial assets or liabilities not held for trading or designated at fair value other than fees included in effective interest rate calculations on these types of assets and liabilities	<b>(33,707)</b>	(23,326)
<b>(Losses)/gains</b>		
Net Impairment losses on:		
– loans and advances	<b>(280,237)</b>	(53,651)
– other credit risk provisions	<b>(4,687)</b>	–
(Losses)/gains on disposal of property, plant and equipment and non-financial investments	<b>(294)</b>	103

## 5 Employee compensation and benefits

	2008 US\$000	2007 US\$000
Wages and salaries	442,275	373,467
Social security costs	5,673	4,678
Post-employment benefits (Note 2(s))	20,173	16,370
	<u>468,121</u>	<u>394,515</u>

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

	2008 Number	2007 Number
Personal Financial Services	2,167	1,880
Commercial Banking	1,348	1,157
Global Banking and Markets	485	329
Private Banking	13	6
Other operations (mainly support functions)	2,242	1,962
	<u>6,255</u>	<u>5,334</u>

### *Post-employment benefits*

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

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

The principal actuarial financial assumptions used to calculate the scheme obligations at 31 December 2008 were:

	<i>Discount rate</i> %	<i>Rate of pay increase</i> %	<i>Rate of resignation</i> %	<i>Rate of employment termination</i> %
<b>At 31 December 2008</b>				
United Arab Emirates	<u>2.85</u>	<u>4.00</u>	<u>10.60</u>	<u>1.20</u>
<b>At 31 December 2007</b>				
United Arab Emirates	<u>4.30</u>	<u>7.50</u>	<u>28.30</u>	<u>8.00</u>

The bank determines discount rates in consultation with its actuary based upon the yield on long term, high quality corporate bonds or Central Bank certificate of deposits, where appropriate.

## Notes on the Financial Statements (continued)

### Actuarial assumption sensitivities

The discount rate is sensitive to changes in market conditions arising during the reporting period. The following table shows the effect of changes in this on the scheme obligation and costs for the following year:

	United Arab Emirates	
	2008 US\$000	2007 US\$000
Discount rate		
Change in scheme obligation at 31 December from a 25bps increase	(42,066)	(32,527)
Change in scheme obligation at 31 December from a 25bps decrease	43,426	33,705
Change in scheme cost from a 25bps increase	(10,532)	(7,259)
Change in scheme cost from a 25bps decrease	10,716	7,624

## 6 General and administrative expenses

### Auditors' remuneration

Auditors' remuneration in relation to statutory audit amounted to US\$847 thousand (2007: US\$576 thousand). The following remuneration was paid by the group to the group's principal auditor, KPMG Channel Islands Limited and its affiliated firms ('KPMG'):

	2008 US\$000	2007 US\$000
Audit fees for HSBC Bank Middle East Limited statutory audit:		
– fees relating to current year	847	576
– fees relating to prior year	29	1
	<u>876</u>	<u>577</u>
Fees payable to KPMG for other services provided to the group		
– other services pursuant to legislation	441	419
– tax services	70	59
– valuation and actuarial services	–	4
– all other services	121	215
	<u>632</u>	<u>697</u>
Total fees payable	<u>1,508</u>	<u>1,274</u>

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

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

## 7 Share-based payments

During 2008, US\$4,677 thousand was charged to the income statement in respect of equity-settled share-based payment transactions (2007: US\$5,168 thousand). This expense, which was computed from the fair values of the share-based payment transactions when contracted, arose under employee share awards made in accordance with the HSBC Group's reward structures.

### *Calculation of fair values*

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

The significant weighted average assumptions used to estimate the fair value of the options granted in 2008 were as follows:

	<i>1-year Savings- Related Share Option Plans</i>	<i>3-year Savings- Related Share Option Plans</i>	<i>5-year Savings- Related Share Option Plans</i>
<b>2008</b>			
Risk-free interest rate (%) <sup>1</sup>	<b>4.5</b>	<b>4.5</b>	<b>4.5</b>
Expected life (years) <sup>2</sup>	<b>1</b>	<b>3</b>	<b>5</b>
Expected volatility (%) <sup>3</sup>	<b>25</b>	<b>25</b>	<b>25</b>
Share price at grant date	<b>8.80</b>	<b>8.80</b>	<b>8.80</b>
<b>2007</b>			
Risk-free interest rate (%) <sup>1</sup>	5.6	5.5	5.4
Expected life (years) <sup>2</sup>	1	3	5
Expected volatility (%) <sup>3</sup>	17	17	17
Share price at grant date	9.24	9.24	9.24

1 *The risk-free rate was determined from the UK gilts yield curve for the UK Savings-Related Share Option Plans. A similar yield curve was used for the Overseas Savings-Related Share Option Schemes.*

2 *Expected life is not a single input parameter but a function of various behavioural assumptions.*

3 *Expected volatility is estimated by considering both historic average share price volatility and implied volatility derived from traded options over HSBC shares of similar maturity to those of the employee options.*

Expected dividends are incorporated into the valuation model for share options/awards, where applicable. The expected US dollar denominated dividend growth was determined to be 7 per cent for the first year (2007: 10 per cent for the first 3 years) and 8 per cent thereafter (2007: 8 per cent), in line with consensus analyst forecasts.

### *HSBC Share Plan*

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

#### Performance share awards

Performance share awards are awarded to executives Directors and other senior executives after taking into account individual performance in the previous year. Each award is divided into two equal parts for testing attainment against pre-determined benchmarks. One half of the reward is subject to a TSR measure, based on HSBC's ranking against a comparator group of 28 major banks; the other half of the award is subject to an earnings per share target. For each



## Notes on the Financial Statements (continued)

element of the award, shares are released to the employee on a sliding scale from 30 to 100 per cent of the award, depending on the scale of achievement against the benchmarks, providing that the minimum criteria for each performance measure have been met. These shares vest after three years to the extent that the vesting conditions are satisfied.

	<b>2008</b>	2007
	<b>Number</b>	Number
	<b>(000's)</b>	(000's)
Outstanding at 1 January	<b>258</b>	246
Additions during the year	<b>178</b>	–
Released in the year	<b>(106)</b>	(165)
Transferred in the year	–	177
Outstanding at 31 December	<b>330</b>	258

The weighted average fair value of shares awarded by the group for Performance Share Awards in 2008 was £8.56 (2007: £8.96)

### Restricted share awards

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

	<b>2008</b>	2007
	<b>Number</b>	Number
	<b>(000's)</b>	(000's)
Outstanding at 1 January	<b>290</b>	128
Additions during the year	<b>438</b>	300
Released during the year	<b>(163)</b>	(41)
Transferred in the year	<b>196</b>	(97)
Outstanding at 31 December	<b>761</b>	290

The weighted average fair value of shares awarded by the group for Restricted Share Awards in 2008 was £8.56 (2007: £8.96)

### 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 plans is to align the interests of all employees with the creation of shareholder value. The options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or the fifth anniversary of the commencement of three-year or five-year contracts, respectively. The exercise price is set at a 20 per cent (2007: 20 per cent) discount to the market value immediately preceding the date of invitation.

	<b>2008</b>		2007	
	<i>Number</i>	<i>Weighted average exercise price</i>	<i>Number</i>	<i>Weighted average exercise price</i>
	<b>(000's)</b>	<b>£</b>	(000's)	£
Outstanding at 1 January	<b>1,601</b>	<b>6.59</b>	1,497	6.46
Granted in the year	<b>726</b>	<b>6.82</b>	724	7.08
Exercised in the year	<b>(486)</b>	<b>5.73</b>	(356)	6.45
Transferred in the year	<b>55</b>	<b>7.20</b>	(66)	6.89
Forfeited in the year	–	–	(1)	6.76
Expired in the year	<b>(250)</b>	<b>7.02</b>	(197)	6.76
Outstanding at 31 December	<b>1,646</b>	<b>6.94</b>	1,601	6.59



The weighted average fair value of options granted during the year was £2.17 (2007: £2.12). The weighted average share price at the dates the share options were exercised was £8.56 (2007: £8.96). The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	<b>2008</b>	2007
Exercise price range (£)	<b>£5.35-£8.02</b>	£5.35-£8.02
Weighted average remaining contractual life (years)	<b>2.19</b>	1.77
Of which exercisable:		
Number (000's)	<b>1,646</b>	1,601
Weighted average exercise price (£)	<b>6.94</b>	6.59

#### *HSBC Holdings Restricted Share Plan 2000*

Performance Share awards made under the HSBC Holdings Restricted Share Plan 2000 (the 'Restricted Share Plan')

Performance Share 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 with the creation of shareholder value. This was achieved by setting certain TSR targets against a peer group of major banks which would normally have to be attained in order for the awards to vest. In addition to these performance conditions, none of the outstanding awards will vest unless the Group's Remuneration Committee is satisfied that, during the performance period, HSBC has achieved sustained growth. Following adoption of The HSBC Share Plan in 2005, no further awards will be made under this Plan other than from reinvested scrip dividends.

	<b>2008</b>	2007
	<b>Number</b>	Number
	<b>(000's)</b>	(000's)
Outstanding at 1 January	<b>100</b>	91
Additions during the year <sup>1</sup>	<b>29</b>	37
Released during the year	<b>(168)</b>	(73)
Transferred in the year	<b>39</b>	45
Outstanding at 31 December	<b>—</b>	<b>100</b>

<sup>1</sup> Additions during the year comprised reinvested scrip dividends

The weighted average remaining vesting period as at 31 December 2007 was 10 months.

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

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

	<b>2008</b>	2007
	<b>Number</b>	Number
	<b>(000's)</b>	(000's)
Outstanding at 1 January	<b>520</b>	340
Additions during the year <sup>1</sup>	<b>374</b>	318
Released during the year	<b>(249)</b>	(128)
Transferred in the year	<b>102</b>	(10)
Outstanding at 31 December	<b>747</b>	<b>520</b>

<sup>1</sup> Additions during the year comprised reinvested scrip dividends

No shares were awarded by the group for HSBC Holdings Restricted Share Plan 2000 in 2008 or 2007.

The weighted average remaining vesting period as at 31 December 2008 was 5 months (2007: 2 months).

## Notes on the Financial Statements (continued)

### The HSBC Holdings Group Share Option Plan

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

	2008		2007	
	Number (000's)	Weighted average exercise price £	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	1,346	7.86	1,255	7.82
Exercised in the year	(77)	7.16	(139)	6.96
Transferred in the year	159	7.78	301	7.72
Forfeited in the year	–	–	(50)	7.97
Expired in the year	(23)	8.09	(21)	7.97
Outstanding at 31 December	<b>1,405</b>	<b>7.87</b>	<b>1,346</b>	<b>7.86</b>

The weighted average share price at the date the share options were exercised was £7.87 (2007: £7.86). No share options were awarded by the group for the Group Share Option Plan in 2008 (2007: Nil). The number of options, weighted average exercise price, and the weighted average remaining contractual life for options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	2008		2007	
	£6.00-£8.00	£8.01-£10.00	£6.00-£8.00	£8.01-£10.00
Exercise price range (£)				
Number (000's)	–	1,405	319	1,027
Weighted average exercise price (£)	6.91	8.30	6.91	8.30
Weighted average remaining contractual life (years)	–	–	–	0.06

### Executive Share Option Scheme

The Executive Share Option Scheme was a long-term incentive scheme under which certain senior employees were awarded share options before 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 2000 and the remaining unexercised options are summarised below:

	2008		2007	
	Number (000's)	Weighted average exercise price £	Number (000's)	Weighted average exercise price £
Outstanding at 1 January	185	6.85	155	6.82
Exercised in the year	(54)	8.01	(61)	6.65
Transferred in the year	42	6.92	95	6.85
Expired in the year	(8)	7.70	(4)	6.84
Outstanding at 31 December	<b>165</b>	<b>6.92</b>	<b>185</b>	<b>6.85</b>

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

	2008	2007
	£6.01-£7.87	£6.01-£7.87
Exercise price range (£)		
Number (000's)	165	185
Weighted average exercise price (£)	6.92	6.85
Weighted average remaining contractual life (years)	0.75	1.66

## 8 Tax expense

The charge for taxation comprises:

	<b>2008</b>	2007
	<b>US\$000</b>	US\$000
<b>Current tax</b>		
Overseas tax – current year	<b>219,233</b>	175,002
Overseas tax – adjustment in respect of prior years	<b>(2,107)</b>	213
	<u><b>217,126</b></u>	<u>175,215</u>
<b>Deferred tax</b>		
Origination and reversal of temporary differences	<b>(3,666)</b>	(7,240)
Effect of write-downs / reversal of write-downs of deferred tax assets	<u><b>(3,666)</b></u>	<u>(7,240)</u>
Tax expense	<u><b>213,459</b></u>	<u>167,975</u>

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

	<u>2008</u>		<u>2007</u>	
	<u>US\$000</u>	<u>Percentage of overall tax charge %</u>	<u>US\$000</u>	<u>Percentage of overall tax charge %</u>
<b>Analysis of overall tax charge</b>				
Taxation at UAE tax rate of 20 per cent (2007: 20 per cent)	<b>234,088</b>	<b>19.6</b>	174,288	19.6
Impact of overseas profits in principal locations taxed at different rates <sup>1</sup>	<b>12,196</b>	<b>1.0</b>	18,796	2.1
Income not subject to tax	<b>(32,646)</b>	<b>(2.7)</b>	(28,918)	(3.3)
Expenses not deductible for tax purposes	<b>2,474</b>	<b>0.2</b>	2,894	0.3
Prior period adjustments	<b>(7,068)</b>	<b>(0.6)</b>	699	0.1
Other items	<b>4,415</b>	<b>0.4</b>	216	0.0
Overall tax charge	<u><b>213,459</b></u>	<u><b>17.9</b></u>	<u>167,975</u>	<u>18.9</u>

<sup>1</sup> Overseas profits taxed at different rates to that which applies in the UAE contributed to a decrease in the effective tax rate of 1 per cent (2007: decrease of 2.1 per cent). The decrease in the effective tax rate is due to an increase in the proportion of income arising from tax free jurisdictions.

In addition to the amount charged to the income statement the aggregate amount of deferred taxation, relating to items that are taken directly to equity, was a US\$3,596 thousand increase in equity (2007: US\$616 thousand reduction in equity).

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

## 9 Dividends

	<u>2008</u>		<u>2007</u>	
	<u>US\$ per share</u>	<u>US\$000</u>	<u>US\$ per share</u>	<u>US\$000</u>
Dividends declared on ordinary share capital	<b>0.396</b>	<u><b>250,000</b></u>	0.238	<u>150,000</u>

## Notes on the Financial Statements (continued)

### 10 Segment analysis

The primary segment reporting format is determined to be by geographical regions.

#### (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.

	<i>UAE</i>	<i>Qatar</i>	<i>Rest of Middle East</i>	<i>Total</i>
	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>
<b>2008</b>				
<b>Total operating income</b>				
Net interest income	951,483	121,469	240,675	1,313,627
Dividend income	1,215	–	–	1,215
Net fee income	430,339	63,482	122,027	615,848
Net trading income	237,844	37,160	51,653	326,657
Gains less losses from financial investments	15,198	–	(7,780)	7,418
Other operating income	8,306	(213)	2,482	10,575
Net operating income before loan impairment charges	<u>1,644,385</u>	<u>221,898</u>	<u>409,057</u>	<u>2,275,340</u>
Profit before tax	839,314	112,975	240,188	1,192,477
Profit attributable to shareholders	685,318	74,293	205,999	965,610
Depreciation and amortisation	(15,410)	(1,866)	(5,267)	(22,543)
Loan impairment charges and other credit risk provisions	(257,741)	(22,751)	(4,432)	(284,924)
Cost to acquire property, plant and equipment	(32,248)	(1,003)	(6,617)	(39,868)
Cost to acquire intangibles	(6,628)	–	(184)	(6,812)
Total assets	31,230,266	3,722,043	6,576,359	41,528,668
Total liabilities	27,917,909	3,721,112	6,558,391	38,197,412
	<i>UAE</i>	<i>Qatar</i>	<i>Rest of Middle East</i>	<i>Total</i>
	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>
<b>2007</b>				
<b>Total operating income</b>				
Net interest income	651,300	101,899	186,399	939,598
Dividend income	1,085	–	–	1,085
Net fee income	285,437	41,750	74,640	401,827
Net trading income	174,183	21,287	28,262	223,732
Gains less losses from financial investments	2,673	–	–	2,673
Other operating income	16,818	469	2,333	19,620
Net operating income before loan impairment charges	<u>1,131,496</u>	<u>165,405</u>	<u>291,634</u>	<u>1,588,535</u>
Profit before tax	603,412	98,768	184,829	887,009
Profit attributable to shareholders	484,351	67,456	152,160	703,967
Depreciation and amortisation	(11,386)	(2,234)	(4,086)	(17,706)
Loan impairment charges	(57,139)	(4,395)	7,883	(53,651)
Cost to acquire property, plant and equipment	(12,376)	(1,705)	(3,256)	(17,337)
Cost to acquire intangibles	(4,612)	–	(4)	(4,616)
Total assets	28,037,340	2,556,054	6,559,731	37,153,125
Total liabilities	25,678,433	2,555,940	6,552,689	34,787,062

**(b) By class of business**

The group'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.

	<b>2008</b>	2007
	<b>US\$000</b>	US\$000
<b>Net operating income before loan impairment charges</b>		
Personal Financial Services	<b>861,239</b>	612,749
Commercial Banking	<b>723,077</b>	527,387
Global Banking & Markets	<b>708,666</b>	462,585
Private Banking	<b>12,319</b>	5,909
Other	<b>23,423</b>	1,202
Inter-segment income	<b>(53,384)</b>	(21,297)
	<b><u>2,275,340</u></b>	<u>1,588,535</u>
<b>Profit on ordinary activities before tax</b>		
Personal Financial Services	<b>195,601</b>	190,656
Commercial Banking	<b>452,281</b>	363,163
Global Banking & Markets	<b>536,554</b>	329,284
Private Banking	<b>3,675</b>	3,129
Other	<b>4,366</b>	777
	<b><u>1,192,477</u></b>	<u>887,009</u>
<b>Total assets</b>		
Personal Financial Services	<b>12,104,259</b>	9,649,768
Commercial Banking	<b>14,918,089</b>	12,885,571
Global Banking & Markets	<b>28,621,065</b>	29,721,062
Private Banking	<b>1,793,057</b>	1,642,889
Other	<b>7,245,453</b>	3,622,444
Inter-segment assets	<b>(23,153,255)</b>	(20,368,609)
	<b><u>41,528,668</u></b>	<u>37,153,125</u>
<b>Cost to acquire property, plant and equipment</b>		
Personal Financial Services	<b>3,281</b>	1,013
Commercial Banking	<b>1,228</b>	91
Global Banking & Markets	<b>40</b>	653
Other	<b>35,319</b>	15,580
	<b><u>39,868</u></b>	<u>17,337</u>
<b>Cost to acquire intangibles</b>		
Personal Financial Services	<b>626</b>	3,961
Commercial Banking	<b>2,726</b>	8
Global Banking & Markets	<b>24</b>	–
Other	<b>3,436</b>	647
	<b><u>6,812</u></b>	<u>4,616</u>

## Notes on the Financial Statements (continued)

### 11 Analysis of financial assets and liabilities by measurement basis

The following table analyses the financial assets and liabilities in the balance sheet by the class of financial instrument to which they are assigned, and therefore by the measurement basis:

2008				<i>Financial assets and liabilities at amortised cost</i>	<i>Derivatives designated as fair value hedging instruments</i>	<i>Derivatives designated as cash flow hedging instruments</i>	<i>Total</i>
	<i>Held for trading</i>	<i>Loans and receivables</i>	<i>Available-for-sale securities</i>	<i>US\$000</i>	<i>US\$000</i>	<i>US\$000</i>	
<b>FINANCIAL ASSET</b>							
Cash and balances at central banks	–	–	–	960,721	–	–	960,721
Items in the course of collection from other banks	–	–	–	229,480	–	–	229,480
Trading assets	365,351	–	–	–	–	–	365,351
Derivatives	980,162	–	–	–	–	–	980,162
Loans and advances to banks	–	7,111,613	–	–	–	–	7,111,613
Loans and advances to customers	–	23,685,672	–	–	–	–	23,685,672
Financial investments	–	–	6,288,010	–	–	–	6,288,010
Other assets	–	–	–	1,348,197	–	–	1,348,197
Accrued income	–	–	–	235,733	–	–	235,733
Total financial assets	<u>1,345,513</u>	<u>30,797,285</u>	<u>6,288,010</u>	<u>2,774,131</u>	<u>–</u>	<u>–</u>	<u>41,204,939</u>
Total non-financial assets							323,729
Total assets							<u>41,528,668</u>
<b>FINANCIAL LIABILITIES</b>							
Deposits by banks	–	–	–	1,811,408	–	–	1,811,408
Customer accounts	–	–	–	28,745,291	–	–	28,745,291
Items in the course of transmission to other banks	–	–	–	174,219	–	–	174,219
Trading liabilities	54,319	–	–	–	–	–	54,319
Derivatives	966,583	–	–	–	521	15,418	982,522
Debt securities in issue	–	–	–	4,441,277	–	–	4,441,277
Other liabilities	–	–	–	1,481,795	–	–	1,481,795
Accruals	–	–	–	148,583	–	–	148,583
Total financial liabilities	<u>1,020,902</u>	<u>–</u>	<u>–</u>	<u>36,802,573</u>	<u>521</u>	<u>15,418</u>	<u>37,839,414</u>
Total non-financial liabilities							357,998
Total liabilities							<u>38,197,412</u>

2007	<i>Held for trading</i>	<i>Loans and receivables</i>	<i>Available-for-sale securities</i>	<i>Financial assets and liabilities amortised at cost</i>	<i>Derivatives designated as fair value hedging instruments</i>	<i>Derivatives designated as cash flow hedging instruments</i>	<i>Total</i>
	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000
<b>ASSETS</b>							
Cash and balances at central banks	–	–	–	861,247	–	–	861,247
Items in the course of collection from other banks	–	–	–	297,440	–	–	297,440
Trading assets	1,503,766	–	–	–	–	–	1,503,766
Derivatives	395,784	–	–	–	242	–	396,026
Loans and advances to banks	–	6,384,369	–	–	–	–	6,384,369
Loans and advances to customers	–	18,614,547	–	–	–	–	18,614,547
Financial investments	–	–	7,403,279	–	–	–	7,403,279
Other assets	–	–	–	1,200,023	–	–	1,200,023
Accrued income	–	–	–	205,020	–	–	205,020
Total financial assets	<u>1,899,550</u>	<u>24,998,916</u>	<u>7,403,279</u>	<u>2,563,730</u>	<u>242</u>	<u>–</u>	<u>36,865,717</u>
Total non-financial assets							287,408
Total assets							<u>37,153,125</u>
<b>LIABILITIES</b>							
Deposits by banks	–	–	–	3,425,491	–	–	3,425,491
Customer accounts	–	–	–	25,648,194	–	–	25,648,194
Items in the course of transmission to other banks	–	–	–	188,860	–	–	188,860
Trading liabilities	84,061	–	–	–	–	–	84,061
Derivatives	390,179	–	–	–	919	10,014	401,112
Debt securities in issue	–	–	–	2,981,754	–	–	2,981,754
Other liabilities	–	–	–	1,656,548	–	–	1,656,548
Accruals	–	–	–	110,698	–	–	110,698
Total financial liabilities	<u>474,240</u>	<u>–</u>	<u>–</u>	<u>34,011,545</u>	<u>919</u>	<u>10,014</u>	<u>34,496,718</u>
Total non-financial liabilities							290,344
Total liabilities							<u>34,787,062</u>

## 12 Trading assets

	2008 US\$000	2007 US\$000
Trading assets:		
– not subject to re-pledge or resale by counterparties	<b>365,351</b>	1,503,766
	<u><b>365,351</b></u>	<u>1,503,766</u>
Debt securities	<b>189,281</b>	379,582
Equity securities	<b>176,070</b>	1,124,184
	<u><b>365,351</b></u>	<u>1,503,766</u>

## Notes on the Financial Statements (continued)

### 13 Derivatives

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

	At 31 December 2008					
	Assets			Liabilities		
	Trading	Hedging	Total	Trading	Hedging	Total
	US\$'000	US\$'000	US\$'000	US\$'000	US\$'000	US\$'000
Exchange rate	646,356	–	646,356	(619,387)	–	(619,387)
Interest rate	280,005	–	280,005	(298,015)	(15,939)	(313,954)
Equities	12,285	–	12,285	(12,286)	–	(12,286)
Credit derivatives	39,802	–	39,802	(36,081)	–	(36,081)
Commodity and others	1,714	–	1,714	(814)	–	(814)
<b>Total</b>	<b>980,162</b>	<b>–</b>	<b>980,162</b>	<b>(966,583)</b>	<b>(15,939)</b>	<b>(982,522)</b>

	At 31 December 2007					
	Assets			Liabilities		
	Trading	Hedging	Total	Trading	Hedging	Total
	US\$'000	US\$'000	US\$'000	US\$'000	US\$'000	US\$'000
Exchange rate	317,829	–	317,829	(309,516)	–	(309,516)
Interest rate	56,450	241	56,691	(59,157)	(10,933)	(70,090)
Equities	21,506	–	21,506	(21,506)	–	(21,506)
Credit derivatives	–	–	–	–	–	–
Commodity and others	–	–	–	–	–	–
<b>Total</b>	<b>395,785</b>	<b>241</b>	<b>396,026</b>	<b>(390,179)</b>	<b>(10,933)</b>	<b>(401,112)</b>

#### Use of derivatives

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

The group's derivative activities give rise to significant open positions in portfolios of derivatives. These positions are managed constantly to ensure that they remain within acceptable risk levels, with matching deals being 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 that are used for traditional lending.

#### Trading derivatives

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



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

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.

	2008	2007
	US\$000	US\$000
Exchange rate	40,262,828	40,485,648
Interest rate	16,486,120	8,665,096
Equities	526,216	350,420
Credit derivatives	931,145	–
Commodity and others	18,613	–
Total derivatives	<u>58,224,922</u>	<u>49,501,164</u>

### Derivatives valued using models with unobservable inputs

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

	2008	2007
	US\$000	US\$000
Unamortized balance at 1 January	1,015	–
Deferral on new transactions	–	3,826
Recognised in the income statement during the period:		
– maturity or termination or offsetting derivatives	–	(1,462)
– FX movements and other	–	(1,349)
Unamortized balance at 31 December	<u>1,015</u>	<u>1,015</u>

### Hedging Instruments

The group uses derivatives (principally interest rate swaps) for hedging purposes in the management of its own asset and liability portfolios and structural positions. This enables the HSBC 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.

### Contract amounts of derivatives held for hedging purposes by product type

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.

	<u>At 31 December 2008</u>		<u>At 31 December 2007</u>	
	<i>Cash flow hedge</i>	<i>Fair value hedge</i>	<i>Cash flow hedge</i>	<i>Fair value hedge</i>
	US\$000	US\$000	US\$000	US\$000
Interest rate	249,956	43,994	250,000	61,010

### Fair value hedges

The group's fair value hedges principally consist of interest rate swaps that are used to protect against changes in the fair value of fixed-rate long-term financial instruments due to movements in market interest rates.

The fair values of outstanding derivatives designated as fair value hedges at 31 December 2008, were assets of nil and liabilities of US\$521 thousand (2007: assets of US\$242 thousand and liabilities of US\$919 thousand).

## Notes on the Financial Statements (continued)

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

	2008	2007
	US\$000	US\$000
Gains/(losses) arising from the change in fair value of fair value hedges:		
– on hedged instruments	210	(493)
– on hedged items attributable to the hedged risk	(288)	476

The gains and losses on ineffective portions of fair value hedges are recognised immediately in ‘Net trading income’. The amount reported in the income statement in respect of the ineffectiveness of fair value hedges was insignificant in the years ended 31 December 2008 and 31 December 2007.

### Cash flow hedges

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

At 31 December 2008, the fair values of outstanding derivatives designated as cash flow hedges of forecast transactions were assets of US\$ Nil (2007: US\$ Nil) and liabilities of US\$15,418 thousand (2007: US\$10,014 thousand).

### The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2008 is as follows:

	At 31 December 2008			
	<i>3 months or less</i>	<i>More than 3 months but less than 1 year</i>	<i>5 years or less but more than 1 year</i>	<i>More than 5 years</i>
	US\$000	US\$000	US\$000	US\$000
Cash inflows from assets	–	–	–	–
Cash outflows from liabilities	250,000	250,000	250,000	–
Net cash inflows/(outflows)	<u>(250,000)</u>	<u>(250,000)</u>	<u>(250,000)</u>	<u>–</u>
	At 31 December 2007			
	<i>3 months or less</i>	<i>More than 3 months but less than 1 year</i>	<i>5 years or less but more than 1 year</i>	<i>More than 5 years</i>
	US\$000	US\$000	US\$000	US\$000
Cash inflows from assets	–	–	–	–
Cash outflows from liabilities	250,000	250,000	250,000	–
Net cash inflows/(outflows)	<u>(250,000)</u>	<u>(250,000)</u>	<u>(250,000)</u>	<u>–</u>

The gains and losses on ineffective portions of such derivatives are recognised immediately in ‘Net trading income’. During the years to 31 December 2008 and 31 December 2007, no gains or losses were recognised due to hedge ineffectiveness.

Fair value profits on derivatives and complex structured products indicated by a valuation model for which observable market data are not available for key components are not recognised immediately in the income statement. These profits are recognised in the income statement when the model valuation inputs become observable in external markets or when the transaction matures or is closed out. The table below summarises the group's portfolios held at fair value by valuation methodology at 31 December:

	<b>Assets</b>		<b>Liabilities</b>	
	<i>Trading securities purchased</i>	<i>Derivatives</i>	<i>Trading securities sold</i>	<i>Derivatives</i>
	%	%	%	%
<b>At 31 December 2008 Fair value based on:</b>				
Quoted market prices	18	–	–	–
Internal models with significant observable market parameters	82	99	100	100
Internal models with significant unobservable market parameters	–	1	–	–
	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
<b>At 31 December 2007 Fair value based on:</b>				
Quoted market prices	91	–	100	–
Internal models with significant observable market parameters	9	98	–	100
Internal models with significant unobservable market parameters	–	2	–	–
	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

#### 14 Financial investments

	2008 US\$000	2007 US\$000
Financial investments:		
– not subject to re-pledge or resale by counterparties	<b>6,288,010</b>	<b>7,403,279</b>
	<b>2008</b>	<b>2007</b>
	<i>Carrying value and fair value</i>	<i>Carrying value and fair value</i>
	US\$000	US\$000
Treasury and other eligible bills:		
– available-for-sale	<b>272,510</b>	107,987
Debt securities:		
– available-for-sale	<b>5,912,885</b>	7,214,611
Equity securities:		
– available-for-sale	<b>102,615</b>	80,681
Total financial investments	<b>6,288,010</b>	<b>7,403,279</b>

**Notes on the Financial Statements** (continued)**15 Interests in associates**

Principal associates of the bank

Name of associate	At 31 December 2008			
	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\$1.8 million of which US\$1.6 million is fully paid
British Arab Commercial Bank Limited	England	Banking	48.92%	US\$81 million and £32 million fully paid £5 million nil paid
HSBC Middle East Leasing Partnership	Dubai, UAE	Leasing	15.00%	US\$10 million fully paid
MENA Infrastructure Fund (GP) Limited	Dubai, UAE	Private equity fund management	33.33%	US\$0.99 million fully paid
MENA Holdings Limited	Cayman Islands	Petro-chemical by products	33.33%	US\$5.4 million fully paid
Rewards Management Middle East Free Zone Limited Liability Company	Dubai, UAE	Multi-participant loyalty programmes	40.00%	AED0.5 million

On September 2008, the bank purchased 33.33 per cent of the equity share capital of MENA Holdings Limited at a cost of US\$1,800 thousand.

British Arab Commercial Bank reduced its paid up share capital during the year. This resulted in an increase in the per cent holdings by the group to 48.92 per cent (2007: 46.51 per cent).

British Arab Commercial Bank Limited has issued US\$44,478 thousand of subordinated unsecured loan stock in which the group has a 34.66 per cent (2007: 34.66 per cent) interest.

The bank's share of associates' contingent liabilities amounted to US\$415,797 thousand at 31 December 2008 (2007: US\$758,380 thousand).

The associates are unlisted.

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

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.

MENA Holdings Limited operates in Cayman Islands.

Movement in investments in associates:

	<b>2008</b>
	<b>US\$000</b>
At 1 January 2008	<b>157,756</b>
Additions	<b>27,595</b>
Retained profits and losses	<b>15,895</b>
Exchange and other movements	<b>(48,817)</b>
<b>At 31 December 2008</b>	<b><u>152,429</u></b>

Summarised aggregated financial information of associates is as follows:

	<b>2008</b>	2007
	<b>US\$000</b>	US\$000
Assets	<b>2,213,775</b>	2,351,170
Liabilities	<b>2,084,751</b>	2,171,839
Revenues	<b>58,336</b>	42,510
Profit	<b>30,844</b>	21,752

**Notes on the Financial Statements** (continued)**16 Intangible assets**

The analysis of the movement of intangible assets for the year ended 31 December 2008 is as follows:

	<i>Internally generated software</i>	<i>Purchased software</i>	<i>Total</i>
<b>Cost</b>	<b>US\$000</b>	<b>US\$000</b>	<b>US\$000</b>
At 1 January 2008	9,944	5,695	15,639
Additions	4,074	2,738	6,812
Disposals	–	(291)	(291)
Other changes	(1)	(1)	(2)
<b>At 31 December 2008</b>	<b>14,017</b>	<b>8,141</b>	<b>22,159</b>
<b>Accumulated depreciation</b>			
At 1 January 2008	(3,308)	(4,124)	(7,432)
Charge for the year <sup>1</sup>	(4,560)	(1,105)	(5,665)
Disposals	–	118	118
Other changes	–	(69)	(69)
<b>At 31 December 2008</b>	<b>(7,868)</b>	<b>(5,180)</b>	<b>(13,048)</b>
<b>Net book value at 31 December 2008<sup>2</sup></b>	<b>6,150</b>	<b>2,961</b>	<b>9,111</b>
<b>Cost</b>			
At 1 January 2007	6,379	5,102	11,481
Additions	3,565	1,051	4,616
Disposals	–	(339)	(339)
Exchange translation differences	–	(119)	(119)
At 31 December 2007	9,944	5,695	15,639
<b>Accumulated depreciation</b>			
At 1 January 2007	(176)	(3,812)	(3,988)
Charge for the year	(2,957)	(753)	(3,710)
Disposals	–	339	339
Exchange translation differences	(175)	102	(73)
At 31 December 2007	(3,308)	(4,124)	(7,432)
<b>Net book value at 31 December 2007</b>	<b>6,636</b>	<b>1,571</b>	<b>8,207</b>

<sup>1</sup> The amortisation charge for the year is recognised within the income statement under 'Amortisation and impairment of intangible assets'

<sup>2</sup> There are no intangible assets whose title is restricted and/or pledged as security for liabilities.

## 17 Property, plant and equipment

	<i>Freehold land and buildings</i>	<i>Short leasehold land and buildings</i>	<i>Equipment, fixtures and fittings</i>	<i>Total</i>
	US\$000	US\$000	US\$000	US\$000
<b>Cost or fair value</b>				
At 1 January 2008	47,961	42,503	80,578	171,042
Additions at cost	547	15,004	24,317	39,868
Disposals	–	(585)	(3,444)	(4,029)
Exchange translation differences	(435)	–	(1,655)	(2,090)
Other changes	–	(11)	8,298	8,287
<b>At 31 December 2008</b>	<b>48,073</b>	<b>56,911</b>	<b>108,094</b>	<b>213,078</b>
<b>Accumulated depreciation</b>				
At 1 January 2008	(3,044)	(24,363)	(57,565)	(84,972)
Depreciation charge for the year	(1,205)	(4,012)	(11,661)	(16,878)
Disposals	–	581	2,641	3,222
Exchange translation differences	76	6	486	568
Other changes	99	(97)	(2,220)	(2,218)
<b>At 31 December 2008</b>	<b>(4,074)</b>	<b>(27,885)</b>	<b>(68,319)</b>	<b>(100,278)</b>
<b>Net carrying amount at 31 December 2008</b>	<b>43,999</b>	<b>29,026</b>	<b>39,775</b>	<b>112,800</b>
<b>Cost or fair value</b>				
At 1 January 2007	47,241	46,155	74,905	168,301
Additions at cost	663	5,067	12,029	17,759
Disposals	–	(8,753)	(6,546)	(15,299)
Exchange translation differences	84	34	70	188
Other changes	(27)	–	120	93
<b>At 31 December 2007</b>	<b>47,961</b>	<b>42,503</b>	<b>80,578</b>	<b>171,042</b>
<b>Accumulated depreciation</b>				
At 1 January 2007	(1,938)	(23,787)	(54,324)	(80,049)
Depreciation charge for the year	(1,201)	(3,261)	(9,534)	(13,996)
Disposals	–	2,814	6,276	9,090
Exchange translation differences	(15)	(9)	(35)	(59)
Other changes	110	(120)	52	42
<b>At 31 December 2007</b>	<b>(3,044)</b>	<b>(24,363)</b>	<b>(57,565)</b>	<b>(84,972)</b>
<b>Net book value at 31 December 2007</b>	<b>44,917</b>	<b>18,140</b>	<b>23,013</b>	<b>86,070</b>

**Notes on the Financial Statements** (continued)

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

	2008		2007	
	<i>Cost</i>	<i>Accumulated depreciation</i>	<i>Cost</i>	<i>Accumulated depreciation</i>
	US\$000	US\$000	US\$000	US\$000
At 1 January	42,503	(24,250)	46,155	(23,820)
Additions	15,004	–	5,067	–
Disposals	(585)	–	(8,753)	–
Depreciation charge for the year	–	(2,811)	–	(410)
Exchange translation differences	(11)	2	34	7
Other changes	–	–	–	(27)
<b>At 31 December</b>	<b>56,911</b>	<b>(27,059)</b>	<b>42,503</b>	<b>(24,250)</b>
<b>Net book value at 31 December</b>	<b>29,852</b>		<b>18,253</b>	

**18 Investments**

The principal subsidiary undertakings of HSBC Bank Middle East Ltd. are:

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

In order to comply with local legal requirements, the ownership of the investment in HSBC Middle East Securities LLC is held 49.00 per cent in the name of the bank and 51.00 per cent in the personal name of Mr Abdul Wahid Al Ulama, as nominee. Under a Memorandum of Understanding, the nominee has transferred his legal and/or beneficial interest in HSBC Middle East Securities LLC to the bank. The total book value of the assets and equity and liabilities of HSBC Middle East Securities LLC amount to US\$14,711 thousand (2007: US\$ 8,235 thousand).

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.



## 19 Other assets

	2008	2007
	US\$000	US\$000
Assets held for sale	1,800	2,135
Endorsements and acceptances	1,210,085	1,108,687
Current tax recoverable	7,872	–
Other accounts	138,111	91,336
	<u>1,357,868</u>	<u>1,202,158</u>

Assets held for sale

	2008	2007
	US\$000	US\$000
<b>Disposal groups</b>		
Property, plant and equipment	1,800	2,135
Non-current assets held for sale	1,800	2,135
Total assets classified as held for sale	<u>1,800</u>	<u>2,135</u>

The property, plant and equipment classified as held for sale is a result of repossession of property and motor vehicles that had been pledged as collateral by customers. No fair value is calculated for repossessed properties. Repossessed motor vehicles are held at fair value. Gains and losses recognised on impairment of these assets to fair value are reported in 'Loan impairment charges'.

## 20 Debt securities in issue

	2008		2007	
	<i>Book value</i>	<i>Fair value</i>	<i>Book value</i>	<i>Fair value</i>
	US\$000	US\$000	US\$000	US\$000
Medium term notes	2,955,154	2,636,066	1,995,607	1,994,190
Other debt securities in issue	136,123	129,246	136,147	136,142
Non-equity preference shares	1,350,000	1,000,600	850,000	844,488
Debt securities in issue	<u>4,441,277</u>	<u>3,765,912</u>	<u>2,981,754</u>	<u>2,974,820</u>

The following table analyses the carrying amounts of medium term notes in issue at 31 December 2008 with original maturities greater than one year.

	2008	2007
	US\$000	US\$000
<b>Variable interest rate</b>		
Vanilla debt - 5.00% to 5.99%: due 2009 to 2013	<u>2,955,154</u>	<u>1,995,607</u>

## Notes on the Financial Statements (continued)

### 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 28 September 2006, the bank's Debt Issuance Programme was extended to provide for the issue of up to US\$3,000,000,000 in debt securities in similar form.

On 17 January 2008, the bank's Debt Issuance Programme was extended to provide for the issue of up to US\$7,000,000,000 in debt securities in similar form.

### Issued

<i>Issue Tranche</i>	<i>Issue Date</i>	<i>Issue Currency</i>	<i>Floating rate Notes Currency Value</i>	<i>Due Date</i>
1	14 December 2004	US\$	300,000,000	14 December 2009
2	5 May 2005	US\$	700,000,000	5 May 2010
3	14 November 2006	US\$	1,000,000,000	14 November 2011
4	30 April 2008	AED	3,000,000,000	30 April 2013
5	23 December 2008	SAR	542,500,000	23 December 2010

1 The costs of each issue have been amortised over the life of the notes.

2 The notes are listed on the Main Official List of the United Kingdom Listing Authority.

### Non-equity preference share capital

#### Authorised

The authorised non-equity preference share capital of the bank at 31 December 2008 was 2,500,000 (2007: 1,250,000) cumulative redeemable preference shares of US\$1.00 each.

On 21 July 2008, the bank's authorised non-equity preference share capital was increased from 1,250,000 cumulative redeemable preference shares of US\$1.00 each to 2,500,000 cumulative redeemable preference shares of US\$1.00 each.

#### Issued

### Perpetual cumulative redeemable preference shares

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

- 1 *The perpetual cumulative redeemable preference shares have been issued at a nominal value of US\$1 each with a premium of US\$999 per share.*
- 2 *Cumulative redeemable preference dividends are payable annually on the issue price of each perpetual share.*
- 3 *The perpetual cumulative redeemable preference shares bear no mandatory redemption date. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.*
- 4 *Each share carries one vote at meetings of the shareholders of the bank.*
- 5 *In the event of a winding up, the US dollar preference shareholders would receive, in priority to the ordinary shareholders of the bank, repayment of US\$1,000 per share, plus an amount equal to any accrued but unpaid dividends. With the exception of the above, the preference shares do not carry any right to participate in the surplus of assets on a winding up.*

#### **Dated cumulative redeemable preference shares**

<i>Issue number</i>	<i>Issue date</i>	<i>Dated cumulative redeemable preference shares</i>	<i>Cumulative redeemable preference dividends</i>	<i>Redeemable at the option of the bank on any date after</i>	<i>Earliest redemption date</i>
<i>number</i>	<i>date</i>	<i>Number</i>	<i>%</i>	<i>Date</i>	<i>Date</i>
3	17 December 2003	225,000	12 month US dollar LIBOR + 0.50	17 December 2008	17 December 2013
4	26 August 2004	100,000	12 month US dollar LIBOR + 0.48	26 August 2009	26 August 2014
5	19 December 2005	100,000	12 month US dollar LIBOR + 0.30	19 December 2010	19 December 2015
6	14 March 2006	100,000	12 month US dollar LIBOR + 0.40	14 March 2011	14 March 2016
7	20 June 2007	100,000	12 month US dollar LIBOR + 0.33	20 June 2012	20 June 2017
8	28 April 2008	200,000	12 month US dollar LIBOR + 2.34	28 April 2013	28 April 2018
9	31 July 2008	300,000	6.70 fixed rate	31 July 2013	31 July 2018

- 1 *The dated cumulative redeemable preference shares have been issued at a nominal value of US\$1 each with a premium of US\$999 per share.*
- 2 *Cumulative redeemable preference dividends are payable annually on the issue price of each dated share.*
- 3 *Redemption of the dated cumulative redeemable preference shares, other than at the option of the bank, will be subject to the approval of the ordinary shareholders of the bank. The earliest redemption date is as disclosed in the table above and if not approved by the shareholders will next fall for review at 10 yearly intervals thereafter. However, the shares may be redeemed at the option of the bank without the approval of the ordinary shareholders of the bank. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.*
- 4 *Each share carries one vote at meetings of the shareholders of the bank.*
- 5 *In the event of a winding up, the US dollar preference shareholders would receive, in priority to the ordinary shareholders of the bank, repayment of US\$1,000 per share, plus an amount equal to any accrued but unpaid dividends. With the exception of the above, the preference shares do not carry any right to participate in the surplus of assets on a winding up.*

## Notes on the Financial Statements (continued)

### 21 Other liabilities

	2008	2007
	US\$000	US\$000
Share-based payments	–	5,316
Endorsements and acceptances	1,210,085	1,108,687
Other liabilities	271,710	547,861
	<u>1,481,795</u>	<u>1,661,864</u>

### 22 Provisions

	2008	2007
	US\$000	US\$000
At 1 January	6,406	1,721
Additional provisions/increase in provisions	3,412	3,152
Provisions utilised	(5,881)	(1,668)
Amounts reversed	–	(6)
Exchange and other movements	2,315	3,207
<b>At 31 December</b>	<u>6,252</u>	<u>6,406</u>

Included within 'Provisions' is an amount of US\$564 thousand (2007: US\$1,749 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 purposes and for environmental projects in the region. Funding is provided on a case by case basis, throughout the year.

### 23 Deferred taxation

	2008			2007		
	<i>Deferred tax asset</i>	<i>Deferred tax liability</i>	<i>Total</i>	<i>Deferred tax asset</i>	<i>Deferred tax liability</i>	<i>Total</i>
	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000
Temporary differences:						
– retirement benefits	–	1,671	1,671	–	604	604
– provision for loan impairment charges	22,634	858	23,492	19,872	–	19,872
– revaluation of property	–	(2,532)	(2,532)	–	(2,569)	(2,569)
– available-for-sale securities	764	(1,631)	(867)	(1,605)	(1,533)	(3,138)
– cash-flow hedges	2,865	–	2,865	1,944	–	1,944
– share based payments	(662)	(23)	(685)	166	(59)	107
– other short term timing differences	14,116	(1,388)	12,728	12,863	–	12,863
<b>At 31 December</b>	<u>39,717</u>	<u>(3,045)</u>	<u>36,672</u>	<u>33,240</u>	<u>(3,557)</u>	<u>29,683</u>

## 24 Fair value of financial instruments

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### *Control Framework*

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

For fair values determined by reference to external quotation or evidenced pricing parameters, independent price determination or validation is used. In less liquid markets, direct observation of a traded price may not be possible. In these circumstances, the group will source alternative market information to validate the financial instrument's fair value. Greater weight will be given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, inter alia:

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

The results of the independent price validation process are reported to senior management, and adjustments to fair values resulting from considerations of the above information are recorded where appropriate.

For fair values determined using a valuation model, the model being a logical framework for the capture and processing of necessary valuation inputs, the control framework may include, as applicable, independent development or validation of the logic within valuation models, the inputs to those models, any adjustments required outside the valuation models, and, where possible, model outputs.

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

### *Determination of fair value*

Fair values are determined according to the following hierarchy:

*Quoted market price:* financial instruments with quoted prices for identical instruments in active markets.

*Valuation technique using observable inputs:* financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

*Valuation technique with significant non-observable inputs:* financial instruments valued using models where one or more significant inputs are not observable.

## Notes on the Financial Statements (continued)

The best evidence of fair value is a quoted price in an actively traded market. In the event that the market for a financial instrument is not active, a valuation technique is used. The majority of valuation techniques employ only observable market data, and so the reliability of the fair value measurement is high. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are not observable. For these instruments, the fair value derived is more judgemental. 'Not observable' in this context means that there is little or no current market data available from which to determine the level at which an arm's length transaction would be likely to occur, but it generally does not mean that there is no market data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used). Furthermore, the majority of the fair value derived from a valuation technique with significant non-observable inputs may in some cases still be attributable to the observable inputs. Consequently, the impact of uncertainty in the determination of the unobservable inputs will generally only give rise to a degree of uncertainty about the overall fair value of the financial instrument being measured. To assist in understanding the extent and the range of this uncertainty, additional information is provided in respect of instruments valued using non-observable inputs in the section headed 'Effect of changes in significant unobservable assumption to reasonably possible alternatives' below.

The fair values of large holdings of non-derivative financial instruments are based on a multiple of the value of a single instrument, and do not include block adjustments for the size of the holding.

Transaction costs are not included in the fair value calculation. Trade origination costs such as brokerage fees and post-trade costs are included in operating expenses. The future costs of administering the over the counter ('OTC') derivative portfolio are also not included in fair value, but are expensed as incurred.

### – Private equity

In the absence of an active market, an investment's fair value is estimated on the basis of an analysis of the investee's financial position and results, risk profile, prospects and other factors, as well as by reference to market valuations for similar entities quoted in an active market, or the price at which similar companies have changed ownership. The exercise of judgment is required because of uncertainties inherent in estimating fair value for private equity investments.

### – Debt securities, treasury and other eligible bills, and equities

The fair value of these instruments is based on quoted market prices from an exchange, dealer, broker, industry group or pricing service, when available. When unavailable, the fair value is determined by reference to quoted market prices for similar instruments.

In the absence of quoted market prices, fair value is determined using valuation techniques. The inputs to these valuation techniques are derived from observable market data and, where relevant, assumptions in respect of unobservable inputs.

### – Derivatives

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

**Bases of valuing financial assets and liabilities measured at fair value:**

	<u>Valuation techniques</u>			<u>Total</u>
	<u>Quoted market price</u>	<u>using observable inputs</u>	<u>with significant non- observable inputs</u>	
	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>
<b>At 31 December 2008</b>				
<b>Assets</b>				
Trading assets	63,985	301,366	–	365,351
Derivatives	–	971,491	8,671	980,162
Financial investments: available-for-sale	24,436	6,226,922	36,652	6,288,010
<b>Liabilities</b>				
Trading liabilities	–	54,319	–	54,319
Derivatives	–	981,758	764	982,522
<b>At 31 December 2007</b>				
<b>Assets</b>				
Trading assets	1,368,492	135,274	–	1,503,766
Derivatives	–	390,179	5,847	396,026
Financial investments: available-for-sale	179,901	7,185,705	37,673	7,403,279
<b>Liabilities</b>				
Trading liabilities	84,061	–	–	84,061
Derivatives	–	401,112	–	401,112

*Effect of changes in significant unobservable assumption to reasonably possible alternatives*

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

	<u>Reflected in profit/(loss)</u>		<u>Reflected in equity</u>	
	<u>Favourable changes</u>	<u>Un- favourable changes</u>	<u>Favourable changes</u>	<u>Un- favourable changes</u>
	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>
<b>At 31 December 2008</b>				
Derivatives/trading assets/trading liabilities <sup>1</sup>	–	(327)	–	–
Financial investments: available-for-sale	–	–	3,081	(3,081)
<b>At 31 December 2007</b>				
Derivatives/trading assets/trading liabilities	–	(327)	–	–
Financial investments: available-for-sale	–	–	–	–

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

## Notes on the Financial Statements (continued)

### *Changes in fair value recorded in the income statement*

The following table quantifies the changes in fair values recognised in profit or loss during the period in respect of exposures where the fair value of these exposures is estimated using valuation techniques that incorporate significant assumptions that are not evidenced by prices from observable current market transactions in the same instrument, and are not based on observable market data:

- the table details the total change in fair value of these instruments; it does not isolate the component of the change that is attributable to the unobservable component;
- instruments valued with significant unobservable inputs are frequently dynamically managed with instruments valued using observable inputs; the table does not include any changes in fair value of these latter instruments; and
- for assets and liabilities valued using significant unobservable inputs at 31 December 2008 where these inputs were observable at 31 December 2007, the table reflects the full change in fair value of those instruments during the period.

	<b>Year ended 31 December</b>	
	<b>2008</b>	2007
	<b>US\$000</b>	US\$000
<b>Recorded profit on:</b>		
Derivatives/trading assets/trading liabilities	<b>3,118</b>	947

### **Fair values of financial instruments not carried at fair value**

Fair values at the balance sheets date of the assets and liabilities set out below are estimated for the purpose of disclosure at follows:

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

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

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

#### (ii) Financial investments

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

#### (iii) Deposits by banks and customer accounts

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

#### (iv) Debt securities in issue

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



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

For all classes of financial instruments, fair value represents the product of the value of a single instrument, multiplied by the number of instruments held. No block discount or premium adjustments are made.

The fair values of intangible assets related to the businesses which originate and hold the financial instruments subject to fair value measurement, such as values placed on portfolios of core deposits, credit card and customer relationships, are not included above because they are not classified as financial instruments. Accordingly, an aggregation of fair value measurements does not approximate the value of the organisation as a whole as a going concern.

The following table lists financial instruments whose carrying amount is a reasonable approximation of fair value because, for example, they are short-term in nature or reprice to current market rates frequently:

<b>Assets</b>	<b>Liabilities</b>
Cash and balances at central banks	Items in the course of transmission
Items in the course of collection	Endorsements and acceptances
Endorsements and acceptances	Short-term payables within 'Other Liabilities'
Short term receivables within 'Other Assets'	Accruals within 'Accruals and deferred income'
Accrued income within 'Prepayments and accrued income'	

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

	<b>2008</b>		<b>2007</b>	
	<i>Carrying value</i>	<i>Fair value</i>	<i>Carrying value</i>	<i>Fair value</i>
	<b>US\$000</b>	<b>US\$000</b>	US\$000	US\$000
<b>Assets</b>				
Loans and advances to banks	<b>7,111,613</b>	<b>6,947,085</b>	6,384,369	6,384,215
Loans and advances to customers	<b>23,685,672</b>	<b>23,563,645</b>	18,614,547	18,676,780
<b>Liabilities</b>				
Deposits by banks	<b>1,811,408</b>	<b>1,839,271</b>	3,425,491	3,422,329
Customer accounts	<b>28,745,291</b>	<b>28,753,674</b>	25,648,194	25,642,865
Debt securities in issue: Medium term notes (Note 20)	<b>2,955,154</b>	<b>2,636,066</b>	1,995,607	1,994,190

## **25 Trading liabilities**

	<i>Carrying amount</i>	
	<b>2008</b>	2007
	<b>US\$000</b>	US\$000
Debt securities in issue	<b>(14,942)</b>	(23,837)
Other liabilities - net short positions	<b>69,261</b>	107,898
	<b>54,319</b>	84,061

## Notes on the Financial Statements (continued)

### 26 Maturity analysis of liabilities

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

Trading liabilities and trading derivatives have been included in the 'On demand' time bucket, and not by contractual maturity, because trading liabilities are typically held for short periods of time. The undiscounted cash flows on hedging derivative liabilities are classified according to their contractual maturity.

	<i>On demand</i>	<i>Due within 3 months</i>	<i>Due between 3 and 12 months</i>	<i>Due between 1 and 5 years</i>	<i>Due after 5 years</i>	<i>Total</i>
	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>
Deposits by banks	727,553	972,449	106,172	6,022	1,002	1,813,198
Customer accounts	14,123,802	9,922,484	3,949,436	861,037	2,057	28,858,816
Derivatives	986,995	–	7,330	–	–	994,325
Debt securities in issue	–	34,055	428,237	3,626,268	1,387,100	5,475,660
Other financial liabilities	39,460	1,732,954	250,128	4,887	–	2,027,429
Loan commitments	2,287,636	4,206,723	14,236,383	736,899	49	21,467,690
<b>Total at 31 December 2008</b>	<b>18,165,446</b>	<b>16,868,665</b>	<b>18,977,686</b>	<b>5,235,113</b>	<b>1,390,208</b>	<b>60,637,118</b>

	<i>On demand</i>	<i>Due within 3 months</i>	<i>Due between 3 and 12 months</i>	<i>Due between 1 and 5 years</i>	<i>Due after 5 years</i>	<i>Total</i>
	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>	<u>US\$000</u>
Deposits by banks	1,418,338	1,828,010	185,369	7,119	–	3,438,836
Customer accounts	13,367,917	10,720,491	1,376,426	334,538	19,565	25,818,937
Derivatives	401,112	–	8,063	–	–	409,175
Debt securities in issue	–	44,474	122,021	2,773,895	1,064,060	4,004,450
Other financial liabilities	14,749	729,505	208,127	11,344	–	963,725
Loan commitments	4,099,523	2,929,760	9,430,985	797,251	229,042	17,486,561
<b>Total at 31 December 2007</b>	<b>19,301,639</b>	<b>16,252,240</b>	<b>11,330,991</b>	<b>3,924,147</b>	<b>1,312,667</b>	<b>52,121,684</b>

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

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

<b>At 31 December 2008</b>			
	<i>Due within 1 year</i>	<i>Due after more than 1 year</i>	<i>Total</i>
	<b>US\$000</b>	<b>US\$000</b>	<b>US\$000</b>
<b>Assets</b>			
Loans and advances to banks	6,810,246	301,367	7,111,613
Loans and advances to customers	14,907,883	8,777,789	23,685,672
Financial investments	5,992,493	295,517	6,288,010
Other financial assets	1,205,194	4,890	1,210,084
	<b><u>28,915,816</u></b>	<b><u>9,379,563</u></b>	<b><u>38,295,379</u></b>
<b>Liabilities</b>			
Deposits by banks	1,806,255	5,153	1,811,408
Customer accounts	27,937,415	807,876	28,745,291
Debt securities in issue	299,637	4,141,640	4,441,277
Other financial liabilities	1,204,828	5,257	1,210,085
	<b><u>31,248,135</u></b>	<b><u>4,959,926</u></b>	<b><u>36,208,061</u></b>
<b>At 31 December 2007</b>			
	<i>Due within 1 year</i>	<i>Due after more than 1 year</i>	<i>Total</i>
	US\$000	US\$000	US\$000
<b>Assets</b>			
Loans and advances to banks	6,266,673	117,696	6,384,369
Loans and advances to customers	12,223,498	6,391,049	18,614,547
Financial investments	6,989,544	413,735	7,403,279
Other financial assets	1,095,098	13,589	1,108,687
	<b><u>26,574,813</u></b>	<b><u>6,936,069</u></b>	<b><u>33,510,882</u></b>
<b>Liabilities</b>			
Deposits by banks	3,419,159	6,332	3,425,491
Customer accounts	25,336,359	311,835	25,648,194
Debt securities in issue	–	2,981,754	2,981,754
Other financial liabilities	1,095,833	12,854	1,108,687
	<b><u>29,851,351</u></b>	<b><u>3,312,775</u></b>	<b><u>33,164,126</u></b>

Further discussion of the group's liquidity and funding management can be found in Note 32 'Risk management'.

**Notes on the Financial Statements** (continued)**27 Foreign currency exposures***Structural foreign exchange exposures*

The group's structural foreign currency exposure is represented by the net asset value of its foreign currency equity and subordinated debt investments in subsidiary undertakings, branches and associates.

The group's management of structural foreign currency exposures is discussed in Note 32.

**Net structural currency exposures**

Currency of structural exposure	2008 US\$000	2007 US\$000
Bahraini dinar	112,052	104,418
Jordanian dinar	147,458	116,023
Kuwaiti dinar	82,965	65,541
Lebanese pound	69,942	50,417
Omani riyal	209,639	139,613
Pakistani rupee	7,470	–
Qatari riyal	271,487	197,245
Sterling	203	281
UAE dirham	3,470,599	2,181,284
<b>Total</b>	<b>4,371,815</b>	<b>2,854,822</b>

**28 Assets charged as security for liabilities and collateral accepted as security for assets**

Financial assets pledged to secure liabilities are as follows:

	Pledged at 31 December	
	2008 US\$000	2007 US\$000
Treasury bills and other eligible securities	9,700	–

These transactions are conducted under terms that are usual and customary to standard securities lending and repurchase agreements.

The fair value of financial assets accepted as collateral that the group is permitted to sell or repledge in the absence of default is US\$44,962 thousand (2007: US\$ Nil). The fair value of financial assets accepted as collateral that have been sold or repledged is US\$5,652 thousand (2007: US\$ Nil). The group is obliged to return these assets.

These transactions are conducted under terms that are usual and customary to standard stock borrowing and lending activities.

**29 Called up share capital**

## Authorised

The authorised ordinary share capital of the bank at 31 December 2008 was 1,500,000,000 (2007: 1,000,000,000) ordinary shares of US\$1.00 each.

On 21 July 2008, the bank's authorised ordinary share capital was increased from 1,000,000,000 ordinary shares of US\$1.00 each to 1,500,000,000 ordinary shares of US\$1.00 each.

On 27 June 2008, the bank issued 200,000,000 ordinary shares of US\$1.00 each, fully paid, at par.

Issued and fully paid	Number of ordinary shares	US\$000
At 1 January 2008	431,055,000	431,055
Shares issued	200,000,000	200,000
<b>At 31 December 2008</b>	<b>631,055,000</b>	<b>631,055</b>
At 1 January and 31 December 2007	431,055,000	431,055

### 30 Reserves

	2008								
	Other reserves								
	<i>Called up share capital</i>	<i>Retained earnings</i>	<i>Available- for-sale fair value reserve</i>	<i>Cash flow hedging reserve</i>	<i>Foreign exchange reserve</i>	<i>Share- based payment reserve</i>	<i>Total share- holders' equity</i>	<i>Minority interests</i>	<i>Total equity</i>
US\$000	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000
At 1 January	431,055	1,739,413	60,458	(7,778)	3,873	3,915	2,230,936	135,127	2,366,063
New share capital subscribed	200,000	-	-	-	-	-	200,000	-	200,000
Profit for the year attributable to shareholders	-	965,610	-	-	-	-	965,610	-	965,610
Dividends to shareholders of the parent company	-	(250,000)	-	-	-	-	(250,000)	-	(250,000)
Share of changes recognised directly in equity in the associate's equity	-	(54,955)	-	-	-	-	(54,955)	-	(54,955)
Actuarial losses on post- employment benefits schemes	-	(6,005)	-	-	-	-	(6,005)	-	(6,005)
Exchange differences arising on monetary items that form part of a net investment in a foreign operation	-	-	-	-	(3,551)	-	(3,551)	-	(3,551)
Fair value gains/(losses) taken to equity	-	-	1,991	(11,040)	-	-	(9,049)	-	(9,049)
Amounts transferred to the income statement	-	-	(13,899)	6,435	-	-	(7,464)	-	(7,464)
Charge to the income statement in respect of equity settled share-based payment transactions	-	-	-	-	-	137	137	-	137
Charge to the income statement in respect of restricted share awards	-	-	-	-	-	3,875	3,875	-	3,875
Charge to the income statement in respect of share save options	-	-	-	-	-	54	54	-	54
Tax on items taken directly to equity	-	1,067	1,607	922	-	-	3,596	-	3,596
Exchange and other movements	-	6,194	(205)	-	-	97	6,086	-	6,086
Profit attributable to minority interests	-	-	-	-	-	-	-	13,408	13,408
Dividends to minority interests	-	-	-	-	-	-	-	(816)	(816)
Increase in minority interest stake and other	-	-	-	-	-	-	-	104,266	104,266
<b>At 31 December</b>	<b>631,055</b>	<b>2,401,324</b>	<b>49,952</b>	<b>(11,461)</b>	<b>322</b>	<b>8,078</b>	<b>3,079,270</b>	<b>251,985</b>	<b>3,331,255</b>

## Notes on the Financial Statements (continued)

	2007								
	Other reserves								
	<i>Called up share capital</i>	<i>Retained earnings</i>	<i>Available- for-sale fair value reserve</i>	<i>Cash flow hedging reserve</i>	<i>Foreign exchange reserve</i>	<i>Share- based payment reserve</i>	<i>Total share- holders' equity</i>	<i>Minority interests</i>	<i>Total equity</i>
US\$000	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000	
At 1 January	431,055	1,187,829	15,023	(3,513)	248	3,385	1,634,027	67,327	1,701,354
New share capital subscribed	-	-	-	-	-	-	-	-	-
Profit for the year attributable to shareholders	-	703,967	-	-	-	-	703,967	-	703,967
Dividends to shareholders of the parent company	-	(150,000)	-	-	-	-	(150,000)	-	(150,000)
Share of changes recognised directly in equity in the associate's equity	-	(7,090)	-	-	-	-	(7,090)	-	(7,090)
Actuarial losses on post- employment benefits schemes	-	(5,251)	-	-	-	-	(5,251)	-	(5,251)
Exchange differences arising on monetary items that form part of a net investment in a foreign operation	-	-	-	-	3,625	-	3,625	-	3,625
Fair value gains/(losses) taken to equity	-	-	51,282	(6,170)	-	-	45,112	-	45,112
Amounts transferred to the income statement	-	-	(2,923)	838	-	-	(2,085)	-	(2,085)
Charge to the income statement in respect of equity settled share-based payment transactions	-	-	-	-	-	530	530	-	530
Tax on items taken directly to equity	-	1,208	(2,891)	1,067	-	-	(616)	-	(616)
Exchange and other movements	-	8,750	(33)	-	-	-	8,717	-	8,717
Profit attributable to minority interests	-	-	-	-	-	-	-	15,067	15,067
Dividends to minority interests	-	-	-	-	-	-	-	(1,962)	(1,962)
Increase in minority interest stake and other	-	-	-	-	-	-	-	54,695	54,695
At 31 December	<u>431,055</u>	<u>1,739,413</u>	<u>60,458</u>	<u>(7,778)</u>	<u>3,873</u>	<u>3,915</u>	<u>2,230,936</u>	<u>135,127</u>	<u>2,366,063</u>

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

Non-cash items included in profit and loss	2008 US\$000	2007 US\$000
Depreciation and amortisation	22,540	17,689
Loan impairment losses	280,237	53,651
Loans written off net of recoveries	(127,734)	(54,786)
Provisions raised	3,645	1
Provisions utilised	(5,882)	(1,668)
	<u>172,806</u>	<u>14,887</u>
Change in operating assets		
Change in prepayments and accrued income	(30,713)	(62,494)
Change in net trading securities and net derivatives	554,279	(922,137)
Change in loans and advances to banks	(626,917)	(204,110)
Change in loans and advances to customers	(5,224,706)	(5,001,230)
Change in other assets	(155,710)	(439,450)
	<u>(5,483,767)</u>	<u>(6,629,421)</u>
Change in operating liabilities		
Change in accruals and deferred income	55,067	20,530
Change in deposits by banks	(1,614,083)	2,063,949
Change in customer accounts	3,097,097	8,066,474
Change in debt securities in issue	968,418	45,949
Change in other liabilities	368,020	892,723
	<u>2,874,519</u>	<u>11,089,625</u>
Cash and cash equivalents comprise		
Cash and balances at central banks	960,721	861,247
Items in the course of collection from other banks	229,480	297,440
Loans and advances to banks of one month or less	5,838,413	5,738,087
Treasury bills, other bills and certificates of deposit less than three months	3,211,860	5,651,932
Less: items in the course of transmission to other banks	(174,219)	(188,860)
	<u>10,066,255</u>	<u>12,359,846</u>

## Notes on the Financial Statements (continued)

### 32 Risk management

All the group's activities involve analysis, evaluation, acceptance and management of some degree of risk or combination of risks.

The most important risk categories that the group is exposed to are credit risk (including cross-border country risk), liquidity risk, market risk (including foreign exchange, interest rate, equity price and credit spread risks). In addition, risk also arises from off-balance sheet arrangements, including financial guarantees, letters of credit and commitments to lend.

The management of all risks which are significant to the group is discussed below.

#### *Credit risk*

Credit risk is the risk of financial loss if a customer or counterparty fails to meet an obligation under a contract. It arises principally from direct lending, trade finance and leasing business, but also from guarantees and derivatives, and from the group's holdings of assets in the form of debt securities. The group has standards, policies and procedures dedicated to monitoring and managing risk from such activities.

#### Credit risk management

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

- Controlling exposures to sovereign entities, banks and other financial institutions. HSBC's credit and settlement risk limits to counterparties in these sectors are approved and managed by Group Credit Risk, to optimise the use of credit availability and avoid excessive risk concentration.
- Monitor intra-Group exposures to ensure they are maintained within regulatory limits. Plans are in place to adopt the FSA's new 'Integrated Groups' regime in accordance with the agreed transition timetable.
- Controlling cross-border exposures, through the imposition of country limits with sub-limits by maturity and type of business. Country limits are determined by taking into account economic and political factors, and applying local business knowledge. Transactions with countries deemed to be higher risk are considered case by case.

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

- Formulating and recording in instruction manuals detailed credit policies and procedures, consistent with HSBC policy.
- Issuing policy guidelines to subsidiaries and offices on appetite for credit risk exposure to specified market sectors, activities and banking products.
- Undertaking independent review and objective assessment of risk. Credit Risk approves all commercial non-bank credit facilities and exposures – including those embedded in derivatives – that are originated or renewed by subsidiaries and offices over designated limits.
- Monitoring the performance and management of retail portfolios.
- Maintaining policy on large credit exposures, ensuring that concentrations of exposure by counterparty, sector or geography do not become excessive in relation to the group's capital base and remain within internal and regulatory limits.
- Maintaining and developing the governance and operation of HSBC's risk rating framework and systems, to classify exposures.
- Assisting the Risk Strategy unit in the development of stress testing scenarios, economic capital measurement and the refinement of key risk indicators and their reporting.
- Reporting to senior executives on aspects of the group's credit risk portfolio. These executives, as well as the Risk Management Committee, Audit Committee and the Board of Directors of the bank receive a variety of regular and ad hoc reports covering:
  - risk concentrations;
  - retail portfolio performance;
  - specific higher-risk portfolio segments, for example, real estate, banks, and automotive sector;



- individual large impaired accounts, and impairment allowances/charges for all customer segments;
- country limits, cross-border exposures and related impairment allowances;
- portfolio and analytical model performance data, employing Basel II metrics, and
- stress testing results and recommendations.
- Where appropriate, establishing specialist units to provide intensive management and control to maximise recoveries of doubtful debts.
- Managing and directing credit risk management systems initiatives.
- Providing advice and guidance to offices and subsidiaries, to promote best practice on credit-related matters such as:
  - regulatory developments;
  - risk modelling;
  - collective impairment allowances; and
  - new products and credit risk reporting.
- Acting on behalf of the group as the primary interface, for credit-related issues, with external parties including rating agencies, corporate analysts, trade associations and counterparties.

#### Credit quality

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

Previously, the group has deployed a seven-grade rating system based on a 'composite' assessment of the likelihood and extent of delinquency and risk mitigation. This legacy risk rating scale has been superseded by a more granular methodology, based on probability of default and loss estimates, compliant with an internal ratings-based ('IRB') approach required to support the Basel II framework for calculating the group's minimum capital requirement. The integration of this framework into the group's reporting structure will enable reporting on the new basis to internal management in accordance with the group's IRB obligations. The new framework is used by the group's principal operating entities.

#### *Impairment assessment*

When impairment losses occur, the group 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. Two types of impairment allowance are in place: individually assessed and collectively assessed. Impairment allowances may be assessed and created either for individually significant accounts or, on a collective basis, for groups of individually significant accounts for which no evidence of impairment has been individually identified or for high-volume groups of homogeneous loans that are not considered individually significant. It is the group's policy that each operating company creates allowances for impaired loans promptly and on a consistent basis.

Management 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.

#### *Maximum exposure to credit risk*

The following table presents the maximum exposure to credit risk in respect of financial instruments, before taking account of any collateral held or other credit enhancements unless such credit enhancements meet offsetting requirements as set out in Note 2(m) on the Financial Statements. For financial assets recognised on the balance sheet, the exposure to credit risk equals their carrying amount. For financial guarantees granted, the maximum exposure to credit risk is the maximum amount that the group would have to pay if the guarantees were called upon. For loan commitments and other credit-related commitments that are irrevocable over the life of the respective facilities, the maximum exposure to credit risk is the full amount of the committed facilities.

**Notes on the Financial Statements** (continued)

	<b>Maximum exposure 2008 US\$000</b>	Maximum exposure 2007 US\$000
<b>Items in course of collection from other banks</b>	<b>229,480</b>	297,440
<b>Trading assets</b>	<b>189,281</b>	379,582
– debt securities	<b>189,281</b>	379,582
<b>Derivatives</b>	<b>980,162</b>	396,026
<b>Loans and advances to banks</b>	<b>7,111,638</b>	6,384,394
<b>Loans and advances to customers</b>	<b>23,685,672</b>	18,614,547
<b>Financial investments</b>	<b>6,185,395</b>	7,322,598
– treasury and other similar bills	<b>272,510</b>	107,987
– debt securities	<b>5,912,885</b>	7,214,611
<b>Other assets</b>		
– endorsements and acceptances	<b>1,210,085</b>	1,108,687
<b>Off-balance sheet</b>		
– financial guarantees and other credit related contingent liabilities	<b>12,013,139</b>	9,075,005
– loan commitments and other credit related commitments	<b>22,496,352</b>	19,204,076
	<b>74,101,204</b>	62,782,355

**Collateral and other credit enhancements**

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

*Items in the course of collection from other banks*

Settlement risk arises in any situation where a payment in cash, securities or equities is made in the expectation of a corresponding receipt in cash, securities or equities. Daily settlement limits are established for each counterparty to cover the aggregate of all settlement risk arising from the group's transactions with them, on any single day. Settlement risk on many transactions, particularly those involving securities and equities, is substantially mitigated through being effected via assured payment systems, or on a delivery-versus-payment basis.

*Treasury, other eligible bills and debt securities*

Collateral held as security for financial assets other than loans and advances is determined by the nature 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.

*Derivatives*

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

### *Loans and advances*

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

Operating entities are required to implement appropriate guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and determine suitable valuation parameters. Such parameters, structures and legal covenants are supported by empirical evidence and continue to fulfil their intended purpose. 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;
- in the financial sector, charges over financial instruments such as debt securities and equities in support of trading facilities.

In addition, credit derivatives, including credit default swaps and structured credit notes, as well as securitisation structures, are used to manage credit risk in the group's loan portfolio.

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

### **Concentrations of credit risk exposure**

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

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

- the majority of the group's exposure to credit risk is concentrated in the Middle East. Within the Middle East, the group's credit risk is diversified over a wide range of industrial and economic groupings; and
- the group's position as part of a major international banking group means, that it has a significant concentration of exposure to banking counterparties. The majority of credit risk to the banking industry at 31 December 2008 and 31 December 2007 was concentrated in Europe and the Middle East.

## Notes on the Financial Statements (continued)

## Loans and advances to customers by industry sector

	At 31 December 2008		At 31 December 2007	
	<i>Gross loans and advances to customers</i> US\$000	<i>Gross loans by industry sector as a % of total gross loans</i> %	<i>Gross loans and advances to customers</i> US\$000	<i>Gross loans by industry sector as a % of total gross loans</i> %
<b>Personal</b>				
Residential mortgages	1,906,911	7.92	1,013,678	5.38
Other personal	5,309,090	22.07	4,207,651	22.33
	<b>7,216,001</b>	<b>29.99</b>	<b>5,221,329</b>	<b>27.71</b>
<b>Corporate and commercial</b>				
Commercial, industrial and international trade	9,104,996	37.84	7,012,320	37.23
Commercial real estate	1,319,830	5.48	1,424,531	7.56
Other property-related	1,444,306	6.00	1,218,220	6.47
Government	1,193,957	4.96	852,467	4.52
Other commercial	2,643,709	10.99	2,053,648	10.90
	<b>15,706,798</b>	<b>65.27</b>	<b>12,561,186</b>	<b>66.68</b>
<b>Financial</b>				
Non-bank financial institutions	1,141,497	4.74	1,056,919	5.61
Settlement accounts	94	0.00	252	0.00
	<b>1,141,591</b>	<b>4.74</b>	<b>1,057,171</b>	<b>5.61</b>
Total gross loans and advances to customers	<b>24,064,390</b>	<b>100.00</b>	<b>18,839,686</b>	<b>100.00</b>

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.

*Credit quality of financial instruments*

The four classifications below describe the credit quality of the group's lending, debt securities portfolios and derivatives. These categories each encompass a range of more granular, internal credit rating grades assigned to wholesale and retail lending business, as well as the external ratings attributed by external agencies to debt securities. There is no direct correlation between the internal and external ratings at granular level, except insofar as both fall within one of the four classifications.

## Quality Classification

	<i>Wholesale lending and Derivatives</i>	<i>Retail lending</i>	<i>Debt securities / other</i>
<b>Strong</b>	CRR 1 to CRR 2	EL 1 to EL 2	A- and above
<b>Medium</b>	CRR 3 to CRR 4	EL 3 to EL 4	B+ to BBB+, and unrated
<b>Sub-Standard</b>	CRR 6 to CRR 8	EL 6 to EL 8	B and below
<b>Impaired</b>	CRR 9 to CRR 10	EL 9 to EL 10	Impaired

### **Quality classification definitions**

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

‘Medium’: Exposures require closer monitoring, with low to moderate default risk. Retail accounts typically show only short periods of delinquency, with losses expected to be minimal following the adoption of recovery processes.

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

‘Impaired’: Exposures have been assessed, individually or collectively, as impaired. The group observes the disclosure convention, reflected in the quality classification definitions above, that all retail accounts delinquent by 90 days or more are considered impaired. Such accounts may occur in any EL grade, whereby in the higher quality grades the grading assignment will reflect the offsetting of the impact of delinquency status by credit risk mitigation in one form or another.

### **Granular risk rating scales**

The CRR (Customer Risk Rating) 10-grade scale maps to a more granular underlying 22-grade scale of obligor probability of default. The scales are used group-wide for all distinct customers, depending on the Basel II approach adopted for the exposure in question. The EL (Expected Loss) 10-grade scale for retail business summarises a more granular, group-wide 29-grade scale combining obligor and facility/product risk factors in a composite measure. For consistency of disclosure and based on market practice for transactions in debt securities and certain other financial instruments, external ratings have been aligned as above, and in the table of ‘Distribution of financial instruments by credit quality’ below, to the four quality classifications defined for internally-rated exposures, although it should be noted that there is no fixed correlation between internal and external ratings. The ratings of Standard and Poor’s are cited, with those of other agencies being treated equivalently. Debt securities with short-term ratings are reported below against the long-term rating of the issuer of the short-term debt securities. If major rating agencies have different ratings for the same debt securities, the securities are reported against the lower rating.

The basis of reporting has been changed from previous years, replacing the former uniform seven-grade portfolio quality scale, in order both to extend the range of financial instruments covered in the presentation of portfolio quality and to reflect the more risk-sensitive rating systems introduced under the group’s Basel II programme.

Impairment is not measured for assets held in trading portfolios or designated at fair value, as assets in such portfolios are managed according to movements in fair value, and the fair value movement is taken directly through the profit and loss statement. Consequently, all such balances are reported under ‘neither past due nor impaired’.

For details of impairment incurred on available-for-sale debt and equity securities, see ‘Accounting policies’ in Note 2(i).

## Notes on the Financial Statements (continued)

## Distribution of financial instruments by credit quality

31 December 2008							
Neither past due nor impaired							
	<i>Strong</i>	<i>Medium</i>	<i>Sub- standard</i>	<i>Past due not impaired</i>	<i>Impaired</i>	<i>Impairment allowances</i>	<i>Total</i>
	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000
Items in the course of collection from other banks	229,480	–	–	–	–	–	229,480
Trading assets	80,000	108,000	1,281	–	–	–	189,281
– debt securities	80,000	108,000	1,281	–	–	–	189,281
Derivatives	343,162	632,000	5,000	–	–	–	980,162
Loans and advances held at amortised cost	14,059,591	12,568,882	1,699,660	2,524,563	323,332	(378,743)	30,797,285
– loans and advances to banks	6,321,193	503,435	287,010	–	–	(25)	7,111,613
– loans and advances to customers	7,738,398	12,065,447	1,412,650	2,524,563	323,332	(378,718)	23,685,672
31 December 2007							
Neither past due nor impaired							
	<i>Strong</i>	<i>Medium</i>	<i>Sub- standard</i>	<i>Past due not impaired</i>	<i>Impaired</i>	<i>Impairment allowances</i>	<i>Total</i>
	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000
Items in the course of collection from other banks	297,440	–	–	–	–	–	297,440
Trading assets	187,098	192,484	–	–	–	–	379,582
– debt securities	187,098	192,484	–	–	–	–	379,582
Derivatives	151,704	244,322	–	–	–	–	396,026
Loans and advances held at amortised cost	8,643,850	13,160,141	1,515,023	1,631,112	273,954	(225,164)	24,998,916
– loans and advances to banks	5,888,347	294,416	201,631	–	–	(25)	6,384,369
– loans and advances to customers	2,755,503	12,865,725	1,313,392	1,631,112	273,954	(225,139)	18,614,547

## Ageing analysis of past due but not impaired gross financial instruments

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

	<i>Up to 29 days</i>	<i>30–59 days</i>	<i>60–89 days</i>	<i>90–180 days</i>	<i>Over 180 days</i>	<i>Total</i>
	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000
At 31 December 2008	2,071,375	271,527	53,800	83,907	43,954	2,524,563
At 31 December 2007	1,378,441	153,904	38,350	22,141	38,276	1,631,112

## Renegotiated loans

Restructuring activity is designed to manage customer relationships, maximise collection opportunities and, if possible, avoid foreclosure or repossession. Such activities include extended payment arrangements, approved external debt management plans, deferring foreclosure, modification, loan rewrites and/or deferral of payments pending a change in circumstances. Following restructuring, an overdue consumer account is normally reset from delinquent to current status. Restructuring policies and practices are based on indicators or criteria which, in the judgement of local management, indicate that repayment will probably continue. These policies are required to be kept under continual review and their application varies according to the nature of the market, the product, and the availability of empirically based data. Criteria vary between products, but typically include: receipt of one or more qualifying payments within a certain period, a minimum lapse of time from origination before restructuring may occur, and restrictions on the number and/or frequency of successive restructurings. When empirical evidence indicates an increased propensity to default on restructured accounts, the use of roll rate methodology ensures this factor is taken into account when calculating impairment allowances.

## Renegotiated loans that would otherwise be past due or impaired

	At 31 December	
	2008	2007
	US\$000	US\$000
Loans and advances to customers	<u>15,763</u>	<u>10,358</u>

## Collateral and other credit enhancements obtained

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

	2008	2007
	US\$000	US\$000
<b>Nature of assets</b>		
Residential property and motor vehicles	<u>1,800</u>	<u>2,135</u>

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

## Impairment allowances as a percentage of gross loans and advances to customers<sup>1</sup>

	At 31 December	
	2008	2007
	%	%
Individually assessed impairment allowances	0.46	0.59
Collectively assessed impairment allowances	1.11	0.61
	<u>1.57</u>	<u>1.20</u>

<sup>1</sup> Net of settlement accounts

**Notes on the Financial Statements** (continued)

## Movement in impairment allowances

	At 31 December 2008		
	<i>Individually assessed</i>	<i>Collectively assessed</i>	<i>Total</i>
	US\$000	US\$000	US\$000
At 1 January	110,638	114,501	225,139
Amounts written off	(5,281)	(151,364)	(156,645)
Recoveries of loans and advances written off in previous years	1,847	27,063	28,910
Charge to income statement	1,687	278,550	280,237
Exchange and other movements	2,248	(1,171)	1,077
At 31 December	<u>111,139</u>	<u>267,579</u>	<u>378,718</u>

	At 31 December 2007		
	<i>Individually assessed</i>	<i>Collectively assessed</i>	<i>Total</i>
	US\$000	US\$000	US\$000
At 1 January	115,566	106,402	221,968
Amounts written off	(5,053)	(77,839)	(82,892)
Recoveries of loans and advances written off in previous years	9,099	19,098	28,197
Charge to income statement	(12,524)	66,175	53,651
Exchange and other movements	3,550	665	4,215
At 31 December	<u>110,638</u>	<u>114,501</u>	<u>225,139</u>

**Liquidity and funding management**

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

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

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

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



## **Policies and procedures**

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

The Group's liquidity and funding management process includes:

- projecting cash flows by major currency under various stress scenarios and considering the level of liquid assets necessary in relation thereto;
- monitoring balance sheet liquidity 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
- maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises, while minimising adverse long-term implications for the business.

## **Primary sources of funding**

Current accounts and savings deposits payable on demand or at short notice form a significant part of the group's funding, and the group places considerable importance on maintaining their stability.

For deposits, which are a primary source of funding, stability depends upon preserving depositor confidence in the group's capital strength and liquidity, and on competitive and transparent pricing.

Of total liabilities of US\$ 38,197,413 thousand at 31 December 2008, funding from customers amounted to US\$28,745,291 thousand, of which US\$ 27,937,415 thousand was contractually repayable within one year. However, although the contractual repayments of many customer accounts are on demand or at short notice, in practice short-term deposit balances remain stable as inflows and outflows broadly match.

An analysis of cash flows payable by the group under financial liabilities by remaining contractual maturities at the balance sheet date is included in Note 26.

Assets available to meet these liabilities, and to cover outstanding commitments to lend (US\$13,457,286 thousand), included cash, central bank balances, items in the course of collection and treasury and other bills (US\$1,462,711 thousand); loans to banks (US\$7,111,613 thousand, including US\$6,810,246 thousand repayable within one year); and loans to customers (US\$23,685,672 thousand, including US\$14,907,883 thousand repayable within one year). In the normal course of business, a proportion of customer loans contractually repayable within one year will be extended.

## **Advances to deposits ratio**

The group emphasises the importance of current accounts and savings accounts as a source of funds to finance lending to customers, and discourages reliance on short-term professional funding. This is achieved by placing limits on group banking entities which restrict their ability to increase loans to customers without corresponding growth in current accounts and savings accounts. This measure is referred to as the 'advances to deposits' ratio. The ratio describes loans and advances to customers as a percentage of the total of core customer current and savings accounts and term funding with a remaining term to maturity in excess of one year. Loans and advances to customers which are part of reverse repurchase arrangements, and where HSBC receives securities which are deemed to be liquid, are excluded from the advances to deposits ratio, as are current accounts and savings accounts from customers deemed to be 'non-core'. The definition of a non-core deposit includes a consideration of the size of the customer's total deposit balances. Due to the distinction between core and non-core depositors, the group's measure of advances to deposits will be more restrictive than that which could be inferred from the published financial statements.

**Notes on the Financial Statements** (continued)**Advances to deposits ratios**

	The bank	
	2008	2007
	%	%
Year-end	<b>131.2</b>	129.2
Maximum	<b>143.2</b>	129.4
Minimum	<b>128.9</b>	116.1
Average	<b>135.3</b>	122.8

Advances to deposits ratio limits are set by the Risk Management Committee ('RMM').

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

The group also uses measures other than the advances to deposits ratio to manage liquidity risk, including the ratio of net liquid assets to customer liabilities and projected cash flow scenario analyses.

**Ratio of net liquid assets to customer liabilities**

Net liquid assets are liquid assets less all funds maturing in the next 30 days from wholesale market sources and from customers who are deemed to be professional. For this purpose, the group defines liquid assets as cash balances, short-term interbank deposits and highly-rated debt securities available for immediate sale and for which a deep and liquid market exists. Customers are deemed 'professional' according to the size of their deposits.

Limits for the ratio of net liquid assets to customer liabilities are set for each bank operating entity.

Ratio of net liquid assets to customer liabilities	The bank	
	2008	2007
	%	%
Year-end	<b>22.6</b>	31.3
Maximum	<b>27.9</b>	45.7
Minimum	<b>12.7</b>	15.6
Average	<b>20.7</b>	28.2

**Projected cash flow scenario analyses**

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

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

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

**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 and commodity prices, interest rates, credit spreads and equity prices will reduce the group's income or the value of its portfolios.

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

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

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 supervision of the local Asset and Liability Management Committee ('ALCO'). The aim is to ensure that all market risks are consolidated within operations which have the necessary skills, tools, management and governance to manage such risks professionally. In certain cases where the market risks cannot be adequately captured by the transfer process, simulation modelling is used to identify the impact of varying scenarios on valuations and net interest income.

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

### **Sensitivity analysis**

Sensitivity measures are used to monitor the market risk positions within each risk type, for example, present value of a basis point movement in interest rates, for interest rate risk. Sensitivity limits are set for portfolios, products and risk types, with the depth of the market being one of the principal factors in determining the level of limits set.

### **Value at risk ('VAR')**

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

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

The historical simulation models used by the group incorporate the following features:

- potential market movements are calculated with reference to data from the last two years;
- historical market rates and prices are calculated with reference to foreign exchange rates and commodity prices, interest rates, equity prices and the associated volatilities;
- VAR is calculated to a 99 per cent confidence level; and
- VAR is calculated for a one-day holding period.

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

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

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

## Notes on the Financial Statements (continued)

### Stress testing

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

Stress testing is performed at a portfolio level, as well as on the consolidated positions of the group, and covers the following scenarios:

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

Stress testing is governed by the 'Stress Testing Review Group' forum that coordinates the group stress testing scenarios in conjunction with the regional risk managers. Consideration is given to the actual market risk exposures, along with market events, in determining the stress scenarios.

Stress testing results are reported to senior management and provide them with an assessment of the financial impact such events would have on the profit of the bank. The daily losses experienced during 2008 were within the stress loss scenarios reported to senior management.

### Sensitivity analysis

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

Risk type	Portfolio	
	<i>Trading</i>	<i>Non-trading</i>
Foreign exchange	VAR	VAR
Interest rate	VAR	N/A
Commodity	VAR	Sensitivity
Equity	VAR	VAR

### Value at risk of the trading and non-trading portfolios

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

Total				<b>US\$000</b>
At 31 December 2008				<b>4,707</b>
At 31 December 2007				2,813
	<i>Average</i>	<i>Minimum</i>	<i>Maximum</i>	
	<b>US\$000</b>	<b>US\$000</b>	<b>US\$000</b>	
<b>2008</b>	<b>4,699</b>	<b>2,776</b>	<b>7,349</b>	
2007	1,881	1,217	2,921	

## Trading portfolios

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

Market-making and proprietary position-taking is undertaken within Global Banking and Markets. The VAR for such trading activity at 31 December 2008 was US\$924 thousand (2007: US\$650 thousand). This is analysed below by risk type:

### Total trading VAR by risk type

	<i>Foreign exchange</i>	<i>Interest rate trading</i>	<i>Total</i>
	<b>US\$000</b>	<b>US\$000</b>	<b>US\$000</b>
<b>At 31 December 2008</b>	<b>885</b>	<b>552</b>	<b>924</b>
At 31 December 2007	670	234	650
<b>Average</b>			
<b>2008</b>	<b>1,183</b>	<b>437</b>	<b>1,344</b>
2007	289	110	357
<b>Minimum</b>			
<b>2008</b>	<b>497</b>	<b>91</b>	<b>529</b>
2007	107	27	148
<b>Maximum</b>			
<b>2008</b>	<b>2,214</b>	<b>1,285</b>	<b>2,481</b>
2007	825	338	1,121

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

2 The VAR for 2007 has been adjusted on the same basis as group VAR

## Gap risk

Certain transactions are structured in such a way that the risk to the group is negligible under a wide range of market conditions or events, but there exists a remote possibility that a significant gap event could lead to loss. A gap event is a change in market price from one level to another with no trading opportunity in between, and where the price change breaches the threshold beyond which the risk profile changes from having no open risk to having full exposure to the underlying structure.

Given the characteristics of these transactions, they will make little or no contribution to VAR or to traditional market risk sensitivity measures. The group captures the risks for such transactions within the stress testing scenarios. Gap risk arising is monitored on an ongoing basis, and the group incurred no gap losses arising from movements in the underlying market price on such transactions in 2008.

### Asset backed securities/mortgage backed securities positions

The asset backed securities/mortgage backed securities exposures within the trading portfolios are managed within sensitivity and VAR limits.

## Notes on the Financial Statements (continued)

### Non-trading portfolios

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

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

The transfer of market risk to trading books managed by Global Banking and Markets or supervised by the ALCO is usually achieved by a series of internal deals between the business units and these 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.

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 alternative investment products and the precise prepayment speeds 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 Banking and Markets or ALCO managed books, the net exposure is typically managed through the use of interest rate swaps within agreed limits. The VAR for these portfolios is included within the group VAR.

### Sensitivity of net interest income

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, while balancing the cost of hedging such activities on the current revenue stream.

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

### Structural foreign exchange exposures

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

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

The group's structural foreign currency exposures are required to be 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.

### 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 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.

### **Capital management**

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

Under the Banking Business (Jersey) Law 1991, the JFSC requires each bank 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 bank'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.

During 2008 and 2007 the group complied with the Jersey Financial Services Commission's (JFSC) capital adequacy requirements.

**Notes on the Financial Statements** (continued)**33 Contingent liabilities and contractual commitments****Contingent liabilities and commitments**

	2008	2007
	US\$000	US\$000
<b>Contract amounts</b>		
Contingent liabilities:		
Guarantees and assets pledged as collateral security:		
– guarantees and irrevocable letters of credit	12,013,139	9,075,005
	<u>12,013,139</u>	<u>9,075,005</u>
Commitments:		
Documentary credits and short-term trade-related transactions	1,028,662	1,647,515
Undrawn note issuing and revolving underwriting facilities	–	70,000
Undrawn formal standby facilities, credit lines and other commitments to lend:		
– one year and under	21,080,289	16,422,827
– over one year	387,401	1,063,734
	<u>22,496,352</u>	<u>19,204,076</u>

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.

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

	2008	2007
	US\$000	US\$000
Guarantees and assets pledged by the bank as collateral security	815,196	752,607
Documentary credits and short-term trade-related transactions	142,977	21,044
	<u>958,173</u>	<u>773,651</u>



## 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 2008 were as follows:

Guarantee type	At 31 December 2008		At 31 December 2007	
	<i>Guarantees in favour of third parties</i> US\$000	<i>Guarantees by the group in favour of other HSBC group entities</i> US\$000	<i>Guarantees in favour of third parties</i> US\$000	<i>Guarantees by the group in favour of other HSBC group entities</i> US\$000
Financial guarantees <sup>1</sup>	803,214	144,396	529,171	221,386
Standby letters of credit which are financial guarantees <sup>2</sup>	1,708,691	–	690,421	–
Other direct credit substitutes <sup>3</sup>	790,086	–	583,812	–
Performance bonds <sup>4</sup>	4,710,656	389,380	3,614,076	228,075
Bid bonds <sup>4</sup>	330,176	55,472	546,203	65,634
Other transaction-related guarantees <sup>4</sup>	2,855,119	225,948	2,358,715	237,512
<b>Total</b>	<b>11,197,942</b>	<b>815,196</b>	<b>8,322,398</b>	<b>752,607</b>

1 *Financial guarantees include undertakings to fulfil 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.*

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

3 *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.*

4 *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 91% of the above guarantees have a term of less than one year (2007: Approximately 92%). Guarantees with terms of more than one year are subject to the group's annual credit review process.

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

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

	2008 US\$000	2007 US\$000
Other items	3,645	1
	<b>3,645</b>	<b>1</b>

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\$548 thousand at 31 December 2008 (2007: US\$1,574 thousand).

## Associates

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

## Notes on the Financial Statements (continued)

### 34 Lease commitments

#### Operating lease commitments

At 31 December 2008, 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.

	2008	2007
	US\$000	US\$000
Future minimum lease payments under non-cancellable operating leases were:		
Land and buildings expiring:		
– no later than one year	18,780	17,298
– later than one year and no later than five years	49,650	49,076
– later than five years	35,228	47,403
	<u>103,658</u>	<u>113,777</u>

In 2008, US\$12,128 thousand (2007: US\$13,523 thousand) was charged to 'General and administrative expenses' in respect of lease agreements related to minimum lease payments.

#### Finance lease receivables

	2008			2007		
	<i>Total future minimum payments</i>	<i>Unearned finance income</i>	<i>Present value</i>	<i>Total future minimum payments</i>	<i>Unearned finance income</i>	<i>Present value</i>
	US\$000	US\$000	US\$000	US\$000	US\$000	US\$000
No later than one year	56,509	–	56,509	57,380	–	57,380
Later than one year and no later than five years	467,763	–	467,763	488,896	–	488,896
Later than five years	846	–	846	3,571	–	3,571
	<u>525,118</u>	<u>–</u>	<u>525,118</u>	<u>549,847</u>	<u>–</u>	<u>549,847</u>

### 35 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. No material adverse impact on the financial position of the group is expected to arise from these proceedings.

### 36 Related party transactions

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

All 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.

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

The table below sets out transactions which fall to be disclosed under IAS24 'Related Party Disclosures' between the group and the Key Management Personnel and their connected persons or controlled companies.

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

	2008			2007		
	Number of persons	Highest balance during the year <sup>1</sup>	Balance at year end <sup>1</sup>	Number of persons	Highest balance during the year <sup>1</sup>	Balance at year end <sup>1</sup>
		US\$000	US\$000		US\$000	US\$000
<b>Key Management Personnel and connected persons and companies controlled by them</b>						
Loans	4	1,764	1,510	2	612	554
Credit cards	3	33	22	3	14	11
	<b>7</b>	<b>1,797</b>	<b>1,532</b>	<b>5</b>	<b>626</b>	<b>565</b>

<sup>1</sup> 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.

In addition to the disclosures of related party transactions, under IAS24 the group is required to disclose an estimate of the cost of services provided by Key Management Personnel to the group, to whom no remuneration is paid.

	2008 US\$000	2007 US\$000
Short-term employee benefits	<b>128</b>	<b>176</b>

#### Transactions with other related parties

	2008		2007	
	Highest balance during the year <sup>1</sup>	Balance at the year end <sup>1</sup>	Highest balance during the year <sup>1</sup>	Balance at the year end <sup>1</sup>
	US\$000	US\$000	US\$000	US\$000
Amounts due from associates				
– Subordinated	15,415	15,415	15,415	15,415
– Unsubordinated	491	395	461	409
	<b>15,906</b>	<b>15,810</b>	<b>15,876</b>	<b>15,824</b>
Amounts due to associates	<b>9,694</b>	<b>7,860</b>	<b>17,467</b>	<b>8,379</b>

## Notes on the Financial Statements (continued)

	2008		2007	
	<i>Highest balance during the year<sup>1</sup></i>	<i>Balance at the year end<sup>1</sup></i>	<i>Highest balance during the year</i>	<i>Balance at the year end<sup>1</sup></i>
	US\$000	US\$000	US\$000	US\$000
<b>Subsidiaries</b>				
<b>Assets:</b>				
Cash and balances at central banks	7	7	7	5
Trading assets	745,366	249,254	1,198,441	1,198,441
Derivatives	4,472	4,472	–	–
Loans and advances to banks	3,014	16	56	56
Loans and advances to customers	740,410	701,401	744,508	741,320
Financial investments	59,577	59,577	70,197	35,709
Intangible assets	171	–	394	230
Property, plant and equipment	331	257	110	51
Other assets	215,271	177,660	141,352	99,220
Prepayments and accrued income	12,227	11,728	7,971	7,971
<b>Liabilities:</b>				
Deposits by banks	4,030	4,029	–	4,030
Items in the course of transmission to other banks	2,454	2,314	3,057	3,057
Other liabilities	1,415,698	846,775	756,639	1,869,421
Accruals and deferred income	7,589	3,347	1,177	1,566
Derivatives	4,472	4,472	–	–
			<i>For the year ended 31 December 2008</i>	<i>For the year ended 31 December 2007</i>
			US\$000	US\$000
<b>Income Statement:</b>				
Interest income			66,529	61,209
Interest expense			(39,150)	(39,012)
Trading income			12,509	17,956
Gains less losses from financial investments			101	480
Dividend income			1,195	1,079
Fee income			13,792	6,557
Fee expense			(2,123)	(3,762)
Other operating income			2,847	794
Loan impairment charges and other credit risk provisions			(3,669)	(980)
General and administrative expenses			(10,756)	(8,275)

<sup>1</sup> 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.

### **37 Ultimate holding company**

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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 2008 and/or Annual Report and Accounts 2008 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](http://www.hsbc.com)

### **38 Events after the balance sheet date**

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Since the year-end, on 28 January 2009, the Bank has executed a buy-back of AED295 million of the AED3 billion Floating Rate Notes due 30 April 2013, originally issued under its Debt Issuance Programme on 30 April 2008 and 17 July 2008, respectively.

On 16 February 2009, the Board of Directors authorised the financial statements for issue.

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

### HSBC Bank Middle East Limited

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St. Helier, Jersey JE4 8UB,  
Channel Islands  
Tel: (44-1534) 606512  
Fax: (44-1534) 606149

### Middle East Management Office

HSBC Building,  
Emaar Square  
P O Box 66  
Dubai  
United Arab Emirates  
Tel: (971-4) 4235168  
Fax: (971-4) 4267397

### BAHRAIN

Adliya  
Bahrain City Centre  
Manama - Batelco Building  
Muharraq  
Sanad  
Seef  
Seef - Wholesale (Offshore)  
Customer Service Units  
Budaiya - The Country Mall  
Seef - Bahrain City Centre

### IRAN

Tehran Representative Office

### JORDAN

Amman - Abdoun  
Amman - Ibn Khaldoun St\*  
Amman - Jebel Hussein  
Amman - Madina al Munawara St\*  
Amman - Zahran St

### KUWAIT

Kuwait City - Qibla Area

### LEBANON

Beirut - Dora  
Beirut - St Georges Bay  
Beirut - Verdum - Farid Trad St  
Ras - Beirut - Hamra Area  
Zouk - La Vega Centre

### LIBYA

Tripoli Representative Office

### OMAN

Bait Al Falaj - HSBC Building  
Muscat - Al Bared St  
Qurum - Roundabout  
Salalah - Al Salam St  
Seeb - Wadi Bahayis St  
Sohar - Al Tareef St  
Customer Service Units  
Madinat Sultan Qaboos - Al Fair  
Al Qurum - Sarooj  
Seeb - City Centre Seeb

### PAKISTAN

Faisalabad - Jail Road  
Islamabad - Markaz  
Karachi - Clifton  
Karachi - Shaheen Comm. Complex  
Karachi - Tauheed Comm. St  
Lahore - Zahoot Elahi Road  
Multan - Qaswar Gardezi Rd  
Rawalpindi - Bank Road Saddar  
Sialkot - Qayyum Trade Centre

### PALESTINIAN AUTONOMOUS Area

Ramallah - Jafa St

### QATAR

Doha - Al Sadd Area  
Doha - Grand Hamad St  
Doha - Mesaieed  
Doha - West Bay  
Customer Service Units  
Doha - Qatar Financial Tower

### UNITED ARAB EMIRATES

Abu Dhabi  
Abu Dhabi - Electra  
Abu Dhabi - Khalidiya Spinneys  
Abu Dhabi - Old Airport Road  
Al Ain - Sheikh Khalifa St

### Dubai

Deira - Al Muraqqabat  
Dubai - Bin Sougat Center  
Dubai - Bur Dubai  
Dubai - Dubai International Financial Centre  
Dubai - Dubai Mall  
Dubai - Garhoud  
Dubai - Mall of the Emirates  
Jebel Ali - Free Trade Zone

### Fujairah

Fujairah - Hamad Bin Abdulla St  
Ras Al Khaimah  
Ras Al Khaimah - Corniche Rd

### Sharjah

Sharjah - Industrial Area - BBC\*\*  
Sharjah - King Faisal Road

### PRINCIPAL SUBSIDIARY COMPANIES

**HSBC Financial Services (Middle East) Limited**  
Dubai

**HSBC Middle East Securities LLC**  
Dubai

**HSBC Middle East Finance Company Limited**  
Abu Dhabi - Al Salam St  
Al Ain - Sanayya  
Dubai - Al Itihad St  
Ras Al Khaimah - HSBC Building -  
Corniche Rd

### 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

**MENA Infrastructure Fund (GP) Limited**  
Dubai

**MENA Holdings Limited**  
Dubai

**HSBC Middle East Leasing Partnership**  
Dubai

### SPECIAL CONNECTIONS EXIST WITH THESE MEMBERS OF THE HSBC GROUP

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

**HSBC Bank Egypt S.A.E.**  
Cairo, Head Office, 65 other branches and 11 Units  
serving specialised companies

**HSBC Bank International Limited**

**HSBC Gibbs Gulf Insurance Consultants Limited**

**HSBC Insurance Brokers Limited**

**HSBC Securities (Egypt) S.A.E.**

**HSBC Saudi Arabia Limited**

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

**The Saudi British Bank**  
Riyadh Head Office, 68 other branches and 31  
exclusive ladies' sections

\* HSBC Wealth Management Office  
\*\* Business Banking Centre

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