HSBC Bank Middle East Limited

Annual Report and Accounts 2009

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Annual Report and Accounts 2009

Contents

1 Presentation of Information
2 Report of the Directors
4 Statement of Directors' Responsibilities in Relation to the Directors' Report and the Financial Statements
5 Independent Auditors' Report to the Member of HSBC Bank Middle East Limited
6 Consolidated income statement for the Year Ended 31 December 2009
7 Consolidated statement of comprehensive income for the Year Ended 31 December 2009
8 Consolidated balance sheet at 31 December 2009
9 Consolidated statement of cash flows for the Year Ended 31 December 2009
10 Consolidated statement of changes in equity for the Year Ended 31 December 2009
12 Notes on the Financial Statements

Presentation of Information

This document comprises the Annual Report and Accounts 2009 for HSBC Bank Middle East Limited ('the Bank') and its subsidiary undertakings (together 'the Group').

It contains the Directors' Report and Accounts, together with the Auditors' report, as required by the Companies (Jersey) Law 1991. References to 'the HSBC Group' within this document mean HSBC Holdings plc together with its subsidiaries.

Report of the Directors

Board of Directors

S T Gulliver, *Chairman*
S N Cooper, *Chief Executive Officer & Deputy Chairman*
A S M El Anwar
R B Gray
R W L Groves
M M Hussain
C J M Keirle
C M Meares
J C Perry
T L Slattery

The present Directors of the Bank are listed above.

During the year:

Directors

- Y A Nasr resigned as Chief Executive Officer on 21 May 2009 and was appointed (also on 21 May 2009) as Executive Chairman. He subsequently resigned as Executive Chairman on 7 December 2009 and from the Bank on 14 March 2010.
- S N Cooper was appointed as Chief Executive Officer, Deputy Chairman and Director on 21 May 2009.
- M M Hussain was appointed as Deputy Chairman on 21 May 2009 and resigned as Deputy Chairman (but remained as a Director) on 7 December 2009.
- J E Coverdale resigned as a Director on 23 March 2009.
- J B Blanthorne resigned as a Director on 11 May 2009.
- W F Boustany resigned as a Director on 17 August 2009.
- J C Tibbo resigned as a Director on 31 December 2009.
- R W L Groves was appointed as a Director on 23 March 2009.
- T L Slattery was appointed as a Director on 1 December 2009.
- R B Gray was appointed as a Director on 15 February 2010.
- S T Gulliver was appointed as a Director and Chairman of the Board on 15 February 2010.

Company Secretary

- M J Seguss resigned as Company Secretary on 30 June 2009.
- J H McKenzie was appointed as acting Company Secretary on 30 June 2009 and resigned on 1 December 2009.
- J A Tothill was appointed as Company Secretary on 1 December 2009.

Principal activities

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

New branch network

With effect from 1 December 2009, the Group purchased the entire branch network in Algeria from HSBC Bank France Limited for consideration of US$52,871,533.

Loss and dividends

The loss attributable to the shareholders amounted to US$6,718 thousand (2008: profit US$965,610 thousand), and has been dealt with as set out in the Consolidated Income Statement on page 5.
During the year, a first interim equity dividend for 2009 of US$150,000 thousand (2008: US$250,000 thousand) was declared and paid.

Equity share capital

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

Non-equity preference share capital

On 30 December 2009 the Bank redeeemed 225,000 cumulative redeemable preference shares of US$1.00 each, issued at a premium of US$999.00 per share.

On 30 December 2009 the Bank issued 225,000 non-cumulative redeemable preference shares of US$1.00 each, fully paid and at a premium of US$999.00 per share

Registered office

HSBC House, Esplande, St Helier, Jersey, JE4 8UB, Channel Islands.
HSBC Bank Middle East Limited is incorporated in Jersey, Channel Islands - number 85600.

Auditors

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

On behalf of the Board
J A Tothill, *Secretary*
Jersey
25 March 2010

The following statement, which should be read in conjunction with the Auditors' statement of their responsibilities set out in their report on page 5, 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 endorsed 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, the Financial Services (Fund Services Business (Accounts, Audits and Reports) (Jersey) Order 2007 and the Financial Services (General Insurance Mediation Business (Accounts, Audits, Reports and Solvency)) (Jersey) Order 2005. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

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

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

We have audited the Group financial statements ("the financial statements") of HSBC Bank Middle East Limited for the year ended 31 December 2009 which comprise the Consolidated Income Statement, the Consolidated statement of comprehensive income, the Consolidated balance sheet, the Consolidated statement of cash flows, the Consolidated statement of changes in equity 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

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 as endorsed by the EU.

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, the Financial Services (Fund Services Business (Accounts, Audits and Reports) (Jersey)) Order 2007 and the Financial Services (General Insurance Mediation Business (Accounts, Audits, Reports and Solvency)) (Jersey) Order 2005.

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

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements.

It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

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

Opinion

In our opinion the financial statements:

– give a true and fair view, in accordance with International Financial Reporting Standards as endorsed by the EU, of the state of the Group's affairs as at 31 December 2009 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, the Financial Services (Fund Services Business (Accounts, Audits and Reports) (Jersey)) Order 2007 and the Financial Services (General Insurance Mediation Business (Accounts, Audits, Reports and Solvency)) (Jersey) Order 2005.

KPMG Channel Islands Limited

KPMG Channel Islands Limited
Chartered Accountants
5 St Andrew's Place, Charing Cross, St Helier, Jersey
25 March 2010

Notes: a) 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.

b) 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 2009

	Notes	**2009**	2008
		US$000	US$000
Interest income		**1,808,997**	1,944,169
Interest expense		**(571,334)**	(630,542)
Net interest income		**1,237,663**	1,313,627
Fee income		**602,129**	658,076
Fee expense		**(48,987)**	(42,228)
Net fee income		**553,142**	615,848
Trading income excluding net interest income		**316,496**	310,927
Net interest income on trading activities		**19,121**	15,730
Net trading income		**335,617**	326,657
Gains less losses from financial investments		**9,113**	7,418
Dividend income		**3,275**	1,215
Other operating income		**76,165**	10,575
Net operating income before loan impairment charges and other credit risk provisions		**2,214,975**	2,275,340
Loan impairment charges and other credit risk provisions		**(1,272,868)**	(284,924)
Net operating income	*4*	**942,107**	1,990,416
Employee compensation and benefits	5	**(473,014)**	(468,121)
General and administrative expenses	6	**(373,360)**	(329,308)
Depreciation of property, plant and equipment		**(20,484)**	(16,878)
Amortisation of intangible assets		**(6,505)**	(5,665)
Total operating expenses		**(873,363)**	(819,972)
Operating profit		**68,744**	1,170,444
Share of profits in associates		**4,253**	22,033
Profit before tax		**72,997**	1,192,477
Tax expense	8	**(62,825)**	(213,459)
Profit for the year		**10,172**	979,018
(Loss) / profit attributable to shareholders of the parent company		**(6,718)**	965,610
Profit attributable to minority interests		**16,890**	13,408

The accompanying notes on pages 12 to 95 form an integral part of these financial statements

Consolidated statement of comprehensive income for the year ended 31 December 2009

	2009	2008
	US$000	US$000
Profit for the year	**10,172**	979,018
Other comprehensive income (net of tax)		
Available-for-sale investments:	**(1,716)**	(11,679)
- fair value gains	**19,760**	65
- fair value gains transferred to income statement on disposal	**(18,922)**	(13,899)
- amounts transferred to the income statement in respect of impairment losses	**2,722**	-
- taxes	**(5,276)**	2,155
Cash flow hedges:	**7,760**	(3,686)
- fair value gains / (losses)	**21,414**	(11,043)
- fair value (gains) / losses transferred to income statement	**(11,713)**	6,435
- taxes	**(1,941)**	922
Actuarial gains / (losses) on defined benefit plans	**5,745**	(4,938)
- before taxes	**7,197**	(6,005)
- taxes	**(1,452)**	1,067
Exchange differences	**10,148**	(50,517)
Total comprehesive income for the year	**32,109**	908,198
Total comprehesive income for the year attributable to:		
- shareholders of the parent company	**15,219**	894,790
- minority interests	**16,890**	13,408
	32,109	908,198

The accompanying notes on pages 12 to 95 form an integral part of these financial statements.

Consolidated balance sheet at 31 December 2009

	Notes	**2009**	2008
ASSETS		**US$000**	US$000
Cash and balances at central banks		**432,386**	960,721
Items in the course of collection from other banks		**49,259**	229,480
Trading assets	*12*	**453,349**	365,351
Derivatives	*13*	**662,301**	980,162
Loans and advances to banks	*23*	**8,106,050**	7,111,613
Loans and advances to customers	*23*	**19,883,399**	23,685,672
Financial investments	*14*	**7,873,086**	6,288,010
Other assets	*19*	**1,016,977**	1,357,868
Prepayments and accrued income		**197,547**	235,734
Interests in associates	*15*	**170,284**	152,429
Intangible assets	*16*	**9,639**	9,111
Property, plant and equipment	*17*	**137,667**	112,800
Deferred taxation	*8*	**174,208**	39,717
Total assets		**39,166,152**	41,528,668
LIABILITIES AND EQUITY			
Liabilities			
Deposits by banks	*23*	**1,674,632**	1,811,408
Customer accounts	*23*	**26,524,487**	28,745,291
Items in the course of transmission to other banks		**65,703**	174,219
Trading liabilities	*24*	**12,874**	54,319
Derivatives	*13*	**647,895**	982,522
Debt securities in issue	*20*	**5,090,208**	4,441,277
Other liabilities	*21*	**1,198,844**	1,481,795
Current tax liabilities		**211,193**	238,333
Accruals and deferred income		**215,666**	200,667
Provisions	*22*	**11,089**	6,252
Deferred taxation	*8*	**4,471**	3,045
Retirement benefit liabilities	*5*	**53,759**	58,285
Total liabilities		**35,710,821**	38,197,413
Equity			
Called up share capital	*28*	**931,055**	631,055
Other reserves		**38,692**	46,891
Retained earnings		**2,267,418**	2,401,324
Total equity attributable to shareholders of the parent company		**3,237,165**	3,079,270
Minority interests		**218,166**	251,985
Total equity		**3,455,331**	3,331,255
Total equity and liabilities		**39,166,152**	41,528,668

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

The accompanying notes on pages 12 to 95 form an integral part of these financial statements.

Consolidated statement of cash flows for the year ended 31 December 2009

	Notes	**2009**	2008
		US$000	US$000
Cash flows from operating activities			
Profit before tax		**72,997**	1,192,477
Adjustments for:			
- non-cash items included in profit before tax	*29*	**1,338,209**	329,451
- change in operating assets	*29*	**2,923,207**	(5,640,412)
- change in operating liabilities	*29*	**(2,364,519)**	2,874,519
1 - elimination of exchange differences		**(6,941)**	11,294
- net gain from investing activities		**(18,757)**	(7,212)
- share of profits in associates		**(4,253)**	(22,033)
- dividends received from associates		**6,267**	6,138
- tax paid		**(228,253)**	(177,766)
Net cash generated from/(used in) operating activities		**1,717,957**	(1,433,544)
Cash flows from investing activities			
Purchase of financial investments		**(1,236,673)**	(1,707,888)
Proceeds from the sale and maturity of financial investments		**733,330**	404,374
Purchase of property, plant and equipment		**(48,476)**	(39,868)
Proceeds from the sale of property, plant and equipment		**3,944**	1,487
Purchase of intangible assets		**(7,286)**	(6,812)
Proceeds from the sale of intangible assets		**41**	174
Net cash outflow from acquisition of and increase in stake of associates		**(811)**	(27,595)
Net cash outflow from acquisition of Algeria branch network		**(15,352)**	–
Net cash used in investing activities		**(571,283)**	(1,376,128)
Cash flows from financing activities			
Issue of ordinary share capital		**300,000**	200,000
Non equity preference share capital issued		**225,000**	500,000
Non equity preference share capital redeemed		**(225,000)**	-
Dividends paid to shareholders		**(150,000)**	(250,000)
Dividends paid to minority interests		**(2,342)**	(816)
Net cash generated from financing activities		**147,658**	449,184
Net increase in cash and cash equivalents		**1,294,332**	(2,360,488)
Cash and cash equivalents at 1 January		**10,066,255**	12,359,846
Exchange differences in respect of cash and cash equivalents		**10,544**	66,897
Cash and cash equivalents at 31 December	*29*	**11,371,131**	10,066,255

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

The accompanying notes on pages 12 to 95 form an integral part of these financial statements.

Consolidated statement of changes in equity for the year ended 31 December 2009

	2009									
			Other reserves							
	Called up share capital US$000	*Retained earnings* US$000	*Available-for sale fair value reserve* US$000	*Cash flow hedging reserve* US$000	*Foreign exchange reserve* US$000	*Share-based payment reserve* US$000	*Merger reserve* US$000	*Total share-holders' equity* US$000	*Minority interests* US$000	*Total equity* US$000
At 1 January	631,055	2,401,324	49,952	(11,461)	322	8,078	–	3,079,270	251,985	3,331,255
Profit /(loss)for the year	–	(6,718)	–	–	–	–	–	(6,718)	16,890	10,172
Other comprehensive income (net of tax)	–	19,156	(1,712)	7,760	(3,251)	(16)	–	21,937	–	21,937
Available-for-sale investments	–	–	(1,716)	–	–	–	–	(1,716)	–	(1,716)
Cash flow hedges	–	–	–	7,760	–	–	–	7,760	–	7,760
Actuarial gains on defined benefit plans	–	5,745	–	–	–	–	–	5,745	–	5,745
Exchange differences and other	–	13,411	4	–	(3,251)	(16)	–	10,148	–	10,148
Total comprehensive income for the year	–	12,438	(1,712)	7,760	(3,251)	(16)	–	15,219	16,890	32,109
Share capital issued	300,000	–	–	–	–	–	–	300,000	–	300,000
Dividends to shareholders of the parent company	–	(150,000)	–	–	–	–	–	(150,000)	–	(150,000)
Realisation on disposal of property taken directly to Equity	–	(1,536)	–	–	–	–	–	(1,536)	–	(1,536)
Shares issued in lieu of dividends and amounts arising thereon	–	–	–	–	–	(319)	–	(319)	–	(319)
Exercise and lapse of share options and vesting of share awards	–	–	–	–	–	(317)	–	(317)	–	(317)
Cost of share-based payment arrangements	–	–	–	–	–	4,625	–	4,625	–	4,625
Other movements	–	5,192	352	–	–	31	–	5,575	–	5,575
Excess of consideration over net asset value	–	–	–	–	–	–	(15,352)	(15,352)	–	(15,352)
Dividends to minority interests	–	–	–	–	–	–	–	–	(900)	(900)
Increase in minority interest stake and other	–	–	–	–	–	–	–	–	(49,809)	(49,809)
At 31 December	931,055	2,267,418	48,592	(3,701)	(2,929)	12,082	(15,352)	3,237,165	218,166	3,455,331

The accompanying notes on pages 12 to 95 form an integral part of these financial statements.

Consolidated statement of changes in equity for the year ended 31 December 2009

	2008									
			Other reserves							
	Called up share capital US$000	*Retained earnings* US$000	*Available-for sale fair value reserve* US$000	*Cash flow hedging reserve* US$000	*Foreign exchange reserve* US$000	*Share-based payment reserve* US$000	*Merger reserve* US$000	*Total share-holders' equity* US$000	*Minority interests* US$000	*Total equity* 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
Profit for the year	–	965,610	–	–	–	–	–	965,610	13,408	979,018
Other comprehensive income (net of tax)	–	(51,884)	(11,665)	(3,684)	(3,551)	(36)	–	(70,820)	–	(70,820)
Available-for-sale investments	–	–	(11,679)	–	–	–	–	(11,679)	–	(11,679)
Cash flow hedges	–	–	–	(3,686)	–	–	–	(3,686)	–	(3,686)
Actuarial losses on defined benefit plans	–	(4,938)	–	–	–	–	–	(4,938)	–	(4,938)
Exchange differences and other	–	(46,946)	14	2	(3,551)	(36)	–	(50,517)	–	(50,517)
Total comprehensive income for the year	–	913,726	(11,665)	(3,684)	(3,551)	(36)	–	894,790	13,408	908,198
Share capital issued	200,000	–	–	–	–	–	–	200,000	–	(250,000)
Dividends to shareholders of parent company	–	(250,000)	–	–	–	–	–	(250,000)	–	(250,000)
Shares issued in lieu of dividends and amounts arising thereon	–	–	–	–	–	–	–	–	–	–
Exercise and lapse of share options and vesting of share awards	–	–	–	–	–	–	–	–	–	–
Cost of share-based payment arrangements	–	–	–	–	–	3,944	–	3,944	–	3,944
Other movements	–	(1,815)	–	1	–	255	–	(1,599)	–	(1,599)
Dividends to minority interests	–	–	1,159	–	–	–	–	1,159	(816)	343
Increase in minority interest stake and other	–	–	–	–	–	–	–	–	104,266	104,266
At 31 December	631,055	2,401,324	49,952	(11,461)	322	8,078	–	3,079,270	251,985	3,331,255

The accompanying notes on pages 12 to 95 form an integral part of these financial statements.

1 Basis of preparation

(a) Compliance with International Financial Reporting Standards

The consolidated financial statements of the Group have been prepared in accordance with International Financial Reporting Standards ('IFRSs') as issued by the International Accounting Standards Board ('IASB') and as endorsed by the EU. EU-endorsed IFRSs may differ from IFRSs as issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 31 December 2009, there were no unendorsed standards effective for the year ended 31 December 2009 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 2009 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 2009, the Group adopted the following significant standards and significant amendments to standards:

- On 1 January 2009, Group adopted IFRS 8 'Operating Segments' ('IFRS 8'), which replaced IAS 14 'Operating Segments'. IFRS 8 requires an entity to 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. Due to the nature of the Group, the chief operating decision-maker regularly reviews operating activity on a number of bases, including by geography, by customer group, and by global businesses. The Group's IFRS 8 operating segments were determined to be geographical segments because the chief operating decision-maker uses information on geographical segments in order to make decisions about allocating resources and assessing performance. The Group's chief operating decision maker was determined to be the Board of HSBC Bank Middle East Limited (the 'Board').

IFRS 8 requires segment financial information to be reported using the same measures reported to the Board for the purpose of making decisions about allocating resources to the operating segments and assessing their performance. Information provided to the Board to make decisions about allocating resources and assessing performance of operating segments is measured in accordance with IFRSs.

- On 1 January 2009, the Group adopted the revised IAS 1 'Presentation of Financial Statements' ('IAS 1'). The revised standard aims to improve users' ability to analyse and compare information given in financial statements. The adoption of the revised standard has no effect on the results reported in the Group's consolidated financial statements. It does, however, result in certain presentational changes in the Group's consolidated financial statements, including:
- the presentation of all items of income and expenditure in two financial statements, the 'Consolidated income statement' and the 'Consolidated statement of comprehensive income'; and
- the presentation of the 'Consolidated statement of changes in equity' as a financial statement, which replaces the 'Equity' note in the financial statements.

During the year the Group, adopted a number of amendments to standards and interpretations which had an insignificant effect on the consolidated financial statements of Group. These amendments include:

- amendments to IFRS 7 'Financial Instruments: Disclosures - Improving Disclosures about Financial Instruments.'The most significant additional disclosures required by this amendment in the consolidated financial statements of the Group include tables of fair value measurement disclosing the source of inputs using a three level fair value hierarchy, and reconciliation of the movement between opening and closing balances of Level 3 financial instruments which are being those measured at fair value using a valuation technique with significant unobservable inputs.

(b) Consolidation

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

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

Notes on the Financial Statements (continued)

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 acquired, the difference is recognised immediately in the income statement.

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

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

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

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

(c) Future accounting developments

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

A revised IFRS 3 'Business Combinations' and an amended IAS 27 'Consolidated and Separate Financial Statements', were issued on 10 January 2008. The revisions and amendments 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 remeasured 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 (previously referred to as minority) interests in the entity acquired either at fair value, or at the non-controlling interests' proportionate hare of the net identifiable assets of the entity acquired.

The effect that the changes will have on Group's consolidated financial statements will depend on the incidence and timing of business combinations occurring on or after 1 January 2010.

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

IFRS 9 'Financial Instruments' introduces new requirements for the classification and measurement of financial assets. The standard is effective for annual periods beginning on or after1 January 2013 with early adoption permitted. IFRS 9 is required to be applied retrospectively. If the standard is adopted prior to 1 January 2012, an entity will be exempt from the requirement to restate prior period comparative information. IFRS 9 is subject to EU endorsement, the timing of which is uncertain. Accordingly, the Group is unable to provide a date by which it plans to apply IFRS 9. The main changes to the requirements of IAS 39 are summarised below.

- All financial assets that are currently in scope of IAS 39 will be classified and measured at either amortised cost or fair value through profit or loss. The available- for-sale and held-to-maturity categories will no longer exist.
- Classification is based on an entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets. Reclassifications between the two categories are prohibited unless there is a change in the entity's business model.
- A financial asset is measured at amortised cost if two criteria are met: i) the objective of the business model is to hold the financial asset for the collection of the contractual cash flows; and ii) the contractual cash flows of the instrument are solely payments of principal and interest on the principal outstanding. All other financial assets are measured at fair value. Movements in the fair value of financial assets classified at fair value are recognised in profit or loss, except for equity investment where an entity takes the option to designate an equity instrument that is not held for trading at fair value through other comprehensive income. If this option is taken, all subsequent changes in fair value are recognised in other comprehensive income with no recycling of gains or losses to the income statement. Dividend income would continue to be recognised in the income statement.
- An entity is only permitted to designate a financial asset otherwise meeting the amortised cost criteria at fair value through profit or loss if doing so significantly reduces or eliminates an accounting mismatch. This designation is made on initial recognition and is irrevocable.
- Financial instruments which contain embedded derivatives are to be classified in their entirety either at fair value or amortised cost depending on whether the contracts as a whole meet the relevant criteria under IFRS 9.

IFRS 9 is the first instalment in the IASB's planned phased replacement of IAS 39 with a less complex and improved standard for financial instruments. The next steps in the IASB's project will address the classification and measurement requirements for financial liabilities, the impairment for financial assets measured at amortised cost and hedge accounting. The IASB has indicated that it aims to finalise the replacement of IAS 39 by the end of 2010. In addition, the IASB is working with the US Financial Accounting Standards Board to reduce inconsistencies between US GAAP and IFRS in accounting for financial instruments. The impact of IFRS 9 may change as a consequence of further developments resulting from the IASB's financial instruments project. As a result, it is impracticable to quantify the impact of IFRS 9 as at the date of publication of these financial statements.

2 Summary of significant accounting policies

(a) Interest income and expense

Interest income and expense for all 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 recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

(b) Non interest income

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

- 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 these financial instruments are also included in 'Net income from financial instruments at fair value', except for interest arising from debt securities issued, and derivatives managed in conjunction with those debt securities, which is recognised in 'Interest expense'.

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

(c) Segment reporting

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

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

(d) Determination of fair value

All financial instruments are recognised initially at fair value. In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (that is, the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, the Group recognises a trading gain or loss on inception of the financial instrument. When unobservable market data 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 measured at fair value that are 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. Fair values of financial instruments 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, where current prices or observable market data are not available.

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 alculated 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) Reclassification of financial assets

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

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

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

(f) Loans and advances to banks and customers

Loans and advances to banks and customers include loans and advances originated by the Group which are not classified either as held for trading or designated at fair value. Loans and advances are recognised when cash is advanced to 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.

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

(g) Impairment of loans and advances

Losses for impaired loans are recognised promptly when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Impairment allowances 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;
- 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 denomiated in 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:

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

Incurred but not yet identified impairment

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

The collective impairment 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

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 analysis 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. a write back is recognised in the income statement.

Reclassified loans and advances

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

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

Assets acquired in exchange for loans

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

together with any realised gains or losses on disposal.

Renegotiated loans

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

(h) Trading assets and trading liabilities

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

(i) Financial instruments designated at fair value

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

- Eliminates or significantly reduces measurement or recognition inconsistencies that would otherwise arise from measuring financial assets or financial liabilities, or recognising gains and losses on them, on different bases. 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 in other comprehensive income. These financial instruments are managed on a fair value basis and information is provided to management on that 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 either sold (assets) or extinguished (liabilities).

  Measurement is initially at fair value, with transaction costs taken directly to the income statement.

Subsequently, the fair values are remeasured, and gains and losses from changes therein are recognised in the income statement in 'Net income from financial instruments designated at fair value'.

(j) Financial investments

Treasury bills, debt securities and equity securities intended to be held on a continuing basis, other than those designated at fair value (Note 2(i)), are classified as available-for-sale or held-to-maturity. Financial investments are recognised on trade date, when the Group enters into contractual arrangements with counterparties to purchase securities, and are normally derecognised when either the securities are sold or the borrowers repay their obligations.

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

Interest income is recognised on available-for-sale securities using the effective interest 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 financial asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset that can be reliably estimated.

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

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

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

- For an available-for-sale debt security, a subsequent decline in the fair value of the instrument is recognised in the income statement when there is further objective evidence of impairment as a result of further decreases in the estimated future cash flows of the financial asset. Where there is no further objective evidence of impairment, the decline in the fair value of the financial asset is recognised in other comprehensive income. If the fair value of a debt security increases in a subsequent period, and the increase can be objectively related to an event occurring after the impairment loss was recognised in the income statement, the impairment loss is reversed through the income statement to the extent of the increase in fair value;
- For an available-for-sale equity security, all subsequent increases in the fair value of the instrument are treated as a revaluation and are recognised in other comprehensive income. Impairment losses recognised on the equity security are not reversed through the income statement. Subsequent decreases in the fair value of the available
- for-sale equity security are recognised in the income statement, to the extent that further cumulative impairment losses have been incurred in relation to the acquisition cost of the equity security less any impairment loss previously recognised.

(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.

Notes on the Financial Statements (continued)

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

When securities are sold subject to a commitment to repurchase them at a predetermined price ('repo's'), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to sell ('reverse repo's') 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'.

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

Hedge accounting

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

Fair value hedge

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

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

Cash flow hedge

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

The accumulated gains and losses recognised in other comprehensive income are reclassified to the income statement in the periods in which the hedged item will affect profit or loss. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously recognised in other comprehensive income are reclassified to the income statement 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 recognised in other comprehensive income at that time remains seperately 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 recognised in other comprehensive income is immediately reclassified to the income statement.

Net investment hedge

Hedges of net investments in foreign operations are accounted for in a similar way to cash flow hedges. A gain or loss on the effective portion of the hedging instrument is recognised in other comprehensive income; a gain or loss on the ineffective portion is recognised immediately in the income statement. Gains and losses previously recognised in other comprehensive income are reclassified to the income statement on the disposal of the foreign operation.

Hedge effectiveness testing

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

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method the 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'.

(m) De-recognition of financial assets and liabilities

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

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

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

Notes on the Financial Statements (continued)

(n) Offsetting financial assets and financial liabilities

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

(o) Subsidiaries and associates

The Group classifies investments in entities which it controls as subsidiaires. 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.

(p) Intangible assets

Intangible assets include the present value of 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 with finite useful lives are amortised, generally on a straight line basis, over their useful lives as follows:

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

(q) Property, plant and equipment

Land and buildings are stated at historical cost, or fair value at the date of transition to IFRSs ("deemed 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 at the greater of two per cent per annum on a straight-line basis or over their remaining useful lives; and
- leasehold buildings are depreciated over the unexpired terms of the leases, or over their remaining useful lives.

Equipment, fixtures and fittings (including equipment on operating leases where the Group is the lessor) are stated at cost less any impairment losses and depreciation calculated on a straight-line basis to write off the assets over their useful lives, which run to a maximum of 35 years but are generally between 5 years and 20 years.Property, plant and equipment is subject to an impairment review if there are events or changes in circumstances which indicate that the carrying amount may not be recoverable.

(r) Finance and operating leases

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

When the Group is a lessee under finance leases, the leased assets are capitalised and included in 'Property, plant and

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

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

(s) Income tax

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

Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled, based on tax rates and laws enacted, or substantively enacted, by the balance sheet date.

Deferred tax relating to actuarial gains and losses on post-employment benefits is recognised directly in equity. Deferred tax relating to fair value remeasurement 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.

(t) Pension and post-employment benefits

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

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

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

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

Notes on the Financial Statements (continued)

(u) Shared based payments

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

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

Vesting conditions, other than market performance conditions, are not taken into account in the initial estimate of the fair value at the grant date. They are taken into account by adjusting the number of equity instruments included in the measurement of the transaction, so that the amount recognised for services received as consideration for the equity instruments that eventually vest. On a cumulative basis, no expense is recognised for equity instruments that do not vest because of a failure to satisfy non-market performance or service conditions.Where an award has been modified, as a minimum, the expense of the original award continues to be recognised as if it had not been modified. Where the effect of a modification is to increase the fair value of an award or increase the number of equity instruments, the incremental fair value of the award or incremental fair value of the extra equity instruments is recognised in addition to the expense of the original grant, measured at the date of modification, over the modification vesting period.

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

(v) Foreign currencies

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

Transactions in foreign currencies are recorded in the functional currency at the rate of exchange prevailing on the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are translated into the functional currency at the rate of exchange ruling at the balance sheet date. Any resulting exchange differences are included in the income statement. Non-monetary assets and liabilities that are measured at historical cost in a foreign currency are translated into the functional currency using the rate of exchange at the date of the initial transaction. Non-monetary assets and liabilities measured at fair value in a foreign currency are translated into the functional currency using the rate of exchange at the date the fair value was determined. Any exchange component of a gain or loss on a non-monetary item is recognised directly in other comprehensive income if the gain or loss on the non-monetary item is recognised directly in other comprehensive income. 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 presentation currency at the rate of exchange ruling at the balance sheet date. The results of branches, subsidiaries and associates whose functional 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 assets, and exchange differences arising from retranslation of the result for the reporting period from the average rate to the exchange rate prevailing at the period end, are recognised in other comprehensive income in 'Exchange differences'.

(w) Provisions

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

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security, are possible obligations that arise from past events whose existence will be confirmed only by the occurrence, or non-occurrence, of one or more uncertain future events not wholly within the control of the Group; or are present obligations that have

arisen from past events but are not recognised because it 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.

(x) 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 proceeds received net of directly attributable transaction costs incurred. Subsequent measurement of financial

liabilities, other than those measured at fair value through profit or loss and financial guarantees, is at amortised cost, using the effective interest method to amortise the difference between proceeds received, net of directly attributable transaction costs incurred, and the redemption amount over the expected life of the instrument.

(y) Share capital

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

(z) Cash and cash equivalents

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

3 Use of assumptions 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 (g) on the Financial Statements. Further information can be found in Note 30 'Risk Management'. Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at the 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 practicable to identify losses on an individual loan basis because of the large number of individually insignificant 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 occuring 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.

Pensions

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

Share-based payments

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

Notes on the Financial Statements (continued)

4 Net operating income

Net operating income for the year ended 31 December 2009 is stated after the following items of income, expense, gains and losses:

	2009 **US$000**	2008 US$000
Income		
Interest recognised on impaired financial assets	**14,595**	2,359
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	**486,069**	538,785
Fees earned relating to trust and other fiduciary activities where the group holds or invests assets on behalf of its customers	**15,789**	55,317
Income from listed investments	**44,422**	17,579
Income from unlisted investments	**86,574**	134,175
Expense		
Interest on financial instruments, excluding interest on financial liabilities held for trading or designated at fair value	**(569,808)**	(630,540)
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	**(28,359)**	(33,707)
Gains/(losses)		
Gain on disposal or settlement of loans and advances	**1,432**	4,206
Gains/(losses) on disposal of property, plant and equipment and non-financial investments	**537**	(294)
Loan impairment charges and other credit risk provisions		
Net Impairment (losses)/gains on:		
– loans and advances	**(1,273,907)**	(280,237)
– other credit risk provisions	**1,038**	(4,687)

5 Employee compensation and benefits

	2009 US$000	2008 US$000
Wages and salaries	**448,829**	446,953
Social security costs	**5,600**	5,673
Post-employment benefits (Note 2(t))	**18,585**	15,495
	473,014	468,121

The average number of persons employed by the Group during the year was made up as follows:[1]	2009 Number	2008 Number
UAE	**3,366**	3,639
Qatar	**603**	635
Rest of Middle East	**2,183**	1,981
	6,152	6,255

1 This disclosure reflects the organisation of the Group's segments from 1 January 2009, as described in Note 10.

Post-employment benefit plans

Income statement charge

	2009 US$000	2008 US$000
Defined benefit pension plans	**14,805**	12,984
Defined contribution pension plans	**3,780**	2,511
	18,585	15,495

Defined benefit post-employment benefit plans

The net liabilities recognised on balance sheet in respect of defined benefit plans were US$53,759 thousand (2008: US$58,285 thousand).

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.

Notes on the Financial Statements (continued)

The principal actuarial financial assumptions used to calculate the scheme obligations at 31 December 2009 were:

	Discount rate	*Rate of pay increase*	*Rate of resignation*	*Rate of employment termination*
	%	%	%	%
At 31 December 2009				
United Arab Emirates	**4.80**	**4.00**	**10.60**	**1.20**
At 31 December 2008				
United Arab Emirates	2.85	4.00	10.60	1.20

The Group 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 or longer dated swap rates of approximately 7 years as a proxy for a government bond yield of suitable term and currency to the liabilities of the scheme, where appropriate.

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

	United Arab Emirates	
	2009	2008
	US$000	US$000
Discount rate		
Change in scheme obligation at 31 December from a 25bps increase	**(41,624)**	(42,066)
Change in scheme obligation at 31 December from a 25bps decrease	**42,935**	43,426
Change in scheme cost from a 25bps increase	**(8,971)**	(10,532)
Change in scheme cost from a 25bps decrease	**9,123**	10,716

Defined benefit pension plans

Value recognised on the balance sheet	**2009**	2008
	US$000	US$000
Fair value of plan assets	**1,579**	1,254
Defined benefit obligation		
–Present value of funded obligations	**(1,484)**	(1,254)
–Present value of unfunded obligations	**(53,854)**	(58,275)
Effect of limit on plan surpluses	**–**	(10)
	(53,759)	(58,285)

Changes in the fair value of defined benefit obligations

	2009 US$000	2008 US$000
At 1 January	**59,529**	46,320
Current service cost	**13,715**	12,747
Interest cost	**1,307**	308
Contributions by employees	**13**	233
Actuarial (losses)/gains	**(8,236)**	5,429
Benefits paid	**(5,342)**	(3,209)
Losses on curtailments	**(3,728)**	(1,865)
Liabilities extinguished on settlements	**(1,840)**	(1,448)
Exchange differences	**(80)**	1,014
At 31 December	**55,338**	59,529

Changes in the fair value of plan assets

	2009 US$000	2008 US$000
At 1 January	**1,254**	–
Expected return on plan assets	**201**	63
Normal contributions by the Group	**291**	260
Contributions by employees	**13**	233
Experience gains	**(43)**	23
Benefits paid	**(33)**	(43)
Exchange differences	**(104)**	718
At 31 December	**1,579**	1,254

The actual return on plan assets for the year ended 31 December 2009 was a positive return US$158 thousand (2008: US$86 thousand). The Group expects to make US$6,499 thousand of contributions to defined benefit pension plans during 2010.

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

	2009 US$000	2008 US$000
Current service cost	**13,715**	12,747
Interest cost	**1,307**	308
Expected return on plan assets	**(201)**	(63)
Total expense	**14,821**	12,992

Notes on the Financial Statements (continued)

6 General and administrative expenses

Auditors' remuneration

Auditors' remuneration in relation to the statutory audit amounted to US$835 thousand (2008: US$847 thousand). The following fees were payable by the Group to the Group's principal auditor, KPMG Channel Islands Limited and its associates (together 'KPMG'):

	2009	2008
	US$000	US$000
Audit fees for HSBC Bank Middle East Limited statutory audit:		
– fees relating to current year	**835**	847
– fees relating to prior year	**85**	29
	920	876

	2009	2008
	US$000	US$000
Fees payable to KPMG for other services provided to the Group		
– other services pursuant to legislation	**472**	441
– tax services	**88**	70
– local regulatory	**16**	17
– group reporting - current year	**260**	–
– group reporting - prior year	**93**	–
– all other services	**260**	104
	1,189	632
Total fees payable	**2,109**	1,508

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

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

7 Share-based payments

During 2009, US$15,589 thousand was charged to the income statement in respect of equity settled share-based payment transactions (2008: US$4,677 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/awards with vesting dependent on the HSBC Group's Total Shareholder Return ('TSR') over a period, the TSR performance targets are incorporated into the model using Monte-Carlo simulation. The expected life of options depends on the behaviour of option holders, which is incorporated into the option model on the basis of historic observable data. The fair values calculated are inherently subjective and uncertain due to the assumptions made and the limitations of the model used.

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

	1-year Savings-Related Share Option Plans	*3-year Savings-Related Share Option Plans*	*5-year Savings-Related Share Option Plans*
2009	**0.7**	**2.1**	**2.4**
1 Risk-free interest rate (%)	**1**	**3**	**5**
2 Expected life (years)	**50**	**35**	**30**
3 Expected volatility (%)	**4.65**	**4.65**	**4.65**
Share price at grant date			
2008			
1 Risk-free interest rate (%)	4.5	4.5	4.5
2 Expected life (years)	1	3	5
3 Expected volatility (%)	25	25	25
Share price at grant date	8.80	8.80	8.80

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

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

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

The expected US dollar denominated dividend growth was determined to be 4.5 per cent in line with consensus analyst forecasts. Prior to 2009, the HSBC Group adpoted a dividend growth model and incorporated expected dividends into the valuation model for share options and awards. In 2008, the expected dividend growth was determined to be 7 per cent for the first year and 8 per cent thereafter.

The HSBC Share Plan

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

Performance share awards

Performance Shares are awarded to executive Directors and other senior executives after taking into account individual performance in the previous year. Each award is divided i nto two equal parts for testing attainment against pre-determined benchmarks. One half of the award is subject to a TSR measure, based on the HSBC Group'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

Notes on the Financial Statements (continued)

each 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.

	2009 *Number* **(000's)**	2008 *Number* (000's)
Outstanding at 1 January	**330**	258
Additions during the year [1]	**9**	178
Adjustment for rights issue [2]	**49**	–
Released in the year	**(109)**	(106)
Outstanding at 31 December	**279**	330

1 Additions during the year comprised reinvested scrip dividends

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

No performance shares were awarded in 2009. The weighted average fair value of shares awarded by the Group for Performance Share Awards in 2008 was £8.56.

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 the HSBC Group for this period.

	2009 *Number* **(000's)**	2008 *Number* (000's)
Outstanding at 1 January	**761**	290
Granted in the year	**2,265**	438
Adjustment for rights issue [1]	**368**	–
Released in the year	**(364)**	(163)
Transferred in the year	**(353)**	196
Outstanding at 31 December	**2,677**	761

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

The weighted average fair value of shares awarded by the Group for Restricted Share Awards in 2009 was £4.00 (2008: £8.56).

Savings-related share option plans

Savings-related share option plans invite eligible employees to enter into savings contracts to save up to £250 per month (or its equivalent in US dollars, Hong Kong dollars or euros), with the option to use the savings to acquire shares. The aim of the plans is to align the interests of all employees with the creation of shareholder value.

The options are exercisable within three months following the first anniversary of the commencement of a one-year savings contract or within six months following either the third or the fifth anniversaries of the commencement of three-year or five-year contracts, respectively. The exercise price is set at a 20 per cent (2008: 20 per cent) discount to the market value immediately preceding the date of invitation.

	2009		2008	
		Weighted average		*Weighted average exercise*
	Number	*exercise price*	*Number*	*price*
	(000's)	**£**	(000's)	£
Outstanding at 1 January	**1,646**	**6.94**	1,601	6.59
Granted in the year	**2,148**	**3.30**	726	6.82
Adjustment for rights issue [1]	**195**	**6.05**	–	–
Exercised in the year	**(55)**	**5.49**	(486)	5.73
Transferred in the year	**(4)**	**6.25**	55	7.20
Forfeited and expired in the year	**(1,181)**	**6.33**	(250)	7.02
Outstanding at 31 December	**2,749**	**5.24**	1,646	6.94

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

The weighted average fair value of options granted during the year was £1.37 (2008: £2.17). The weighted average share price at the date the share options were exercised was £5.86 (2008: £7.99). The exercise price range and weighted average remaining contractual life for options outstanding at the balance sheet date, were as follows

	2009	2008
Exercise price range (£)	**£5.34–£9.77**	£5.35–£8.02
Weighted average remaining contractual life (years)		
of which exercisable:	**3.10**	2.19
Number (000's)	**2,749**	1,646
Weighted average exercise price (£)	**6.23**	6.94

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 2000 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 Remuneration Committee is satisfied that, during the performance period, the HSBC Group 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.

	2009	2008
	Number	*Number*
	(000's)	(000's)
Outstanding at 1 January	–	100
Granted in the year [1]	–	29
Released in the year	–	(168)
Transferred in the year	–	39
Outstanding at 31 December	–	–

1 Additions during the year comprised reinvested scrip dividends

Notes on the Financial Statements (continued)

There was no weighted average remaining vesting period as at 31 December 2009 (2008: 0 years).

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 amd retention requirements. Restricted shares were also awarded as part-deferral of annual bonuses or for recruitment purposes. Shares were 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.

	2009 *Number* **(000's)**	2008 *Number* (000's)
Outstanding at 1 January	**747**	520
Granted in the year [1]	**5**	374
2 Adjustment for rights issue [2]	**99**	–
Released in the year	**(249)**	(249)
Transferred in the year	**144**	102
Outstanding at 31 December	**746**	747

1 Additions during the year comprised reinvested scrip dividends

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

No shares were awarded by the Group for HSBC Holdings Restricted Share Plan 2000 in 2009 or 2008.

The weighted average remaining vesting period as at 31 December 2009 was 3 months (2008: 5 months).

The HSBC Holdings Group Share Option Plan

The HSBC Holdings Group Share Option Plan was a long-term incentive plan under which certain HSBC 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.

	2009		2008	
	Number **(000's)**	*Weighted average exercise price* **£**	*Number* (000's)	*Weighted average exercise price* £
Outstanding at 1 January	**1,405**	**7.87**	1,346	7.86
Adjustment for rights issue [1]	**198**	**7.86**	–	–
Exercised in the year	**(15)**	**6.26**	(77)	7.16
Transferred in the year	**(10)**	**7.94**	159	7.78
Forfeited and expired in the year	**(71)**	**7.34**	(23)	8.09
Outstanding at 31 December	1,507	6.85	1,405	7.87

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

The weighted average share price at the date the share options were exercised was £6.85 (2008: £7.87). No share options were awarded by the Group for the Group Share Option Plan in 2009 (2008: Nil). The number of options, weighted average exercise price, and the weighted average remaining contractual life of options outstanding at the balance sheet date, analysed by exercise price range, were as follows:

	2009		2008	
Exercise price range (£)	**£6.00-£7.00**	**£8.01-£8.50**	£6.00-£8.00	£8.01-£10.00
Number (000's)	**311**	**1,196**	–	1,405
Weighted average exercise price (£)	**6.02**	**7.23**	6.91	8.30
Weighted average remaining contractual life (years)	–	–	–	–

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:

	2009		2008	
	Number **(000's)**	*Weighted average exercise price* **£**	*Number* (000's)	*Weighted average exercise price* £
Outstanding at 1 January	**165**	**6.92**	185	6.85
Adjustment for rights issue [1]	**21**	**6.04**	–	–
Exercised in the year	**(8)**	**6.39**	(54)	8.01
Transferred in the year	**3**	**6.50**	42	6.92
Expired in the year	**(101)**	**5.61**	(8)	7.70
Outstanding at 31 December	**80**	**6.50**	165	6.92

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

The weighted average share price at the date the share options were exercised was US$9.14 (2008: US$14.65).

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:

	2009	2008
	£5.50-£7.00	£6.01-£7.87
Number (000's)	**80**	165
Weighted average exercise price (£)	**6.50**	6.92
Weighted average remaining contractual life (years)	**0.26**	0.75

Notes on the Financial Statements (continued)

8 Tax expense

The charge for taxation comprises:	**2009**	2008
	US$000	US$000
Current tax		
Tax - current year	**200,200**	219,233
Tax - adjustment in respect of prior years	**802**	(2,107)
	201,002	217,126
Deferred tax		
Origination and reversal of temporary differences	**(138,177)**	(3,667)
Effect of write-downs / reversal of write-downs of deferred tax assets	**(138,177)**	(3,667)
Tax expense	**62,825**	213,459

The Group is not resident in the United Kingdom for taxation purposes. The Group provides for taxation at the appropriate rates in the countries in which its operates.

	2009		2008	
		Percentage of profit before tax		*Percentage of profit before tax*
Analysis of overall tax charge	**US$000**	**%**	US$000	%
Taxation at UAE tax rate of 20 per cent (2008: 20 per cent)	**13,749**	**18.8**	234,088	19.6
Impact of overseas profits in principal locations taxed at different rates [1]	**47,426**	**65.0**	12,196	1.0
Income not subject to tax	**(30,685)**	**(42.0)**	(32,646)	(2.7)
Expenses not deductible for tax purposes	**5,844**	**8.0**	2,474	0.2
Prior period adjustments	**(556)**	**(0.8)**	(7,068)	(0.6)
Disallowance of loan impairment charges	**16,913**	**23.2**	0	0.0
Other items	**10,134**	**13.9**	4,415	0.4
Overall tax charge	**62,825**	**86.1**	213,459	17.9

1 Overseas profits taxed at different rates to that which applies in the UAE contributed to an increase in the effective tax rate of 68 per cent (2008: decrease of 1 per cent).

The increase in the effective tax rate is due to an increase in the proportion of losses arising in tax free jurisdictions.

In addition to the amount charged to the income statement the aggregate amount of deferred taxation, relating to items that are taken directly to equity, was a US$8,668 thousand decrease in equity (2008: US$3,596 thousand increase 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.

Deferred taxation

	2009			2008		
	Deferred tax asset	*Deferred tax liability*	*Total*	*Deferred tax asset*	*Deferred tax liability*	*Total*
	US$000	**US$000**	**US$000**	US$000	US$000	US$000
At 1 January	**39,717**	**(3,045)**	**36,672**	33,240	(3,557)	29,683
Income statement credit	**138,122**	**55**	**138,177**	3,984	(317)	3,667
Other comprehensive income						
– available-for-sale securities	**–**	**(5,276)**	**(5,276)**	–	1,607	1,607
– cash-flow hedges	**–**	**(1,941)**	**(1,941)**	–	922	922
– actuarial (losses)/gains	**–**	**(1,452)**	**(1,452)**		1,067	1,067
Foreign exchange and other adjustments	**(3,631)**	**7,188**	**3,556**	2,493	(2,767)	(274)
At 31 December	**174,208**	**(4,471)**	**169,737**	39,717	(3,045)	36,672

The amount of deferred taxation accounted for in the consolidated balance sheet comprised the following deferred tax assets and liabilities.

	2009			2008		
	Deferred tax asset	*Deferred tax liability*	*Total*	*Deferred tax asset*	*Deferred tax liability*	*Total*
	US$000	**US$000**	**US$000**	US$000	US$000	US$000
Temporary differences:						
– retirement benefits	**–**	**218**	**218**	–	1,671	1,671
– provision for loan impairment charges	**166,384**	**–**	**166,384**	22,634	858	23,492
– revaluation of property	**–**	**(2,477)**	**(2,477)**	–	(2,532)	(2,532)
– available-for-sale securities	**(3,773)**	**(2,126)**	**(5,899)**	764	(1,631)	(867)
– cash-flow hedges	**925**	**–**	**925**	2,865	–	2,865
– share based payments	**111**	**(86)**	**25**	(662)	(23)	(685)
– other short term timing differences	**10,561**	**–**	**10,561**	14,116	(1,388)	12,728
At 31 December	**174,208**	**(4,471)**	**169,737**	39,717	(3,045)	36,672

9 Dividends

	2009		2008	
	US$ per share	**US$000**	*US$ per share*	**US$000**
Dividends declared on ordinary share capital	**0.238**	**150,000**	0.396	250,000

10 Segment analysis

The factors used to identify the Group's reporting segment are discussed in "Accounting Policies" in Note 2(c).

Products and services

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

- Personal Financial Services offers a broad range of products and services to meet the personal banking need, consumer finance and wealth management needs of individual customers. Personal banking products typically include current and savings accounts, mortgages and personal loans, credit cards, insurance, wealth management and local and international payment services.
- Commercial Banking product offerings include the provision of financing services, payments and cash management, international trade finance, treasury and capital markets, commercial cards, insurance, wealth management and investment banking services.
- Global Banking and Markets provide tailored financial solutions to government, corporate and institutional clients. The client focused business lines deliver a full range of banking capabilities including investment banking and financing solutions; a markets business that provides services in credit, rates, foreign exchange, money markets and securities services; global asset management and principle investment activities.
- Private Banking provides a range of services to meet the banking, investment and wealth advisory needs of high net worth individuals.

Financial information
Profit/(loss) for the year

	Year ended 31 December 2009				
	UAE	*Qatar*	*Rest of Middle East*	*Intra-Group items*	*Total*
	US$000	**US$000**	**US$000**	**US$000**	**US$000**
Net interest income	**829,759**	**156,246**	**251,658**	–	**1,237,663**
Net fee income	**387,109**	**66,271**	**99,762**	–	**553,142**
Net trading income	**253,711**	**33,635**	**48,271**	–	**335,617**
Gains less losses from financial investments	**10,377**	**(300)**	**(964)**	–	**9,113**
Dividend income	**3,268**	–	**7**	–	**3,275**
Other operating income	**142,149**	**(48)**	**3,626**	**(69,562)**	**76,165**
Net operating income before loan impairment charges and other credit risk provisions	**1,626,373**	**255,804**	**402,360**	**(69,562)**	**2,214,975**
Loan impairment charges and other credit risk provisions	**(993,590)**	**(28,217)**	**(251,061)**	–	**(1,272,868)**
Net operating income	**632,783**	**227,587**	**151,299**	**(69,562)**	**942,107**
Employee compensation and benefits	**(338,251)**	**(48,702)**	**(86,061)**	–	**(473,014)**
General and administrative expenses	**(292,014)**	**(42,460)**	**(108,448)**	**69,562**	**(373,360)**
Depreciation of property, plant and equipment	**(13,017)**	**(1,315)**	**(6,152)**	–	**(20,484)**
Amortisation of intangible assets	**(6,363)**	**(35)**	**(107)**	–	**(6,505)**
Total operating expenses	**(649,645)**	**(92,512)**	**(200,768)**	**69,562**	**(873,363)**
Operating profit	**(16,862)**	**135,075**	**(49,469)**	–	**68,744**
Share of profits in associates	**4,253**	–	–	–	**4,253**
Profit before tax	**(12,609)**	**135,075**	**(49,469)**	–	**72,997**
Tax expense	**587**	**(44,917)**	**(18,495)**	–	**(62,825)**
Profit for the year	**(12,022)**	**90,158**	**(67,964)**	–	**10,172**
Cost efficiency ratio	**39.94%**	**36.17%**	**49.90%**	–	**39.43%**

	Year ended 31 December 2008				
	UAE	*Qatar*	*Rest of Middle East*	*Intra-Group items*	*Total*
	US$000	US$000	US$000	US$000	US$000
Net interest income	951,482	121,469	240,676	–	1,313,627
Net fee income	430,340	63,481	122,027	–	615,848
Net trading income	237,843	37,160	51,654	–	326,657
Gains less losses from financial investments	14,001	–	(6,583)	–	7,418
Dividend income	1,215	–	–	–	1,215
Other operating income	61,689	(213)	2,483	(53,384)	10,575
Net operating income before loan impairment charges and other credit risk provisions	1,696,570	221,897	410,257	(53,384)	2,275,340
Loan impairment charges and other credit risk provisions	(257,664)	(22,751)	(4,509)	–	(284,924)
Net operating income	1,438,906	199,146	405,748	(53,384)	1,990,416
Employee compensation and benefits	(337,754)	(43,893)	(86,474)	–	(468,121)
General and administrative expenses	(248,429)	(40,413)	(93,850)	53,384	(329,308)
Depreciation of property, plant and equipment	(9,796)	(1,835)	(5,247)	–	(16,878)
Amortisation of intangible assets	(5,615)	(31)	(19)	–	(5,665)
Total operating expenses	(601,594)	(86,172)	(185,590)	53,384	(819,972)
Operating profit	837,312	112,974	220,158	–	1,170,444
Share of profits in associates	22,033	–	–	–	22,033
Profit before tax	859,345	112,974	220,158	–	1,192,477
Tax expense	(140,587)	(38,681)	(34,191)	–	(213,459)
Profit for the year	718,758	74,293	185,967	–	979,018
Cost efficiency ratio	35.46%	38.83%	45.24%	–	36.04%

Notes on the Financial Statements (continued)

Balance sheet information

	Year ended 31 December 2009				
	UAE	*Qatar*	*Rest of Middle East*	*Intra-Group items*	*Total*
	US$000	**US$000**	**US$000**	**US$000**	**US$000**
Loans and advances to customers	**13,724,340**	**1,811,217**	**4,347,842**	**–**	**19,883,399**
Interests in associates	**170,284**	**–**	**–**	**–**	**170,284**
Total assets	**28,797,009**	**4,258,320**	**9,867,141**	**(3,756,318)**	**39,166,152**
Customer accounts	**17,559,029**	**2,698,045**	**6,267,413**	**–**	**26,524,487**
Total liabilities	**25,350,999**	**4,256,221**	**9,859,919**	**(3,756,318)**	**35,710,821**
1 Capital expenditure incurred	**38,714**	**11,330**	**5,718**	**–**	**55,762**

	Year ended 31 December 2008				
	UAE	*Qatar*	*Rest of Middle East*	*Intra-Group items*	*Total*
	US$000	US$000	US$000	US$000	US$000
Loans and advances to customers	17,367,329	1,934,317	4,384,026	–	23,685,672
Interests in associates	152,429	–	–	–	152,429
Total assets	32,974,252	4,117,217	10,106,327	(5,669,128)	41,528,668
Customer accounts	19,859,053	2,860,199	6,026,039	–	28,745,291
Total liabilities	29,661,895	4,116,286	10,088,360	(5,669,128)	38,197,413
1 Capital expenditure incurred	38,876	1,003	6,801	–	46,680

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

Other financial information

Net operating income by customer group and global business

	Year ended 31 December 2009						
	Personal Financial Services	*Commercial Banking*	*Global Banking and Markets*	*Private Banking*	*Other*	*Inter Segment*	*Total*
	US$000	**US$000**	**US$000**	**US$000**	**US$000**	**US$000**	**US$000**
Net operating income:	**259,224**	**191,988**	**519,970**	**9,184**	**31,293**	**(69,552)**	**942,107**
External	**171,157**	**376,855**	**508,036**	**(4,546)**	**(103,423)**	**–**	**948,079**
Inter-segment	**88,067**	**(184,867)**	**11,934**	**13,730**	**134,716**	**(69,552)**	**(5,972)**

	Year ended 31 December 2008						
	Personal Financial Services	*Commercial Banking*	*Global Banking and Markets*	*Private Banking*	*Other*	*Inter Segment*	*Total*
	US$000	US$000	US$000	US$000	US$000	US$000	US$000
Net operating income:	636,480	671,905	699,702	12,295	23,413	(53,379)	1,990,416
External	595,048	793,637	771,342	(44,943)	(136,089)	–	1,978,995
Inter-segment	41,432	(121,732)	(71,640)	57,238	159,502	(53,379)	11,421

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:

2009	*Held for trading*	*Loans and receivables*	*Available-for-sale securities*	*Financial assets and liabilities at amortised cost*	*Derivatives designated as fair value hedging instruments*	*Derivatives designated as cash flow hedging instruments*	*Total*
	US$000	**US$000**	**US$000**	**US$000**	**US$000**	**US$000**	**US$000**
FINANCIAL ASSETS							
Cash and balances at central banks	–	–	–	**432,386**	–	–	**432,386**
Items in the course of collection from other banks	–	–	–	**49,259**	–	–	**49,259**
Trading assets	**453,349**	–	–	–	–	–	**453,349**
Derivatives	**662,301**	–	–	–	–	–	**662,301**
Loans and advances to banks	–	**8,106,050**	–	–	–	–	**8,106,050**
Loans and advances to customers	–	**19,883,399**	–	–	–	–	**19,883,399**
Financial investments	–	–	**7,873,086**	–	–	–	**7,873,086**
Other assets	–	–	–	**1,006,225**	–	–	**1,006,225**
Accrued income	–	–	–	**197,545**	–	–	**197,545**
Total financial assets	**1,115,650**	**27,989,449**	**7,873,086**	**1,685,415**	–	–	**38,663,600**
Total non-financial assets							**502,552**
Total assets							**39,166,152**
FINANCIAL LIABILITIES							
Deposits by banks	–	–	–	**1,674,632**	–	–	**1,674,632**
Customer accounts	–	–	–	**26,524,487**	–	–	**26,524,487**
Items in the course of transmission to other banks	–	–	–	**65,703**	–	–	**65,703**
Trading liabilities	**12,874**	–	–	–	–	–	**12,874**
Derivatives	**641,157**	–	–	–	–	**6,738**	**647,895**
Debt securities in issue	–	–	–	**5,090,208**	–	–	**5,090,208**
Other liabilities	–	–	–	**1,198,844**	–	–	**1,198,844**
Accruals	–	–	–	**122,422**	–	–	**122,422**
Total financial liabilities	**654,031**	–	–	**34,676,296**	–	**6,738**	**35,337,065**
Total non-financial liabilities							**373,756**
Total liabilities							**35,710,821**

2008	*Held for trading*	*Loans and receivables*	*Available-for-sale securities*	*Financial assets and liabilities at amortised cost*	*Derivatives designated as fair value hedging instruments*	*Derivatives designated as cash flow hedging instruments*	*Total*
	US$000	US$000	US$000	US$000	US$000	US$000	US$000
FINANCIAL ASSETS							
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	–	–	–	235,734	–	–	235,734
Total financial assets	1,345,513	30,797,285	6,288,010	2,774,132	–	–	41,204,940
Total non-financial assets							
Total assets							
FINANCIAL LIABILITIES							
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	1,020,902	-	-	36,802,573	521	15,418	37,839,414
Total non-financial liabilities							357,999
Total liabilities							38,197,413

Notes on the Financial Statements (continued)

12 Trading assets

	2009	2008
	US$000	US$000
Trading assets:		
- not subject to re-pledge or resale by counterparties	**453,349**	365,351
	453,349	365,351
Debt securities	**235,750**	189,281
Equity securities	**210,344**	176,070
Loans and advances to customer	**7,255**	–
	453,349	365,351

13 Derivatives

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

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

	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)
Total	980,162	–	980,162	(966,583)	(15,939)	(982,522)

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.

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

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

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.

	2009	2008
	US$000	US$000
Exchange rate	**39,220,020**	40,262,828
Interest rate	**19,354,061**	16,486,120
Equities	**678,499**	526,216
Credit derivatives	**2,057,179**	931,145
Commodity and others	**30,349**	18,613
Total derivatives	**61,340,108**	58,224,922

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.

	2009	2008
	US$000	US$000
Unamortized balance at 1 January		
– Deferral on new transactions	**1,015**	1,015
– Recognised in the income statement during the period:	**14,133**	–
– subsequent to unobservable inputs becoming observable	**(1,015)**	–
– Exchange differences	**(1)**	–
Unamortized balance at 31 December	**14,132**	1,015

Notes on the Financial Statements (continued)

Hedging Instruments

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

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.

	At 31 December 2009		At 31 December 2008	
	Cash flow hedge	*Fair value hedge*	*Cash flow hedge*	*Fair value hedge*
	US$000	**US$000**	US$000	US$000
Interest rate	**249,963**	–	249,956	43,994

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 2009, were assets of nil and liabilities of nil (2008: assets of nil and liabilities of US$521 thousand).

	2009	2008
Gains or losses arising from the change in fair value of fair value hedges	**US$000**	US$000
Gains/(losses) arising from the change in fair value of fair value hedges:		
– on hedged instruments	**83**	210
– on hedged items attributable to the hedged risk	**(54)**	(288)

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 2009 and 31 December 2008.

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 2009, the fair values of outstanding derivatives designated as cash flow hedges of forecast transactions were assets of nil (2008: Nil) and liabilities of US$6,738 thousand (2008: US$15,418 thousand).

The schedule of forecast principal balances on which the expected interest cash flows arise as at 31 December 2009 is as follows:

	At 31 December 2009			
	3 months or less	*More than 3 months but less than 1 year*	*5 years or less but more than 1 year*	*More than 5 years*
	US$000	**US$000**	**US$000**	**US$000**
Cash inflows from assets	–	–	–	–
Cash outflows from liabilities	**250,000**	**250,000**	–	–
Net cash inflows (outflows)	**(250,000)**	**(250,000)**	–	–

	At 31 December 2008			
	3 months or less	*More than 3 months but less than 1 year*	*5 years or less but more than 1 year*	*More than 5 years*
	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)	(250,000)	(250,000)	(250,000)	–

The gains and losses on ineffective portions of such derivatives are recognised immediately in 'Net trading income'. During the years to 31 December 2009 and 31 December 2008, 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:

	Assets		Liabilities	
	Trading securities purchased	*Derivatives*	*Trading securities sold*	*Derivatives*
	%	%	%	%
At 31 December 2009 Fair value based on:				
Quoted market prices	**18**	–	–	–
Internal models with significant observable market parameters	**39**	**97**	**100**	**95**
Internal models with significant unobservable market parameters	**43**	**3**	–	**5**
	100	**100**	**100**	**100**

	Assets		Liabilities	
	Trading securities purchased	*Derivatives*	*Trading securities sold*	*Derivatives*
	%	%	%	%
At 31 December 2008 Fair value based on:				
Quoted market prices	18	–	–	–
Internal models with significant observable market parameters	82	99	100	100
Internal models with significant unobservable market parameters	–	1	–	–
	100	100	100	100

Notes on the Financial Statements (continued)

14 Financial investments

	2009	2008
Financial investments:	**US$000**	US$000
– not subject to re-pledge or resale by counterparties	**7,873,086**	6,288,010

	2009 Carrying value and fair value **US$000**	2008 Carrying value and fair value US$000
Treasury and other eligible bills:		
– available-for-sale	**517,025**	272,510
Debt securities:		
– available-for-sale	**7,250,081**	5,912,885
Equity securities:		
– available-for-sale	**105,980**	102,615
Total financial investments	**7,873,086**	6,288,010

15 Interests in associates

Principal associates of the Group	At 31 December 2009			
Name of associate	*Country of incorporation*	*Principal activity*	*The Group's interest in equity capital*	*Issued equity capital*
Arabian Real Estate Investment Trust Management Limited	Cayman Islands	Real estate	39.58%	US$3.9 million of which US$3.6 million is fully paid
British Arab Commercial Bank plc	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	Petrochemical 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

British Arab Commercial Bank plc has issued US$44,478 thousand of subordinated unsecured loan stock in which the Group has a 34.66 per cent (2008: 34.66 per cent) interest. The Group's share of associates' contingent liabilities amounted to US$809,214 thousand at 31 December 2009 (2008: US$415,797 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 plc 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.

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

Movement in investments in associates:	**2009** **US$000**	2008 US$000
At 1 January	**152,429**	157,756
Additions	**811**	27,595
Retained profits and losses	**(2,014)**	15,895
Exchange and other movements	**19,058**	(48,817)
At 31 December	**170,284**	152,429

Summarised aggregated financial information of associates is as follows:	**2009** **US$000**	2008 US$000
Assets	**2,635,457**	2,213,775
Liabilities	**2,629,519**	2,084,751
Revenues	**48,616**	58,336
Profit	**6,156**	30,844

Notes on the Financial Statements (continued)

16 Intangible assets

The analysis of the movement of intangible assets for the year ended 31 December 2009 is as follows:

	Internally generated software	*Purchased software*	*Total*
	US$000	**US$000**	**US$000**
At 1 January 2009	**14,018**	**8,141**	**22,159**
Additions	**4,578**	**2,708**	**7,286**
Disposals	**–**	**(70)**	**(70)**
Other changes	**(1)**	**1**	**–**
At 31 December 2009	**18,595**	**10,780**	**29,375**
Accumulated depreciation			
At 1 January 2009	**(7,868)**	**(5,180)**	**(13,048)**
Charge for the year [1]	**(5,018)**	**(1,487)**	**(6,505)**
Disposals	**–**	**56**	**56**
Other changes	**1**	**(240)**	**(239)**
At 31 December 2009	**(12,885)**	**(6,851)**	**(19,736)**
Net book value at 31 December 2009 [2]	**5,710**	**3,929**	**9,639**
At 1 January 2008	9,944	5,695	15,639
Additions	4,074	2,738	6,812
Disposals	–	(291)	(291)
Exchange translation differences	–	(1)	(1)
At 31 December 2008	14,018	8,141	22,159
Accumulated depreciation	(3,308)	(4,124)	(7,432)
At 1 January 2008 Charge for the year	(4,560)	(1,105)	(5,665)
Disposals	–	118	118
Exchange translation differences	–	(69)	(69)
At 31 December 2008	(7,868)	(5,180)	(13,048)
Net book value at 31 December 2008	6,150	2,961	9,111

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

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

17 Property, plant and equipment

	Freehold land and buildings	*Short leasehold land and buildings*	*Equipment, fixtures and fittings*	*Total*
	US$000	**US$000**	**US$000**	**US$000**
Cost or fair value				
At 1 January 2009	**48,073**	**56,911**	**108,094**	**213,078**
Additions at cost	**10,314**	**13,773**	**24,389**	**48,476**
Disposals	**(6,953)**	**(3,491)**	**(5,787)**	**(16,231)**
Exchange translation differences	**190**	**(12)**	**(584)**	**(406)**
Other changes	**–**	**–**	**1,229**	**1,229**
At 31 December 2009	**51,624**	**67,181**	**127,341**	**246,146**
Accumulated depreciation				
At 1 January 2009	**(4,074)**	**(27,885)**	**(68,319)**	**(100,278)**
Depreciation charge for the year	**(2,172)**	**(4,847)**	**(13,465)**	**(20,484)**
Disposals	**5,647**	**3,199**	**3,441**	**12,287**
Exchange translation differences	**(25)**	**5**	**192**	**172**
Other changes	**(2)**	**1**	**(175)**	**(176)**
At 31 December 2009	**(626)**	**(29,527)**	**(78,326)**	**(108,479)**
Net carrying amount at 31 December 2009	**50,998**	**37,654**	**49,015**	**137,667**

Notes on the Financial Statements (continued)

	Freehold land and buildings US$000	*Short leasehold land and buildings* US$000	*Equipment, fixtures and fittings* US$000	*Total* US$000
Cost or fair value				
At 1 January 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
At 31 December 2008	48,073	56,911	108,094	213,078
Accumulated depreciation				
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)
At 31 December 2008	(4,074)	(27,885)	(68,319)	(100,278)
Net carrying amount at 31 December 2008	43,999	29,026	39,775	112,800

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:

	2009		2008	
	Cost **US$000**	*Accumulated depreciation* **US$000**	*Cost* US$000	*Accumulated depreciation* US$000
At 1 January	**56,911**	**(27,059)**	42,503	(24,250)
Additions	**6,576**	–	15,004	–
Disposals	**(1,069)**	–	(585)	–
Depreciation charge for the year	–	**(3,970)**	-	(2,811)
Exchange translation differences	**(11)**	**(5)**	(11)	2
Other changes	–	–	–	-
At 31 December	**62,407**	**(31,034)**	56,911	(27,059)
Net carrying amount at 31 December	**31,373**		29,852	

18 Investments in subsidaries

The principal subsidiary undertakings of the Bank are:

	Country of incorporation or registration	*Bank's interest in equity capital*
HSBC Bank Middle East Nominees W.L.L.	Bahrain	95%
HSBC Financial Services (Middle East) Limited	Dubai, UAE	100%
HSBC Middle East Finance Company Limited	Dubai, UAE	80%
HSBC Middle East Securities LLC	Dubai, UAE	100%
HSBC Insurance Services (Lebanon) S.A.L.	Lebanon	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$29,624 thousand (2008: US$14,711 thousand).

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

19 Other assets

	2009	2008
	US$000	US$000
Assets held for sale	**1,465**	1,800
Endorsements and acceptances	**851,420**	1,210,085
Current tax recoverable	**9,287**	7,872
Other accounts	**154,805**	138,111
	1,016,977	1,357,868

	2009	2008
	US$000	US$0000
Disposal groups		
Property, plant and equipment	**1,465**	1,800
Non-current assets held for sale	**1,465**	1,800
Total assets classified as held for sale	**1,465**	1,800

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

	2009		2008	
	Book value	*Fair value*	*Book value*	*Fair value*
	US$000	**US$000**	US$000	US$000
Medium term notes	**3,572,187**	**3,452,739**	2,940,212	2,621,124
Other debt securities in issue	**136,127**	**134,765**	136,123	129,246
Non-equity preference shares	**1,350,000**	**1,332,090**	1,350,000	1,000,600
	5,058,314	**5,058,314**	4,426,335	3,750,970
Of which debt securities in issue reported as trading liabilities (Note 24)	**31,894**	**31,894**	14,942	14,942
	5,090,208	**4,951,488**	4,441,277	3,765,912

Notes on the Financial Statements (continued)

The following table analyses the carrying amounts of medium term notes in issue at 31 December 2009 with original maturities greater than one year.

	2009	2008
	US$000	US$000
Fixed interest rate		
Vanilla debt - 4.00% due 2013	**199,612**	–
Floating interest rate		
Vanilla debt – 0.00% to 0.99%: due 2010 to 2015	**1,792,146**	–
Vanilla debt – 1.00% to 1.99%: due 2010 to 2015	**99,121**	–
Vanilla debt – 2.00% to 2.99%: due 2010 to 2015	**600,529**	–
Vanilla debt – 5.00% to 5.99%: due 2009 to 2013	–	2,940,212
	2,491,796	2,940,212
Floating interest rate		
Sukuk - 1.00% to 1.99%: due 2012	**89,714**	–

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 2009, 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

Issue Tranche	*Issue Date*	*Issue Currency*	*Floating rate Notes Currency Value*	*Due Date*
2	5 May 2005	USD	700,000,000	5 May 2010
3	14 November 2006	USD	1,000,000,000	14 November 2011
4	30 April 2009	AED	3,000,000,000	30 April 2013
5	23 December 2008	SAR	542,500,000	23 December 2010
6	14 June 2007	AED	500,000,000	14 June 2010
7	24 March 2009	USD	113,255,000	30 March 2011
8	14 October 2009	EUR	50,045,000	14 October 2010
9	19 October 2009	USD	400,000,000	22 April 2010
10	8 October 2009	USD	57,000,000	14 October 2014
11	10 November 2009	USD	200,000,000	19 November 2013
12	9 November 2009	USD	90,234,000	19 November 2012
13	21 December 2009	EUR	30,160,000	5 January 2015
14	28 September 2009	GBP	224,009,000	28 September 2010
15	14 October 2009	USD	126,980,000	14 October 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 2009 was 1,350,000 (2008: 2,500,000) cumulative redeemable preference shares of US$1.00 each and 1,150,000 (2008: Nil) non-cumulative redeemable preference shares of US$1.00 each.

Issued

Perpetual cumulative redeemable preference shares

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

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

Dated cumulative redeemable preference shares

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

Notes on the Financial Statements (continued)

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.

Dated non-cumulative redeemable preference shares

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

1 The dated non-cumulative redeemable preference shares have been issued at a nominal value of US$1 each with a premium of US$999 per share.
2 Non-cumulative redeemable preference dividends are payable annually on the issue price of each dated share.
3 Redemption of the dated cumulative redeemable preference shares, other than at the option of the Bank, will be subject to the approval of the ordinary shareholders of the Bank. The earliest redemption date is as disclosed in the table above and if not approved by the shareholders will next fall for review at 10 yearly intervals thereafter. However, the shares may be redeemed at the option of the Bank without the approval of the ordinary shareholders of the Bank. On redemption, the holders of the shares shall be entitled to receive an amount equal to any accrued but unpaid dividends plus the issue price of each share.
4 Each share carries one vote at meetings of the shareholders of the Bank.
5 As regards dividends and on a winding up of the company as regards capital, the non-cumulative preference shares shall rank after the undated and dated cumulative preference shares already in issue and ahead of the ordinary shares.

21 Other liabilities

	2009	2008
	US$000	US$0000
Share-based payments	**6,504**	–
Obligations under finance leases	**9,180**	–
Endorsements and acceptances	**851,420**	1,210,085
Other liabilities	**331,740**	271,710
	1,198,844	1,481,795

22 Provisions

	2009 US$000	2008 US$000
At 1 January	**6,252**	6,406
Additional provisions/increase in provisions	**4,856**	3,412
Provisions utilised	**(3,206)**	(5,881)
Amounts reversed	**(1,279)**	–
Exchange and other movements	**4,466**	2,315
At 31 December	**11,089**	6,252

Included within 'Provisions' is an amount of US$383 thousand (2008: US$564 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, primarily for educational purposes and for environmental projects in the region. Funding is provided on a case by case basis, throughout the year.

23 Fair value of financial instruments

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 the Finance department, which reports functionally through the Group's Chief Financial Officer to the HSBC Group Finance Director. The Finance department 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:

Level 1– quoted market price: financial instruments with quoted prices for identical instruments in active markets.

Level 2– Valuation technique using observable inputs: financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.

Level 3– Valuation technique with significant non-observable inputs: financial instruments valued using models where one or more significant inputs are not observable.

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 assumptions 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 cross 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:

		Valuation techniques		
	Level 1 Quoted market price	*Level 2 using observable inputs*	*Level 3 with significant non-observable inputs*	*Total*
At 31 December 2009	**US$000**	**US$000**	**US$000**	**US$000**
Assets				
Trading assets	**80,865**	**175,669**	**196,815**	**453,349**
Derivatives	**–**	**648,161**	**14,140**	**662,301**
Financial investments:				
available-for-sale	**62,280**	**7,719,628**	**91,178**	**7,873,086**
Liabilities				
Trading liabilities	**–**	**12,874**	**–**	**12,874**
Derivatives	**–**	**644,703**	**3,192**	**647,895**
At 31 December 2008				
Assets				
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
Liabilities				
Trading liabilities	–	54,319	–	54,319
Derivatives	–	981,758	764	982,522

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

	Assets			Liabilities
	Available-for-sale	*Held for trading*	*Derivatives*	*Derivatives*
	US$000	**US$000**	**US$000**	**US$000**
At 31 December 2009				
Private equity investments	**91,178**	**196,815**	**–**	**–**
Structured notes	**–**	**–**	**–**	**2,882**
Other derivatives	**–**	**–**	**12,945**	**310**
Other	**–**	**–**	**1,195**	**–**
	91,178	**196,815**	**14,140**	**3,192**
At 31 December 2008				
Private equity investments	36,652	–	–	–
Structured notes	–	–	–	–
Other derivatives	–	–	8,671	764
Other	–	–	–	
	36,652	–	8,671	764

Notes on the Financial Statements (continued)

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

	Assets			Liabilities
	Available-for-sale	*Held for trading*	*Derivatives*	*Derivatives*
	US$000	**US$000**	**US$000**	**US$000**
At 1 January 2009	**36,652**	**–**	**8,671**	**764**
Total gains or losses recognised in profit or loss	**(49)**	**–**	**(5,217)**	**(415)**
Purchases	**6,678**	**–**	**–**	**–**
Sales	**(12,786)**	**–**	**–**	**–**
Settlements	**–**	**–**	**7,844**	**(39)**
Transfers out	**–**	**–**	**(6,750)**	**–**
Transfers in	**60,683**	**196,815**	**9,592**	**2,882**
At 31 December 2009	**91,178**	**196,815**	**14,140**	**3,192**
At 1 January 2008	37,673	–	5,847	–
Total gains or losses recognised in profit or loss	(3,672)	–	2,824	764
Purchases	16,803	–	–	–
Sales	(14,152)	–	–	–
Settlements	–	–	–	–
Transfers out	–	–	–	–
Transfers in	–	–	–	–
At 31 December 2008	36,652	–	8,671	764

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:

	Reflected in profit/(loss)		Reflected in equity	
	Favourable changes	*Unfavourable changes*	*Favourable changes*	*Unfavourable changes*
	US$000	**US$000**	**US$000**	**US$000**
At 31 December 2009				
1 Derivatives/trading assets/ trading liabilities	**21,213**	**(21,213)**	**–**	**–**
Financial investments: available-for-sale	**–**	**–**	**9,118**	**(9,118)**
At 31 December 2008				
Derivatives/trading assets/ trading liabilities	–	(327)	–	–
Financial investments: available-for-sale	–	–	3,081	(3,081)

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

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 2009 where these inputs were observable at 31 December 2008, the table reflects the full change in fair value of those instruments during the period.

Recorded profit on:	Year ended 31 December **2009** **US$000**	Year ended 31 December 2008 US$000
Derivatives/trading assets/trading liabilities	**(4,632)**	3,118

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.

Notes on the Financial Statements (continued)

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:

Assets	**Liabilities**
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 receivables within 'Other Assets'	Short-term payables within 'Other Liabilities'
Accrued income within 'Prepayments and accrued income'	Accruals within 'Accruals and deferred income'

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

	2009		2008	
	Carrying value **US$000**	*Fair value* **US$000**	*Carrying value* US$000	*Fair value* US$000
Assets				
Loans and advances to banks	**8,106,050**	**8,102,354**	7,111,613	6,947,085
Loans and advances to customers	**19,883,399**	**19,577,859**	23,685,672	23,563,645
Liabilities				
Deposits by banks	**1,674,632**	**1,670,347**	1,811,408	1,839,271
Customer accounts	**26,524,487**	**26,392,031**	28,745,291	28,753,674
Debt securities in issue: Medium term notes (Note 20)	**3,572,187**	**3,452,739**	2,940,212	2,621,124

24 Trading liabilities

	2009 **US$000**	2008 US$000
Debt securities in issue	**(31,894)**	(14,942)
Other liabilities - net short positions	**44,768**	69,261
	12,874	54,319

25 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.

	On demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*Total*
	US$000	**US$000**	**US$000**	**US$000**	**US$000**	**US$000**
Deposits by banks	**862,081**	**720,614**	**15,372**	**2,861**	**2,622**	**1,603,550**
Customer accounts	**16,317,139**	**6,745,071**	**2,180,117**	**1,367,856**	**24,571**	**26,634,754**
Derivatives	**650,761**	**–**	**3,111**	**–**	**–**	**653,872**
Debt securities in issue	**–**	**34,286**	**1,910,266**	**1,888,094**	**1,206,470**	**5,039,116**
Other financial liabilities	**7,999**	**264,147**	**107,404**	**356,265**	**127,256**	**863,071**
Loan commitments	**1,425,233**	**3,292,504**	**4,027,486**	**4,637,917**	**2,452,465**	**15,835,605**
Total at 31 December 2009	**19,263,213**	**11,056,622**	**8,243,756**	**8,252,993**	**3,813,384**	**50,629,968**

	On demand	*Due within 3 months*	*Due between 3 and 12 months*	*Due between 1 and 5 years*	*Due after 5 years*	*Total*
	US$000	US$000	US$000	US$000	US$000	US$000
Deposits by banks	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
Total at 31 December 2008	18,165,446	16,868,665	18,977,686	5,235,113	1,390,208	60,637,118

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.

Notes on the Financial Statements (continued)

	At 31 December 2009		
	Due within 1 year	*Due after more than 1 year*	*Total*
	US$000	**US$000**	**US$000**
Assets			
Loans and advances to banks	**7,883,272**	**222,778**	**8,106,050**
Loans and advances to customers	**12,972,702**	**6,910,697**	**19,883,399**
Financial investments	**6,378,182**	**1,494,904**	**7,873,086**
Other financial assets	**847,783**	**3,637**	**851,420**
	28,081,939	**8,632,016**	**36,713,955**
Liabilities			
Deposits by banks	**1,649,680**	**24,952**	**1,674,632**
Customer accounts	**25,162,304**	**1,362,183**	**26,524,487**
Debt securities in issue	**2,283,107**	**2,807,101**	**5,090,208**
Other financial liabilities	**839,914**	**20,686**	**860,600**
	29,935,005	**4,214,922**	**34,149,927**

	At 31 December 2008		
	Due within 1 year	*Due after more than 1 year*	*Total*
	US$000	US$000	US$000
Assets			
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
	28,915,816	9,379,563	38,295,379
Liabilities			
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
	31,248,135	**4,959,926**	**36,208,061**

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

26 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 30.

Net structural currency exposures

Currency of structural exposure

	2009 **US$000**	2008 US$000
Algerian dinar	**146,374**	–
Bahraini dinar	**83,757**	112,052
Jordanian dinar	**159,536**	147,458
Kuwaiti dinar	**95,755**	82,965
Lebanese pound	**63,475**	69,942
Omani riyal	**211,468**	209,639
Pakistani rupee	**4,122**	7,470
Qatari riyal	**384,126**	271,487
Sterling	**226**	203
UAE dirham	**2,248,284**	3,470,599
Total	**3,397,123**	4,371,815

27 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	
	2009 **US$000**	2008 US$000
Treasury bills and other eligible securities	–	9,700

These transactions are conducted under terms that are usual and customaryto 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$103,876 thousand (2008: US$44,962 thousand). The fair value of financial assets accepted as collateral that have been sold or repledged is US$24,023 thousand (2008: US$5,652 thousand). 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

28 Called up share capital

Authorised

The authorised ordinary share capital of the Bank at 31 December 2009 was 1,500,000,000 (2008: 1,500,000,000) 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.
On 29 December 2009, the Bank issued 300,000,000 ordinary shares of US$1.00 each, fully paid, at par.

Issued and fully paid

	Number of ordinary shares	**2009** **US$000**	*Number of ordinary shares*	2008 US$000
At 1 January	**631,055,000**	**631,055**	431,055,000	431,055
Shares issued	**300,000,000**	**300,000**	200,000,000	200,000
At 31 December	**931,055,000**	**931,055**	631,055,000	631,055

Notes on the Financial Statements (continued)

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

Non-cash items included in profit and loss	**2009 US$000**	2008 US$000
Depreciation and amortisation	**26,987**	22,540
Loan impairment losses net of recoveries	**1,301,249**	309,148
Provisions raised	**3,725**	3,645
Provisions utilised	**(3,206)**	(5,882)
Retirement benefits	**9,454**	–
	1,338,209	329,451
Change in operating assets		
Change in prepayments and accrued income	**38,187**	(30,713)
Change in net trading securities and net derivatives	**229,862**	554,279
Change in loans and advances to banks	**(201,693)**	(626,917)
Change in loans and advances to customers	**2,516,515**	(5,381,351)
Change in other assets	**340,336**	(155,710)
	2,923,207	(5,640,412)
Change in operating liabilities		
Change in accruals and deferred income	**14,999**	55,067
Change in deposits by banks	**(136,776)**	(1,614,083)
Change in customer accounts	**(2,220,804)**	3,097,097
Change in debt securities in issue	**631,980**	968,418
Change in other liabilities	**(648,576)**	368,020
Change in retirement benefits	**(5,342)**	–
	(2,364,519)	2,874,519
Cash and cash equivalents comprise		
Cash and balances at central banks	**432,386**	960,721
Items in the course of collection from other banks	**49,259**	229,480
Loans and advances to banks of one month or less	**6,646,160**	5,838,413
Treasury bills, other bills and certificates of deposit less than three months	**4,309,029**	3,211,860
Less: items in the course of transmission to other banks	**(65,703)**	(174,219)
	11,371,131	10,066,255

30 Risk management

Introduction

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

The management of these various risk categories is discussed below.

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

Risk governance and ownership

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

The Board approves the Group's risk appetite framework, plans and performance targets for the Group and its principal operating subsidiaries, the appointment of senior officers, the delegation of authorities for credit and other risks and the establishment of effective control procedures. Under authority delegated by the Board, the separately convened Risk Management Meeting ('RMM') formulates high-level Group risk management policy, exercises delegated risk authorities and oversees the implementation of risk appetite and controls. It monitors all categories of risk, receives reports on actual performance and emerging issues, determines action to be taken and reviews the efficacy of the Group's risk management framework.

Primary responsibility for managing risk at operating entity level lies with the respective boards and Chief Executive Officers, as custodians of their balance sheets. In their oversight and stewardship of risk management at Group level, RMM are supported by a dedicated Risk function headed by the Chief Risk Officer ('CRO'), who is a member of RMM and reports to Chief Executive Officer.

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

Risk appetite

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

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

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

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

- the framework itself defines the governance bodies, processes, metrics and other features of how the Group addresses risk appetite as part of its ongoing business;
- periodic risk appetite statements define, at various levels in the business, the desired level of risk commensurate with return and growth targets and in line with the corporate strategy and stakeholder objectives.

The risk appetite framework covers both the beneficial and adverse aspects of risk. Within it, economic capital is the

Notes on the Financial Statements (continued)

common currency through which risk is measured and used as the basis for risk evaluation, capital allocation and performance measurement across regions and customer groups. Risk appetite is executed through the operational limits that control the levels of risk run by the Group, geographic segments and customer groups and is measured using risk-adjusted performance metrics.

Risk control culture

The Group's risk management policies are encapsulated in the HSBC Group Standards Manual and cascaded in a hierarchy of policy manuals throughout the HSBC Group and communicated standards, instructions and guidance to employees. They support the formulation of risk appetite and establish procedures for monitoring and controlling risks, with timely and reliable reporting to management. The Group regularly reviews and updates its risk management policies, systems and methodologies to reflect changes in law, regulation, markets, products and emerging best practice. It is the responsibility of all Group officers to identify, assess and manage risk within the scope of their assigned responsibilities. Personal accountability, reinforced by the Group's governance structure and instilled by training and experience, helps to foster throughout the Group a disciplined and constructive culture of risk management and control.

Credit risk

Credit risk management

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

The objectives of credit risk management, underpinning sustainably profitable business, are principally to maintain a strong culture of responsible lending, supported by a robust risk policy and control framework; to both partner and challenge the business line in defining and implementing risk appetite, with its continuous re-evaluation under actual and scenario conditions; and to ensure independent, expert scrutiny of credit risks, their costs and their mitigation. The credit risk governance structures and control frameworks implemented by the Group are designed for all stages of economic and financial cycles, including the current economic environment. No material changes were initiated to the Group's risk management objectives, policies or procedures as a direct result of market turmoil. Certain measures already undertaken, however, are helping the Group to manage the effects of that turmoil. Such measures, for example the reinforcement of central credit risk oversight and independent review activities, continue to be implemented within a common operating model for the responsibilities, regionally integrated risk functions and country-based management. In addition, certain operational processes have been invoked and applied in order to manage risks more intensively.

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

- Controlling exposures to sovereign entities, banks and other financial institutions. The HSBC Group's credit and settlement risk limits to counterparties in these sectors are approved and managed by HSBC 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 Group 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 the HSBC Group'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 Meeting, 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 2 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 counterparts.

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

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

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

Periodic risk-based audits of the Group's credit processes and portfolios are undertaken by HSBC Group's Internal Audit function. Audits include consideration of the adequacy and clarity of credit policy/procedure manuals; an in-depth analysis of a representative sample of accounts; an overview of homogeneous portfolios of similar assets to assess the quality of the loan book and other exposures; consideration of any oversight or review work performed by credit risk management functions and the adequacy of impairment calculations; a review of analytical model governance and implementation; a review of management objectives and a check that Group and local standards and policies are adhered to in the approval and management of credit facilities. Individually significant accounts are reviewed on a sample basis to ensure that risk ratings are appropriate, that credit and collection procedures have been properly followed and that, when an account or portfolio evidences deterioration, impairment allowances are raised in accordance with the Group's established procedures. Internal Audit discusses with management any risk ratings it considers to be inappropriate; after discussion, its final recommendations for revised ratings must then be adopted.

Credit quality

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

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.

Individually assessed impairment allowances

These are determined by evaluating exposure to loss, case by case, on all individually significant accounts and all other accounts that do not qualify for the collective assessment approach outlined below. Loans are treated as impaired as soon as there is objective evidence that an impairment loss has been incurred. The criteria used by the Group to determine that there is such objective evidence include:

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

In determining the level of allowances on such accounts, the following factors are typically considered:

- the Group's aggregate exposure to the customer;
- the viability of the customer's business model and their capacity to trade successfully out of financial difficulties, generating sufficient cash flow to service debt obligations;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency;
- the amount and timing of expected receipts and recoveries;
- 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 value of security and likelihood of successfully realising it;
- the existence of other credit mitigants and the ability of the providers of such credit mitigants to deliver as contractually committed; and
- when available, the secondary market price of the debt.

The level of impairment allowances on individually significant accounts that are above defined materiality thresholds is reviewed at least semi-annually, and more regularly when circumstances require. This normally encompasses re-assessment of the enforceability of any collateral held and of actual and anticipated receipts. For significant commercial and corporate debts, specialised loan 'work-out' teams with experience in insolvency and specific market sectors are used to manage the lending and assess likely losses.

Individually assessed impairment allowances are only released when there is reasonable and objective evidence of a reduction in the established loss estimate.

Collectively assessed impairment allowances

Impairment is assessed on a collective basis in two circumstances:

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

Incurred but not yet identified impairment

Individually assessed loans for which no evidence of impairment has been specifically identified on an individual basis are grouped together according to their credit risk characteristics. A collective impairment allowance is calculated to reflect impairment losses incurred at the balance sheet date which will only be individually identified in the future.

The collective impairment allowance is determined having taken into account:

- historical loss experience in portfolios of similar credit risk characteristics (for example, by industry sector, risk rating or product segment);
- 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 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 relevant portfolio. In general, the periods used vary between four and twelve months although, in exceptional cases, longer periods are warranted.

The basis on which impairment allowances for incurred but not yet identified losses is established in each reporting entity is documented and reviewed by senior Finance and Credit Risk management to ensure conformity with HSBC Group policy.

Homogeneous groups of loans

Two methodologies are used to calculate impairment allowances where large numbers of relatively low-value assets are managed using a portfolio approach, typically:

- low-value, homogeneous small business accounts in certain countries or territories;
- residential mortgages that have not been individually assessed;
- credit cards and other unsecured consumer lending products; and
- motor vehicle financing.

When appropriate empirical information is available, the Group uses roll rate methodology. This employs a statistical analysis of historical trends of default and the amount of consequential loss, based on the delinquency of accounts within a portfolio of homogeneous accounts. Other historical data and current economic conditions are also evaluated when calculating the appropriate level of impairment allowance required to cover inherent loss. In certain highly developed markets, models also take into account behavioural and account management trends revealed in, for example, bankruptcy and rescheduling statistics.

When the portfolio size is small, or when information is insufficient or not reliable enough to adopt a roll rate methodology, a formulaic approach is used that allocates progressively higher percentage loss rates the longer a customer's loan is overdue. Loss rates reflect the discounted expected future cash flows for a portfolio.

Generally, historical experience is the most objective and relevant information from which to begin to assess inherent loss within each portfolio. In circumstances where 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 conditions or regulations - management considers the more recent trends in the portfolio risk factors which may not be

Notes on the Financial Statements (continued)

adequately reflected in its statistical models and, subject to guidance from HSBC Group Finance and Risk, adjusts impairment allowances accordingly.

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

Write-off of loans and advances

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

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

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

Cross-border exposures

Management assesses the vulnerability of countries to foreign currency payment restrictions when considering impairment allowances on cross-border exposures. This assessment includes an analysis of the economic and political factors existing at the time. Economic factors include the level of external indebtedness, the debt service burden and access to external sources of funds to meet the debtor country's financing requirements. Political factors taken into account include the stability of the country and its government, threats to security, and the quality and independence of the legal system.

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

- performing, trade-related and of less than one year's maturity;
- mitigated by acceptable security cover which is, other than in exceptional cases, held outside the country concerned;
- in the form of securities held for trading purposes for which a liquid and active market exists, and which are measured at fair value daily;
- performing facilities with a principal (excluding security) of US$1 million or below; or
- performing facilities with maturity dates shorter than three months.

Credit exposure

Maximum exposure to credit risk

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

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

	Maximum **2009** **US$000**	*Maximum* 2008 US$000
Cash and balances at central banks	**432,386**	960,721
Items in course of collection from other banks	**49,259**	229,480
Trading assets	**453,349**	365,351
– debt securities	**235,750**	189,281
– equity securities	**210,344**	176,070
– loans and advances to customers	**7,255**	–
Derivatives	**662,301**	980,162
Loans and advances to banks	**8,106,050**	7,111,613
Loans and advances to customers	**19,883,399**	23,685,672
Financial investments	**7,807,206**	6,185,395
– treasury and other similar bills	**517,025**	272,510
– debt securities	**7,290,181**	5,912,885
Other assets		
– endorsements and acceptances	**851,420**	1,210,085
Off-balance sheet		
– Financial guarantees and other credit related contingent liabilities	**10,548,006**	12,013,139
– loan commitments and other credit related commitments	**16,852,098**	22,496,352
	65,645,474	75,237,970

Collateral and other credit enhancements

Collateral held against financial instruments presented in the 'Maximum exposure to credit risk' table above 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 International Swaps and Derivatives Association Inc ('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 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 2009 and 31 December 2008 was concentrated in Europe and the Middle East.

Total securities excluding equity securities held for trading within trading assets were US$235,750 thousand at 31 December 2009 (2008:US$189,281 thousand). The largest concentration of these assets was in government debt securities, which amounted to US$93,400 thousand, or 40 per cent of overall trading securities (2008: US$63,102 thousand, 33 per cent).

Debt securities, treasury and other eligible bills

At US$7,767,106 thousand total financial investments excluding equity securities were 26 per cent higher at 31 December 2009 than at 31 December 2008. Debt securities, at US$7,250,081 thousand, represented the largest concentration of financial investments at 93 per cent of the total, compared with US$ 5,912,885 thousand (96 per cent) at 31 December 2008. The Group's holdings of govenment, corporate debt, and other securities were spread across a wide range of issuers and geographical regions.

Investments in securities of governments and government agencies of US$6,564,555 thousand were 85 per cent of overall financial investments (2008 - US$5,997,588 thousand (97%)).

Derivatives

Derivatives exposures at 31 December 2009 were US$662,301 thousand, a decline of 32 per cent from 31 December 2008, with reductions across all asset classes, notably foreign exchange, interest rate and credit derivatives. Lower volatility within the financial markets, steepening yield curves in major currencies and narrowing credit spreads led to a fall in the fair value of outstanding derivative contracts. Derivatives exposure is shown gross under IFRSs. Derivative liabilities fell for the same reasons.

Loans and advances

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

Loans and advances to customers by industry sector

	At 31 December 2009		At 31 December 2008	
	Gross loans and advances to customer	*Gross loans by industry sector as a % of total gross loans*	*Gross loans and advances to customer*	*Gross loans by industry sector as a % of total gross loans*
	US$000	**%**	US$000	%
Personal				
Residential mortgages	**1,894,395**	**8.95**	1,906,911	7.92
Other personal	**4,167,672**	**19.70**	5,309,090	22.07
	6,062,067	**28.65**	7,216,001	29.99
Corporate and commercial				
Commercial, industrial and international trade	**7,842,194**	**37.05**	9,104,996	37.84
Commercial real estate	**1,240,418**	**5.86**	1,319,830	5.48
Other property-related	**1,289,371**	**6.09**	1,444,306	6.00
Government	**1,311,613**	**6.20**	1,193,957	4.96
Other commercial	**2,443,404**	**11.54**	2,643,709	10.99
	14,127,000	**66.74**	15,706,798	65.27
Financial				
Non-bank financial institutions	**973,423**	**4.60**	1,141,497	4.74
Settlement accounts	**3,053**	**0.01**	94	0.00
	976,476	**4.61**	1,141,591	4.74
Total gross loans and advances to customers	**21,165,543**	**100.00**	24,064,390	100.00
Impaired loans – as a percentage of gross loans and advances to customers	7.32%		1.33%	
Total impairment allowances – as a percentage of total gross loans and advances to customers	5.95%		1.16%	

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

Areas of special interest

Dubai and the UAE

In November 2009, Dubai World, a Dubai government-owned firm, requested a creditor standstill on its debt repayments and those of some of its subsidiaries. The announcement prompted a significant sell-off in markets across the world as exposure to Dubai and to firms where government guarantees of support were assumed but not explicit were appraised. The government of Dubai's repayment in full of the Nakheel-09 bond helped to reverse negative sentiment and build a platform from which an orderly reconstruction of debt could be negotiated. Abu Dhabi also announced that it would offer assistance to Dubai, providing liquidity and a platform for the debt restructuring process to continue.

Notes on the Financial Statements (continued)

The Group, as the longest-established bank in the region, has a longstanding relationship with the government of Dubai and its related entities. The Group has contributed from the earliest days to the development of Dubai as an emerging economy and continues to maintain supportive relationships with all parts of the UAE. The Group and the HSBC Group will continue to offer its support to the government of Dubai in achieving a workable resolution of its current liquidity problems.

The Group's exposure within Dubai is reasonably well spread and is primarily to operating companies within the emirate.

Wholesale lending

Wholesale lending covers the range of credit facilities granted to sovereign borrowers, banks, non-bank financial institutions and corporate entities. The Group's wholesale portfolios are well diversified across geographical and industry sectors, with exposure subject to portfolio controls. Overall credit quality showed some signs of deterioration during 2009, as portfolios were affected by the global economic downturn.

The widespread intervention by many governments to stabilise, and in some cases to re-capitalise, banks and other financial intermediaries had a positive effect in minimising the risk and perception of a systemic threat to financial markets. Nonetheless, credit risk levels remained high, with customers and counterparties facing the challenges of a significant reduction in available credit and liquidity and much reduced demand for their products and services. The Group has sought to identify problem areas early, if possible before they arise, and thereby minimise the likelihood of adverse situations developing and their effect. During 2009, the Group has taken steps to improve the structure of exposures, including tenor and collateral, in response to the heightened risks.

Commercial real estate

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

Sovereign counterparties

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

Personal lending

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

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

Various underwriting controls are applied before a loan is issued, and delinquency is managed through collection and customer management procedures. The expected occurrence and degree of delinquency varies according to the type of loan and the customer segment. Delinquency levels tend to increase in the normal course of portfolio ageing. As a result, loan impairment charges usually relate to lending originated in earlier accounting periods.

The economic downturn in the Middle East Region has been the major factor in the deterioration in credit quality of personal lending portfolios in 2009. Further weakening in consumers' confidence and capacity to service financial commitments may result in deteriorating payment patterns and increased delinquencies and default rates and, as a consequence, higher loan impairment allowances and write-offs. The Group monitors the effect of these factors on its personal lending portfolios and keeps under review a range of measures designed to limit the Group's exposure and mitigate the effect on customers.

Loan impairment allowances are sensitive to changes in the level of unemployment, particularly at the current time, which affects customers' future ability to repay their loans. The relationship between changes in unemployment and loan impairment charges cannot be predicted with any degree of certainty. For example, sharp increases in unemployment may not have a linear impact on the level of increase in loan impairment charges.

Credit quality of financial instruments

The five credit quality classifications set out and defined below describe the credit quality of the Group's lending, debt securities portfolios and derivatives. These classifications 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 to the extent each falls within a single quality classification.

Quality Classification

	Wholesale	Retail lending	Debt securities
Strong	CRR 1 to CRR 2	EL 1 to EL 2	A- and above
Medium - Good	CRR 3	EL 3	BBB+ to BBB-
Medium - Satisfactory	CRR 4 to CRR 5	EL 4 to EL 5	BB+ to B+ and unrated
Sub-Standard	CRR 6 to CRR 8	EL 6 to EL 8	B and below
Impaired	CRR 9 to CRR 10	EL 9 to EL 10	Impaired

Quality classification definitions

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

'Medium-Good': exposures with low default risk. Retail accounts typically show only short periods of delinquency, with any losses expected to be minimal following the adoption of recovery processes.

'Medium-Satisfactory': exposures require closer monitoring, with low to moderate default risk. Retail accounts typically show some period of delinquency with any losses expected to be low to moderate following 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 Expected Loss ('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.

Risk rating scales

Compared with previous years, the basis of reporting has been changed to replace 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.

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

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

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

Notes on the Financial Statements (continued)

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

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

Distribution of financial instruments by credit quality

	31 December 2009							
	Neither past due nor impaired							
	Strong	*Medium - Good*	*Medium - Satisfactory*	*Sub-standard*	*Past due not impaired*	*Impaired*	*Impairment allowance*	*Total*
	US$000	**US$000**	**US$000**	**US$000**	**US$000**	**US$000**	**US$000**	**US$000**
Cash and balances at central banks	**432,386**	**–**	**–**	**–**	**–**	**–**	**–**	**432,386**
Items in the course of collection from other banks	**–**	**–**	**49,259**	**–**	**–**	**–**	**–**	**49,259**
Trading assets	**90,803**	**117,255**	**33,172**	**–**	**–**	**–**	**–**	**243,005**
– debt securities	**83,548**	**117,255**	**33,172**	**1,7575**	**–**	**–**	**–**	**243,005**
– loans and advances to customers	**7,255**	**–**	**–**	**–**	**–**	**–**	**–**	**7,255**
Derivatives	**117,460**	**317,700**	**227,137**	**4**	**–**	**–**	**–**	**662,301**
Loans and advances held at amortised cost	**12,754,592**	**4,280,144**	**6,928,922**	**2,108,913**	**1,644,963**	**1,569,082**	**(1,297,167)**	**27,989,449**
– loans and advances to banks	**6,363,099**	**1,192,355**	**272,814**	**272,782**	**–**	**20,025**	**(15,025)**	**8,106,050**
– loans and advances to customers	**6,391,493**	**3,087,789**	**6,656,108**	**1,836,131**	**1,644,963**	**1,549,057**	**(1,282,142)**	**19,883,399**
Financial investments	**3,088,213**	**1,982**	**4,152,020**	**524,891**	**–**	**–**	**–**	**7,767,106**
– treasury and other similar bills	**165,752**	**–**	**55,134**	**296,139**	**–**	**–**	**–**	**517,025**
– debt securities	**2,922,461**	**1,982**	**4,096,886**	**228,752**	**–**	**–**	**–**	**7,250,081**
– Other assets	**26,357**	**31,406**	**928,870**	**110,412**	**9,824**	**71,177**	**–**	**1,178,046**
– endorsements and acceptances	**26,190**	**31,406**	**604,000**	**110,412**	**8,950**	**70,462**	**–**	**851,420**
– other	**167**	**–**	**324,870**	**–**	**874**	**715**	**–**	**326,626**

Distribution of financial instruments by credit quality

	31 December 2008							
	Neither past due nor impaired							
	Strong	*Medium - Good*	*Medium - Satisfactory*	*Sub-standard*	*Past due not impaired*	*Impaired*	*Impairment allowances*	*Total*
	US$000	US$000	US$000	US$000	US$000	US$000	US$000	US$000
Cash and balances at central banks	960,721	–	–	–	–	–	–	960,721
Items in the course of collection from other banks	229,480	–	–	–	–	–	–	229,480
Trading assets	80,000	12,000	96,000	1,281	–	–	–	189,281
– debt securities	80,000	12,000	96,000	1,281	–	–	–	189,281
Derivatives	343,162	–	632,000	5,000	–	–	–	980,162
Loans and advances held at amortised cost	14,059,591	5,245,463	7,323,419	1,699,660	2,524,563	323,332	(378,743)	30,797,285
– loans and advances to banks	6,321,193	229,520	273,915	287,010	–	–	(25)	7,111,613
– loans and advances to customers	7,738,398	5,015,943	7,049,504	1,412,650	2,524,563	323,332	(378,718)	23,685,672
Financial investments	700,000	–	5,242,000	243,395	–	–	–	6,185,395
– treasury and other similar bills	144,000	–	–	128,510	–	–	–	272,510
– debt securities	556,000	–	5,242,000	114,885	–	–	–	5,912,885
–Other assets	127,000	336,000	654,000	430,000	11,085	–	3,368	1,561,453
– endorsements and acceptances	70,000	336,000	363,000	430,000	11,085	–	–	1,210,085
– other	57,000	–	291,000	–	–	–	3,368	351,368

Notes on the Financial Statements (continued)

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.

	Up to 29 days	*30-59 days*	*60-89 days*	*90-179 days*	*Over 180 days*	*Total*
	US$000	**US$000**	**US$000**	**US$000**	**US$000**	**US$000**
At 31 December 2009	**1,068,958**	**122,296**	**240,786**	**82,152**	**130,771**	**1,644,963**
At 31 December 2008	2,071,375	271,527	53,800	83,907	43,954	2,524,563

Renegotiated loans

Restructuring activity is designed to manage customer relationships, maximise collection opportunities and, if possible, avoid foreclosure or repossession. Such activities include extended payment arrangements, lower interest rates, approved external debt management plans, deferring foreclosure, modification, loan rewrites and/or deferral of payments pending a change in circumstances. Restructuring is most commonly applied to consumer finance portfolios. 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 two 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	
	2009	2008
	US$000	US$000
Loans and advances to customers	**102,925**	15,763

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:

	2009	2008
Nature of assets	**US$000**	US$000
Residential property and motor vehicles	**1,465**	2,135

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

Movement in impairment allowances for banks and customers

	At 31 December 2009			
	Banks		*Customers*	
	Individually assessed	*Individually assessed*	*Collectively assessed*	*Total*
	US$000	**US$000**	**US$000**	**US$000**
At 1 January	**25**	**111,139**	**267,579**	**378,743**
Amounts written off	**–**	**(10,934)**	**(371,401)**	**(382,335)**
Recoveries of loans and advances written off in previous years	**–**	**2,469**	**24,873**	**27,342**
Charge to income statement	**15,000**	**509,052**	**749,855**	**1,273,907**
Exchange and other movements	**–**	**(559)**	**69**	**(490)**
At 31 December	**15,025**	**611,167**	**670,975**	**1,297,167**

	At 31 December 2008			
	Banks		*Customers*	
	Individually assessed	*Individually assessed*	*Collectively assessed*	*Total*
	US$000	US$000	US$000	US$000
At 1 January	25	110,638	114,501	225,164
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	25	111,139	267,579	378,743

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

	At 31 December	
	2009	2008
	%	%
Individually assessed impairment allowances	**2.14**	0.36
Collectively assessed impairment allowances	**2.29**	0.86
	4.43	1.22

1 Net of settlement accounts

Liquidity and funding management

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

The objective of the Group's liquidity and funding management framework is to ensure that all foreseeable funding commitments can be met when due, and that access to the wholesale markets is co-ordinated and cost-effective. To this end, Group maintains a diversified 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 Group to respond quickly and smoothly to unforeseen liquidity requirements.

Notes on the Financial Statements (continued)

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 anticipated obligations can be met when due.

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

Policies and procedures

The management of liquidity and funding is primarily undertaken locally in the Group's operating entities in compliance with practices and limits set by the 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 the HSBC Group'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 and advances to deposits ratios against internal and regulatory requirements;
– maintaining a diverse range of funding sources with back-up facilities;
– managing the concentration and profile of debt maturities;
– managing contingent liquidity commitment exposures within pre-determined caps;
– maintaining debt financing plans;
– monitoring depositor concentration in order to avoid undue reliance on large individual depositors and ensure a satisfactory overall funding mix; and
– maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises, while minimising adverse long-term implications for the business.

Primary sources of funding

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

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

Of total liabilities of US$35,710,821 thousand at 31 December 2009, funding from customers amounted to US$26,524,487 thousand, of which US$25,162,304 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 25.

Assets available to meet these liabilities, and to cover outstanding commitments to lend (US$16,852,098 thousand), included cash, central bank balances, items in the course of collection and treasury and other bills (US$998,670 thousand); loans to banks (US$8,106,050 thousand, including US$7,898,298 thousand repayable within one year); and loans to customers (US$19,883,399 thousand, including US$14,254,848 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 the Group 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.

	The Bank	
	2009	2008
	%	%
Year-end	**110.4**	131.2
Maximum	**132.6**	143.2
Minimum	**110.4**	128.9
Average	**121.0**	135.3

Advances to deposits ratio limits are set by the 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 Group banking entity.

Ratio of net liquid assets to customer liabilities

	The Bank	
	2009	2008
	%	%
Year-end	**35.2**	22.6
Maximum	**35.2**	27.9
Minimum	**24.4**	12.7
Average	**28.6**	20.7

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.

Notes on the Financial Statements (continued)

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 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 one of the world's largest banking and financial services organisations.

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 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 board. Limits are set for portfolios, products and risk types, with market liquidity being a principal factor in determining the level of limits set. Group Risk, an independent unit within Group Management Office, develops the Group'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 Group Risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis.

Each operating entity is required to assess the market risks 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 Risk Management Committee. 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 based predominantly on historical simulation. These models derive plausible future scenarios from past series of recorded market rates and prices, taking account of inter-relationships between different markets and rates such as interest rates and foreign exchange rates. The models also incorporate the effect of option features on 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; and
- VAR is calculated to a 99 per cent confidence level; and

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 risk 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 moves.

Stress testing

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

The process is governed by the 'Stress Testing Review Group' forum. This coordinates the Group's stress testing scenarios in conjunction with regional risk managers, considering actual market risk exposures and market events in determining the scenarios to be applied at portfolio and consolidated level, as follows:

- sensitivity scenarios, which consider the impact of any single risk factor or set of factors that are unlikely to be captured within the VAR models, such as the break of a currency peg;
- 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 including the 'Global Pandemic' scenario; and
- historical scenarios, which incorporate historical observations of market moves during previous periods of stress which would not be captured within VAR.

Stress testing results provide senior management with an assessment of the financial impact such events would have on the Group's profit. The daily losses experienced during 2009 were within the stress loss scenarios reported to senior management.

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

	Portfolio	
	Trading	*Non-trading*
Risk type		
Foreign exchange	VAR	VAR
Interest rate	VAR	VAR

Notes on the Financial Statements (continued)

Value at risk of the trading and non-trading portfolios

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

Total	US$000
At 31 December 2009	**4,223**
At 31 December 2008	4,707

	Average US$000	*Minimum* US$000	*Maximum* US$000
2009	**4,489**	**3,273**	**5,999**
2008	4,699	2,776	7,349

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 Markets. The VAR for such trading activity at 31 December 2009 was US$1,576 thousand (2008: US$924 thousand). This is analysed below by risk type:

Total trading VAR by risk type

	Foreign Exchange US$000	*Interest rate trading* US$000	*Total* US$000
At 31 December 2009	**4,225**	**4,349**	**1,576**
At 31 December 2008	885	552	924
Average			
2009	**2,259**	**2,031**	**1,695**
2008	1,183	437	1,344
Minimum			
2009	**444**	**476**	**924**
2008	497	91	529
Maximum			
2009	**6,222**	**4,713**	**3,480**
2008	2,214	1,285	2,481

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

Gap risk

For certain transactions that are structured so that the risk to the Group is negligible under a wide range of market conditions or events, there exists a remote possibility that a significant gap event could lead to loss. A gap event could arise from a change in market price from one level to another with no accompanying trading opportunity, 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. Such movements may occur, for example, when adverse news announcements turn the

market for a specific investment illiquid, making hedging impossible.

Given the characteristics of these transactions, they will make little or no contribution to VAR or to traditional market risk sensitivity measures. The Group captures the risks of such transactions within its stress testing scenarios and monitors gap risk arising on an ongoing basis. The Group realised no gap losses arising from movements in the underlying market price on such transactions in 2009. The Group regularly considers the probability of gap loss and fair value adjustments are booked against this risk.

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 Markets or to separate ALCO books managed under the supervision of the RMM.

The transfer of market risk to books managed by Global Markets or supervised by RMM 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 RMM's are required to regularly monitor all such behavioural assumptions and interest rate risk positions to ensure they comply with interest rate risk limits established by the 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, and where expectations about future moves in interest rates change. In such circumstances, simulation modelling is used to identify the impact of varying scenarios on valuations and net interest income.

Once market risk has been consolidated in Global Markets or RMM-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 effect of prospective interest rate movements which could reduce future net interest income, while balancing the cost of hedging such activities on the current net revenue stream.

For simulation modelling, businesses use a combination of 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 associates, the functional currencies of which are currencies other than the US dollar. Exchange differences on structural exposures are recorded in the consolidated statement of comprehensive income. 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 practicable, that the Group's capital ratio is protected from the effect of changes in exchange rates. This is usually achieved by holding qualifying capital broadly in proportion to the corresponding foreign-currency-denominated risk-weighted assets. The Group considers hedging structural foreign currency exposures only in limited circumstances, to protect the capital ratio or the US dollar value of capital invested. Such hedging would be undertaken using forward

Notes on the Financial Statements (continued)

foreign exchange contracts or by financing with borrowings in the same currencies as the functional currencies involved.

Defined benefit pension schemes

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

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.

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

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

Legal risk

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

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

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

Operating companies must notify the legal department immediately if any litigation is either threatened or commenced against the Group or an employee. The legal department must be immediately advised (and must in turn immediately advise the HSBC Group Head Office legal department) of any action by a regulatory authority, where the proceedings are criminal, or where the claim might materially affect the HSBC Group's reputation. Further, any claims which exceed US$1.5 million or equivalent must also be advised to the legal department and the legal department must immediately advise the HSBC Group Head Office if any such claim exceeds US$5 million. All such matters are then reported to the HSBC Group Risk Management Meeting of the HSBC Group Board in a monthly paper.

An exception report must be made to the local compliance function and escalated to the Head of Group Compliance in

respect of any breach which has given rise to a fine and/or costs levied by a court of law or regulatory body where the amount is US$1,500 or more, and material or significant issues are reported to RMM and/or the Group Audit Committee.

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

Capital management

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

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

The Bank's capital is divided into two tiers:

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

Various limits are applied to elements of the capital base. Qualifying tier 2 capital cannot exceed tier 1 capital, and qualifying term non-equity preference share capital may not exceed 50 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 2009 and 2008 the Bank continued to operate under both Basel I and Basel II standardised frameworks for the calculation and monitoring of capital adequacy ratios. The Bank complied with the JFSC capital adequacy requirements during that period.

Notes on the Financial Statements (continued)

Capital structure at 31 December (solo basis)

	2009	2008
	Basel II	*Basel II*
	Actual	*Actual*
Composition of regulatory capital	**US$000**	US$000
Tier 1 capital	**3,013,441**	2,871,433
Tier 2 capital	**1,569,252**	1,386,715
Total regulatory capital	**4,582,693**	4,258,148
Risk weighted assets		
Credit and counterparty risk	**27,893,669**	31,513,879
Market risk	**1,637,232**	501,913
Operational risk	**3,720,795**	3,041,250
	33,251,696	35,057,042
	%	%
Capital ratios		
Risk asset ratio	**13.78%**	12.15%

31 Contingent liabilities and contractual commitments

Contingent liabilities and commitments

	2009	2008
	US$000	US$000
Contract amounts		
Contingent liabilities:	**10,548,006**	12,013,139
Guarantees and assets pledged as collateral security:		
- guarantees and irrevocable letters of credit	**10,548,006**	12,013,139
Commitments:		
Documentary credits and short-term trade-related transactions	**954,477**	1,028,662
Undrawn formal standby facilities, credit lines and other commitments to lend:		
- one year and under	**15,270,007**	21,080,289
- over one year	**627,614**	387,401
	16,852,098	22,496,352

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:

	2009	2008
	US$000	US$000
Guarantees and assets pledged by the bank as collateral security	**876,808**	815,196
Documentary credits and short-term trade-related transactions	**150,307**	142,977
	1,027,115	958,173

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 2009 were as follows:

	At 31 December 2009		At 31 December 2008	
	Guarantees in favour of third parties	*Guarantees by the Group in favour of other HSBC Group entities*	*Guarantees in favour of third parties*	*Guarantees by the Group in favour of other HSBC Group entities*
	US$000	**US$000**	US$000	US$000
Guarantee type				
Financial guarantees [1]	**853,594**	**135,502**	803,214	144,396
Standby letters of credit which are financial guarantees [2]	**918,712**	–	1,708,691	–
Other direct credit substitutes [3]	**651,357**	–	790,086	–
Performance bonds [4]	**4,626,051**	**491,213**	4,710,656	389,380
Bid bonds [4]	**427,016**	**55,039**	330,176	55,472
Other transaction-related guarantees [4]	**2,194,468**	**195,054**	2,855,120	225,948
Total	**9,671,198**	**876,808**	11,197,943	815,196

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 94 % of the above guarantees have a term of less than one year (2008: Approximately 91%). 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

	2009	2008
	US$000	US$000
Other items	**3,725**	3,645
	3,725	3,645

The Group had commitments to purchase from a number of suppliers within one year, land and buildings and other fixed assets for a value of US$8 thousand at 31 December 2009 (2008: US$548 thousand).

Notes on the Financial Statements (continued)

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.

32 Lease commitments

Operating lease commitments

At 31 December 2009, 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.

	2009	2008
Future minimum lease payments under non-cancellable operating leases were:	**US$000**	US$000
Land and buildings expiring:		
- no later than one year	**14,072**	18,780
- later than one year and no later than five years	**46,408**	49,650
- later than five years	**24,141**	35,228
	84,621	103,658

In 2009, US$14,501 thousand (2008: US$12,128 thousand) was charged to 'General and administrative expenses' in respect of lease agreements related to minimum lease payments.

Finance lease receivables

	2009			2008		
	Total future minimum payments	*Unearned finance income*	*Present value*	*Total future minimum payments*	*Unearned finance income*	*Present value*
	US$000	**US$000**	**US$000**	US$000	US$000	US$000
No later than one year	**46,189**	**–**	**46,189**	56,509	–	56,509
Later than one year and no later than five years	**345,702**	**–**	**345,702**	467,763	–	467,763
Later than five years	**–**	**–**	**–**	846	–	846
	391,891	**–**	**391,891**	525,118	–	525,118

33 Litigation

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

34 Related party transactions

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

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.

		2009			2008	
	Number of persons	*Highest balance during the year 1* **US$000**	*Balance at year end 1* **US$000**	*Number of persons*	*Highest balance during the year 1* US$000	*Balance at year end 1* US$000
Key Management Personnel and connected persons and companies controlled by them						
Loans	**3**	**1,471**	**410**	4	1,764	1,510
Credit cards	**4**	**45**	**9**	3	33	22
Credit cards	**7**	**1,516**	**419**	7	1,797	1,532

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

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.

	2009 **US$000**	2008 US$000
Short-term employee benefits	**195**	128

Transactions with other related parties

	2009		2008	
	Highest balance during the year 1	*Balance at the year end 1*	*Highest balance during the year 1*	*Balance at the year end 1*
Amounts due from associates	**US$000**	**US$000**	US$000	US$000
- Subordinated	**15,415**	**15,415**	15,415	15,415
- Unsubordinated	**737**	**294**	491	395
	16,152	**15,709**	15,906	15,810
Amounts due to associates	**23,649**	**22,081**	9,694	7,860

Notes on the Financial Statements (continued)

	2009		2008	
Subsidiaries	*Highest balance during the year 1* **US$000**	*Balance at the year end 1* **US$000**	*Highest balance during the year 1* US$000	*Balance at the year end 1* US$000
Assets:				
Cash and balances at central banks	**5**	**5**	7	7
Trading assets	**292,775**	**277,681**	745,366	249,254
Derivatives	**3,808**	**373**	4,472	4,472
Loans and advances to banks	**10,921**	**10,921**	3,014	16
Loans and advances to customers	**659,287**	**483,780**	740,410	701,401
Financial investments	**74,365**	**67,828**	59,577	59,577
Intangible assets	**-**	**-**	171	-
Property, plant and equipment	**570**	**533**	331	257
Other assets	**138,599**	**88,390**	215,271	177,660
Prepayments and accrued income	**7,648**	**6,318**	12,227	11,728
Liabilities:				
Deposits by banks	**5,391**	**5,391**	4,030	4,029
Items in the course of transmission to other banks	**1,151**	**960**	2,454	2,314
Other liabilities	**800,051**	**624,071**	1,415,698	846,775
Accruals and deferred income	**1,806**	**1,549**	7,589	3,347
Derivatives	**3,808**	**373**	4,472	4,472

	For the year ended 31 December **2009** **US$000**	*For the year ended 31 December* 2008 US$000
Income Statement:		
Interest income	**53,558**	66,529
Interest expense	**(29,894)**	(39,150)
Trading income	**25,773**	12,509
Gains less losses from financial investments	**1,701**	101
Dividend income	**2,341**	1,195
Fee income Fee	**10,587**	13,792
Expense	**(1,912)**	(2,123)
Other operating income	**3,430**	2,847
Loan impairment charges and other credit risk provisions	**(22,364)**	(3,669)
General and administrative expenses	**(29,094)**	(10,756)

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

35 Ultimate holding company

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

The largest and smallest group in which the financial statements of the Group are consolidated is that headed by HSBC Holdings plc. Copies of the HSBC Holdings plc Annual Review 2009 and/or Annual Report and Accounts 2009 may be obtained by writing to Group Communications, HSBC Holdings plc, 8 Canada Square, London E14 5HQ, United Kingdom; or from the HSBC web site, www.hsbc.com.

36 Events after the balance sheet date

On 15 February 2010, the Board of Directors authorised the financial statements for issue.

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Published by HSBC Bank Middle East Limited, Dubai.

Cover designed by Black Sun Plc, London; text pages designed by Group Communications (Asia), The Hongkong and Shanghai Banking Corporation Limited, Hong Kong.

Printed by Masar Printing & Publishing, Dubai, United Arab Emirates, on Magno Satin paper using vegetable oil-based inks. Made in Finland, the paper comprises 74% virgin fibre and 26% post-consumer waste. Pulps used are totally chlorine-free.

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