

HSBC Bank Middle East Limited – UAE Operations

Financial Statements

For the year ended 31 December 2016

Annual Report and Accounts 2016

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Presentation of Information

This document comprises the *financial statements* for HSBC Bank Middle East Limited – UAE Operations ('the Bank'). References to 'HSBC' or 'HSBC Group' within this document mean HSBC Holdings plc together with its subsidiaries.



Independent auditor's report to the directors of HSBC Bank Middle East Limited in respect of its UAE Operations

Report on the audit of the financial statements

Our opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of HSBC Bank Middle East Limited-UAE Operations (the "Branch") as at 31 December 2016, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards ('IFRS').

What we have audited

The Branch's financial statements comprise:

- the income statement for the year ended 31 December 2016;
- the statement of comprehensive income for the year then ended;
- the statement of financial position as at 31 December 2016;
- the statement of cash flows for the year then ended;
- the statement of changes in equity for the year then ended; and
- the notes to the financial statements, which include a summary of significant accounting policies.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's responsibilities for the audit of the financial statements section of our report*.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We are independent of the Branch in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) and the ethical requirements that are relevant to our audit of financial statements in the United Arab Emirates. We have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code.

*PricewaterhouseCoopers (Dubai Branch), License no. 102451
Emaar Square, Building 4, Level 8, P O Box 11987, Dubai - United Arab Emirates
T: +971 (0)4 304 3100, F: +971 (0)4 346 9150, www.pwc.com/me*

Douglas O'Mahony, Paul Suddaby, Jacques Fakhoury and Mohamed ElBorno are registered as practising auditors with the UAE Ministry of Economy



Independent auditor's report to the directors of HSBC Bank Middle East Limited in respect of its UAE Operations (continued)

Responsibilities of management and those charged with governance for the financial statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Branch's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Branch or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Branch's financial reporting process.

Auditor's responsibilities for the audit of the financial statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.



Independent auditor's report to the directors of HSBC Bank Middle East Limited in respect of its UAE Operations (continued)

Auditor's responsibilities for the audit of the financial statements (continued)

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Branch's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Branch's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Branch to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

Report on other regulatory requirements

Further, as required by the UAE Union Law No (10) of 1980, as amended, we report that we have obtained all the information and explanations we considered necessary for the purpose of our audit.

PricewaterhouseCoopers

A handwritten signature in blue ink, appearing to read 'Douglas O' Mahony'.

Douglas O' Mahony
Registered Auditor number 834
Dubai, United Arab Emirates
9 March 2017

Financial Statements

Income statement for the year ended 31 December 2016

	Notes	2016 AED000	2015 AED000
Interest income	5	3,005,628	2,984,465
Interest expense	5	(487,695)	(484,576)
Net interest income		2,517,933	2,499,889
Fee income	6	1,447,868	1,513,805
Fee expense	6	(185,826)	(180,339)
Net fee income		1,262,042	1,333,466
Trading income excluding net interest income		759,851	806,805
Net interest expense on trading activities		(70,627)	(68,360)
Net trading income		689,224	738,445
Net (expense)/income from financial instruments designated at fair value ...	4	(767)	26,648
Gains less losses from financial investments		5,497	7,809
Other operating income	7	284,336	404,749
Net operating income before loan impairment charges and other credit risk provisions		4,758,265	5,011,006
Loan impairment charges and other credit risk provisions	8	(435,405)	(1,027,604)
Net operating income		4,322,860	3,983,402
Employee compensation and benefits	9	(1,522,475)	(1,703,960)
General and administrative expenses		(845,616)	(910,242)
Depreciation and impairment of property, plant and equipment	20	(29,472)	(29,930)
Amortisation and impairment of intangible assets	19	(20,049)	(19,695)
Total operating expenses		(2,417,612)	(2,663,827)
Profit before tax		1,905,248	1,319,575
Tax expense	11	(343,384)	(274,875)
Profit for the year		1,561,864	1,044,700

The accompanying notes on pages 11 to 68 form an integral part of these financial statements.

Financial Statements (continued)**Statement of comprehensive income for the year ended 31 December 2016**

	2016 AED000	2015 AED000
Profit for the year.....	1,561,864	1,044,700

Other comprehensive income/(expense)**Items that will be reclassified subsequently to profit or loss when specific conditions are met:**

Available-for-sale investments.....	(4,799)	(10,591)
– fair value losses	(6,121)	(13,162)
– others	789	1,394
– income taxes	533	1,177

Cash flow hedges.....	18,464	(8,419)
– fair value gains/(losses).....	20,515	(9,355)
– income taxes	(2,051)	936

Items that will not be reclassified subsequently to profit or loss:

Re-measurement of defined benefit asset/liability.....	(315)	(28,490)
– before income taxes (note 9).....	(315)	(28,490)

Total comprehensive income for the year.....	1,575,214	997,200
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The accompanying notes on pages 11 to 68 form an integral part of these financial statements.

Financial Statements (continued)

Statement of financial position at 31 December 2016

	Notes	2016 AED000	2015 AED000
Assets			
Cash and balances at central bank	13	8,109,427	8,891,364
Trading assets	16	624,212	429,871
Derivatives	17	4,558,739	3,329,812
Loans and advances to banks	14	15,472,758	13,553,668
Loans and advances to customers	15	62,933,189	67,861,215
Reverse repurchase agreements – non-trading		3,859,692	2,963,845
Financial investments	18	16,110,930	17,649,352
Interest in associate	38	-	277,071
Other assets	21	1,389,784	1,946,474
Intangible assets	19	45,842	55,798
Property, plant and equipment	20	147,613	132,760
Deferred tax assets	22	720,839	782,217
Total assets		113,973,025	117,873,447
Liabilities and equity			
Liabilities			
Deposits by banks		14,591,570	12,619,282
Customer accounts	23	60,867,651	67,167,079
Trading liabilities	24	5,496,794	5,010,003
Financial liabilities designated at fair value	25	1,475,028	3,115,575
Derivatives	17	4,896,867	3,607,128
Debt securities in issue	26	5,139,667	5,643,810
Subordinated liabilities	33	2,757,742	2,757,354
Other liabilities	27	3,878,369	4,949,499
Current tax liabilities		371,542	391,157
Accruals and deferred income		440,701	237,993
Provisions for liabilities & charges	28	573,915	501,151
Total liabilities		100,489,846	106,000,031
Head Office funds			
Allocated capital		4,495,255	4,495,255
Legal reserves		1,908,118	1,751,932
Other reserves		(218,407)	(245,806)
Retained earnings		7,298,213	5,872,035
Total Head Office funds		13,483,179	11,873,416
Total Head Office funds and liabilities		113,973,025	117,873,447

The accompanying notes on pages 11 to 68 form an integral part of these financial statements.

Abdulattah Sharaf

Chief Executive Officer - UAE

09 MAR 2017

Financial Statements (continued)

Statement of cash flows for the year ended 31 December 2016

	Note	2016 AED000	2015 AED000
Cash flows from operating activities			
Profit before tax		1,905,248	1,319,575
Adjustments for:			
– Provision for liabilities and charges.....		130,909	133,295
– Allowance for impairment losses.....		435,405	1,027,604
– Depreciation and amortisation		49,521	49,626
– Share based payment expense including options.....		40,401	62,845
– Fair value movement on own debt.....		767	(26,648)
– (Gain) on investment in shares.....		(5,497)	(7,809)
– (Gain) on derecognition of associate		(6,620)	-
– Loss/(gain) on disposal of property and equipment		375	(166)
Net cash generated before changes in operating assets / liabilities		2,550,509	2,558,322
– Change in loans and advances to banks and reverse repurchase agreements – non-trading		(848,662)	(4,751,690)
– Change in loans and advances to customers		4,492,620	(2,447,865)
– Change in other assets		(653,609)	556,783
– Change in deposits by banks		1,972,288	3,159,413
– Change in customer accounts.....		(6,299,428)	(5,575,731)
– Change in other liabilities		434,599	80,409
– Retirement benefits and other charges paid.....		(76,077)	(56,211)
– Tax paid.....		(303,139)	(425,344)
Net cash generated from/(absorbed in) operating activities		1,269,101	(6,901,914)
Cash flows from investing activities			
– Sale of financial assets and liabilities classified as fair value through profit and loss (net)		(1,348,864)	(136,935)
– Outflow from increase in investment in associate		283,691	(277,071)
– Sale of available-for-sale investments (net)		(3,717,882)	1,498,709
– Purchase of property and equipment and intangible assets (net)		(54,957)	(68,633)
Net cash (absorbed in)/generated from investing activities		(4,838,012)	1,016,070
Cash flows from financing activities			
– Debt securities (repaid) (net).....		(503,754)	(763,436)
– Dividend paid to Head Office		-	(1,089,500)
Net cash used in financing activities		(503,754)	(1,852,936)
Net (decrease) in cash and cash equivalents		(4,072,665)	(7,738,780)
Cash and cash equivalents as at 1 January		30,195,727	37,934,507
Cash and cash equivalents as at 31 December	34	26,123,062	30,195,727

The accompanying notes on pages 11 to 68 form an integral part of these financial statements.

Financial Statements (continued)

Statement of changes in equity for the year ended 31 December 2016

	2016							
	Other reserves							
	Allocated capital AED000	Legal Reserve AED000	Available- for-sale fair value reserve AED000	Cash flow hedging reserve AED000	Actuarial gains/(losses) reserve AED000	Other reserve AED000	Unremitted profits AED000	Total Head Office funds AED000
At 1 January 2016	4,495,255	1,751,932	(8,042)	(30,793)	(233,312)	26,342	5,872,034	11,873,416
Profit for the year	-	-	-	-	-	-	1,561,864	1,561,864
Other comprehensive income (net of tax)								
Available-for-sale investments	-	-	(4,799)	-	-	-	-	(4,799)
Cash flow hedges	-	-	-	18,464	-	-	-	18,464
Actuarial losses on defined benefit plans	-	-	-	-	(315)	-	-	(315)
Total comprehensive income for the year	-	-	(4,799)	18,464	(315)	-	-	13,350
Transfer of profits to Head Office	-	-	-	-	-	-	-	-
Other movements	-	156,186	-	-	-	14,048	(135,685)	34,549
At 31 December 2016	4,495,255	1,908,118	(12,841)	(12,329)	(233,627)	40,390	7,298,213	13,483,179

The accompanying notes on pages 11 to 68 form an integral part of these financial statements.

Financial Statements (continued)

Statement of changes in equity for the year ended 31 December 2015

	2015							
	Other reserves							
	Allocated capital AED000	Legal Reserve AED000	Available-for-sale fair value reserve AED000	Cash flow hedging reserve AED000	Actuarial gains/(losses) reserve AED000	Other reserve AED000	Unremitted profits AED000	Total Head Office funds AED000
At 1 January 2015	4,495,255	1,647,462	2,549	(22,374)	(204,822)	(48,535)	6,087,115	11,956,650
Profit for the year	-	-	-	-	-	-	1,044,700	1,044,700
Other comprehensive income (net of tax)								
Available-for-sale investments	-	-	(10,591)	-	-	-	-	(10,591)
Cash flow hedges	-	-	-	(8,419)	-	-	-	(8,419)
Actuarial losses on defined benefit plans	-	-	-	-	(28,490)	-	-	(28,490)
Total comprehensive income for the year	-	-	(10,591)	(8,419)	(28,490)	-	-	(47,500)
Transfer of profits to Head Office	-	-	-	-	-	-	(1,089,500)	(1,089,500)
Other movements	-	104,470	-	-	-	74,877	(170,281)	9,066
At 31 December 2015	4,495,255	1,751,932	(8,042)	(30,793)	(233,312)	26,342	5,872,034	11,873,416

The accompanying notes on pages 11 to 68 form an integral part of these financial statements.

Notes on the Financial Statements

1 Legal status and principal activities

HSBC Bank Middle East Limited – United Arab Emirates ('UAE') Operations ('the Bank') is a branch of HSBC Bank Middle East Limited ('HBME'). Effective 30 June 2016, HBME transferred its place of incorporation and head office from Jersey, Channel Islands, where it was regulated by Jersey Financial Services Commission to Dubai International Financial Centre, in the United Arab Emirates, under a category 1 license issued by the Dubai Financial Services Authority ('DFSA').

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

The bank is regulated by the Central Bank of the UAE.

The principal activity of the Bank is to offer a comprehensive range of financial services to personal, commercial, corporate and institutional clients, which are carried out from the branches as follows:

Abu Dhabi	Bur Dubai	Deira
Jumeirah	Jebel Ali	Sharjah
Ras Al Khaimah	Fujairah	

2 Basis of preparation

(a) Compliance with International Financial Reporting Standards

The financial statements of the Bank have been prepared in accordance with International Financial Reporting Standards ('IFRSs') as issued by the International Accounting Standards Board ('IASB') as well as interpretations issued by the IFRS Interpretations Committee ('IFRS IC').

Standards adopted during the year ended 31 December 2016

There were no new standards applied during the year ended 31 December 2016. During 2016, the Bank adopted a number of interpretations and amendments to standards which had an insignificant effect on the financial statements of the Bank.

(b) Presentation of information

Capital disclosures under IAS 1 'Presentation of Financial Statements' have been included in Note 35.

(c) The functional currency of the Bank is United Arab Emirates Dirham ('AED'), which is also the presentation currency of the financial statements of the Bank. The AED is also the Bank's functional currency because the AED is the most significant currency relevant to the underlying transactions, and represents a significant proportion of its funds generated from operating activities.

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 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 either in other comprehensive income or in the income statement depending where the gain or loss on the underlying non-monetary item is recognised.

(d) Critical accounting estimates and judgements

The preparation of financial information requires the use of estimates and judgements about future conditions. In view of the inherent uncertainties and the high level of subjectivity involved in the recognition or measurement of items highlighted as the critical accounting estimates and judgements in section 3 below, it is possible that the outcomes in the next financial year could differ from those on which management's estimates are based, resulting in materially different conclusions from those reached by management for the purposes of the 2016 Financial Statements. Management's selection of the Bank's accounting policies which contain critical estimates and judgements reflects the materiality of the items to which the policies are applied and the high degree of judgement and estimation uncertainty involved.

Notes to the Financial Statements (continued)

(e) Future accounting developments

Minor amendments to IFRSs

The IASB has published a number of minor amendments to IFRSs through the Annual Improvements to IFRSs 2012-2014 cycle and in a series of stand-alone amendments. The Bank has not early applied any of the amendments effective after 31 December 2016 and it expects they will have an insignificant effect, when applied, on the financial statements of the Bank.

Major new IFRSs

The IASB has published IFRS 9 ‘Financial Instruments’, IFRS 15 ‘Revenue from Contracts with Customers’ and IFRS 16 ‘Leases’.

IFRS 9 ‘Financial Instruments’

In July 2015, the IASB issued IFRS 9 ‘Financial Instruments’, which is the comprehensive standard to replace IAS 39 ‘Financial Instruments: Recognition and Measurement’, and includes requirements for classification and measurement of financial assets and liabilities, impairment of financial assets and hedge accounting.

Classification and measurement

The classification and measurement of financial assets will depend on how these are managed (the entity’s business model) and their contractual cash flow characteristics. These factors determine whether the financial assets are measured at amortised cost, fair value through other comprehensive income (‘FVOCI’) or fair value through profit or loss (‘FVPL’). The combined effect of the application of the business model and the contractual cash flow characteristics tests may result in some differences in the population of financial assets measured at amortised cost or fair value compared with IAS 39. However, based on an assessment of financial assets performed to date and expectations around changes to balance sheet composition, the Bank expects that the overall impact of any change will not be significant.

For financial liabilities designated to be measured at fair value, gains or losses relating to changes in the entity’s own credit risk are to be included in other comprehensive income.

Impairment

The impairment requirements apply to financial assets measured at amortised cost and FVOCI, and lease receivables and certain loan commitments and financial guarantee contracts. At initial recognition, an impairment allowance (or provision in the case of commitments and guarantees) is required for expected credit losses (‘ECL’) resulting from default events that are possible within the next 12 months (‘12-month ECL’). In the event of a significant increase in credit risk, an allowance (or provision) is required for ECL resulting from all possible default events over the expected life of the financial instrument (‘lifetime ECL’). Financial assets where 12-month ECL is recognised are considered to be ‘stage 1’; financial assets which are considered to have experienced a significant increase in credit risk are in ‘stage 2’; and financial assets for which there is objective evidence of impairment so are considered to be in default or otherwise credit impaired are in ‘stage 3’.

The assessment of credit risk and the estimation of ECL are required to be unbiased and probability-weighted, and should incorporate all available information which is relevant to the assessment including information about past events, current conditions and reasonable and supportable forecasts of economic conditions at the reporting date. In addition, the estimation of ECL should take into account the time value of money. As a result, the recognition and measurement of impairment is intended to be more forward-looking than under IAS 39 and the resulting impairment charge will tend to be more volatile. It will also tend to result in an increase in the total level of impairment allowances, since all financial assets will be assessed for at least 12-month ECL and the population of financial assets to which lifetime ECL applies is likely to be larger than the population for which there is objective evidence of impairment in accordance with IAS 39.

Hedge accounting

The general hedge accounting requirements aim to simplify hedge accounting, creating a stronger link with risk management strategy and permitting hedge accounting to be applied to a greater variety of hedging instruments and risks, but do not explicitly address macro hedge accounting strategies, which are particularly important for banks. As a result, IFRS 9 includes an accounting policy choice to remain with IAS 39 hedge accounting.

Notes to the Financial Statements (continued)

Based on the analysis performed to date, the Bank expects to exercise the accounting policy choice to continue IAS 39 hedge accounting and therefore is not currently planning to change hedge accounting, although it will implement the revised hedge accounting disclosures required by the related amendments to IFRS 7 ‘Financial Instruments: Disclosures’.

Transition

The classification and measurement and impairment requirements are applied retrospectively by adjusting the opening balance sheet at the date of initial application, with no requirement to restate comparative periods.

The mandatory application date for the standard as a whole is 1 January 2018, but it is possible to apply the revised presentation for certain liabilities measured at fair value from an earlier date. The Bank intends to revise the presentation of fair value gains and losses relating to the entity’s own credit risk on certain liabilities as soon as permitted. If this presentation was applied at 31 December 2016, the effect would be to increase or decrease profit before tax with the opposite effect on other comprehensive income based on the change in fair value attributable to changes in the Bank’s credit risk for the year, with no effect on net assets. Further information on change in fair value attributable to changes in credit risk, including the Bank’s credit risk, is disclosed in Note 29.

The Bank intends to quantify the potential impact of IFRS 9 once it is practicable to provide reliable estimates, which will be no later than in the Financial Statements for the year ended 31 December 2017.

IFRS 15 ‘Revenue from Contracts with Customers’

In May 2014, the IASB issued IFRS 15 ‘Revenue from Contracts with Customers’. The original effective date of IFRS 15 has been delayed by one year and the standard is now effective for annual periods beginning on or after 1 January 2018 with early application permitted. IFRS 15 provides a principles-based approach for revenue recognition, and introduces the concept of recognising revenue for obligations as they are satisfied. The standard should be applied retrospectively, with certain practical expedients available. The Bank has assessed the impact of IFRS 15 and it is expected that the standard will have no significant effect, when applied, on the financial statements of the Bank.

IFRS 16 ‘Leases’

In January 2016, the IASB issued IFRS 16 ‘Leases’ with an effective date of annual periods beginning on or after 1 January 2019. IFRS 16 results in lessees accounting for most leases within the scope of the standard in a manner similar to the way in which finance leases are currently accounted for under IAS 17 ‘Leases’. Lessees will recognise a ‘right of use’ asset and a corresponding financial liability on the balance sheet. The asset will be amortised over the length of the lease and the financial liability measured at amortised cost. Lessor accounting remains substantially the same as in IAS 17. The group is currently assessing the impact of IFRS 16 and it is not practicable to quantify the effect as at the date of the publication of these financial statements. Existing operating lease commitments are set out in Note 37.

3 Summary of significant accounting policies

(a) Interest income and expense

Interest income and expense for all financial instruments except for those classified as held-for-trading or designated at fair value (other than debt securities issued by the Bank 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 Bank 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 Bank 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.

Notes to the Financial Statements (continued)

(b) Non-interest income and expense

Fee income is earned from a diverse range of services provided by the Bank 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 an arrangement for the acquisition of shares or other securities);
- income earned from the provision of services is recognised as revenue as the services are provided (for example, asset management, portfolio and other management advisory and service fees); and
- income which forms an integral part of the effective interest rate of a financial instrument is recognised as an adjustment to the effective interest rate (for example, certain loan commitment fees) and recorded in 'Interest income' (Note 5).

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

(c) Valuation of financial instruments

All financial instruments are initially recognised at fair value. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value of a financial instrument on initial recognition is generally its transaction price (that is, the fair value of the consideration given or received). However, if there is a difference between the transaction price and the fair value of financial instruments whose fair value is based on a quoted price in an active market or a valuation technique that uses only data from observable markets, the Bank recognises the difference as a trading gain or loss at inception ('day 1 gain or loss'). In all other cases, the entire day 1 gain or loss is deferred and recognised in the income statement over the life of the transaction until the transaction matures or is closed out, the valuation inputs become observable or the Bank enters into an offsetting transaction.

The fair value of financial instruments is generally measured on an individual basis. However, in cases where the Bank manages a group of financial assets and liabilities according to its net market or credit risk exposure, the fair value of the Bank of financial instruments is measured on a net basis but the underlying financial assets and liabilities are presented separately in the financial statements, unless they satisfy the IFRSs offsetting criteria.

Critical accounting estimates and judgements

The majority of valuation techniques employ only observable market data. However, certain financial instruments are valued on the basis of valuation techniques that feature one or more significant market inputs that are unobservable, where the measurement of fair value is more judgemental. An instrument in its entirety is classified as valued using significant unobservable inputs if, in the opinion of management, a significant proportion of the instrument's inception profit or greater than 5% of the instrument's valuation is driven by unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the price at which an arm's length transaction would be likely to occur. It generally does not mean that there is no data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used).

Subsequent to initial recognition, the fair values of financial instruments measured at fair value are determined in accordance with the Bank's valuation methodology which is described in Note 29.

(d) Interests in associates and joint arrangement

A Joint arrangement is an investment in which the Bank, together with one or more parties, has joint control. Depending on the Bank's rights and obligations, the joint arrangement is classified as either a joint operation or a joint venture. The Bank classifies investments in entities over which it has significant influence, and that are neither subsidiaries nor joint arrangements, as associates.

The Bank recognises its share of the assets, liabilities and results in a joint operation. Investments in associates are recognised using the equity method. The attributable share of the results and reserves of associates are included in the financial statements of the Bank based on financial statements as at 31 December 2016 or pro-rated amounts adjusted for any material transactions or events occurring between the date of financial statements available and 31 December 2016.

Notes to the Financial Statements (continued)

Investments in associates are assessed at each reporting date and tested for impairment when there is an indication that the investment may be impaired.

(e) Loans and advances to banks and customers

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

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

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

Critical accounting estimates and judgments

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 estimates when calculating loan impairment allowances on both individually and collectively assessed loans and advances.

Collective impairment allowances are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis due to the large number of individually insignificant loans in the portfolio. The estimation methods include the use of statistical analyses of historical information, supplemented with significant management judgement, to assess whether current economic and credit conditions are such that the actual level of incurred losses is likely to be greater or less than historical experience.

Where changes in economic, regulatory or behavioural conditions result in the most recent trends in portfolio risk factors being not fully reflected in the statistical models, risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

(f) Impairment of loans and advances

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

Individually assessed loans and advances

The factors considered in determining whether a loan is individually significant for the purposes of assessing impairment include the size of the loan, the number of loans in the portfolio, the importance of the individual loan relationship, and how this is managed. Loans that are determined to be individually significant based on the above and other relevant factors will be individually assessed for impairment, except when volumes of defaults and losses are sufficient to justify treatment under a collective methodology.

Notes to the Financial Statements (continued)

Loans considered as individually significant are typically to corporate and commercial customers, are for larger amounts and are managed on an individual basis. For these loans, the Bank considers on a case-by-case basis at each balance sheet date whether there is any objective evidence that a loan is impaired.

The determination of the realisable value of security is based on the current market value at the time the impairment assessment is performed. The value is not adjusted for anticipated increases in future market prices though; adjustments are made to reflect local conditions, such as forced sale discounts.

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

Collectively assessed loans and advances

Impairment is assessed collectively to cover losses which have been incurred but have not yet been identified on loans subject to individual assessment or for homogeneous groups of loans that are not considered individually significant, generally retail lending portfolios.

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 for a collective impairment assessment. This assessment captures impairment losses that the Bank has incurred as a result of events occurring before the balance sheet date which the Bank is not able to identify on an individual loan basis, and that can be reliably estimated. When information becomes available which identifies losses on individual loans within a group, those loans are removed from the Bank and assessed individually.

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. The methods that are used to calculate collective allowances are:

- When appropriate empirical information is available, the Bank utilises roll-rate methodology. This methodology employs statistical analyses of historical data and experience of delinquency and default to estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date which the Bank 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. In addition to the delinquency groupings, loans are segmented according to their credit characteristics as described above. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. 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.
- When the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, the Bank adopts a basic formulaic approach based on historical loss rate experience, or a discounted cash flow model. Where a basic formulaic approach is undertaken, the period between a loss event occurring and its identification is explicitly estimated by local management, and is typically between six and twelve months.

Write-off of loans and advances

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

Reversals of impairment

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

Notes to the Financial Statements (continued)

Assets acquired in exchange for loans

When non-financial assets acquired in exchange for loans as part of an orderly realisation are held for sale, these assets are recorded as 'Assets held for sale' and reported in 'Other assets'.

Renegotiated loans

Loans subject to collective impairment assessment whose terms have been renegotiated are no longer considered past due, but are treated as up to date loans for measurement purposes once a minimum number of payments under the original or revised terms, as appropriate to the circumstances, have been received. Where collectively assessed loan portfolios include significant levels of renegotiated loans, these loans are segregated from other parts of the loan portfolio for the purposes of collective impairment assessment to reflect their risk profile. Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired. The carrying amount of loans that have been classified as renegotiated retain this classification until maturity or derecognition.

A loan that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement made on substantially different terms, or if the terms of an existing agreement are modified, such that the renegotiated loan is substantially a different financial instrument. Any new loans that arise following derecognition events will continue to be disclosed as renegotiated loans and are assessed for impairment as above.

(g) Trading assets and trading liabilities

Treasury bills, debt securities, equity shares, loans, deposits, debt securities in issue, and short positions in securities are classified as held for trading if they have been acquired or incurred 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 Bank enters into contractual arrangements with counterparties to purchase or sell the financial instruments, and are normally derecognised when either sold (assets) or extinguished (liabilities). Measurement is initially at fair value, with transaction costs taken to the income statement. Subsequently their fair values are remeasured, and gains and losses from changes therein are recognised in the income statement in 'Net trading income'.

(h) Financial instruments designated at fair value

Financial instruments, other than those held for trading, are classified in this category if they meet one or more of the criteria set out below, and are so designated by management. The Bank 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 Bank 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.
- 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 Banks of financial instruments is reported to management on that basis; and
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, including certain debt issues and debt securities held.

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

Notes to the Financial Statements (continued)

(i) Financial instruments measured at fair value

Available-for-sale financial assets

Available-for-sale financial assets are recognised on the trade date when the Bank enters into contractual arrangements to purchase those instruments, and are normally derecognised when either the securities are sold or redeemed. They are subsequently remeasured at fair value, and changes therein are recognised in other comprehensive income until the assets are either sold or become impaired. Upon disposal, the cumulative gains or losses in other comprehensive income are recognised in the income statement as 'Gains less losses from financial investments'.

Impairment of available-for-sale financial assets

Available-for-sale financial assets are assessed at each balance sheet date for objective evidence of impairment. Impairment losses are recognised in the income statement within 'Loan impairment charges and other credit risk provisions' for debt instruments.

Available-for-sale debt securities

In assessing objective evidence of impairment at the reporting date, the Bank considers all available evidence, including observable data or information about events specifically relating to the securities which may result in a shortfall in the recovery of future cash flows. A subsequent decline in the fair value of the instrument is recognised in the income statement when there is objective evidence of impairment as a result of decreases in the estimated future cash flows. 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, or the instrument is no longer impaired, the impairment loss is reversed through the income statement.

Derivatives

Derivatives are financial instruments that derive their value from the price of underlying items such as equities, interest rates or other indices. Derivatives are recognised initially and are subsequently measured at fair value. Derivatives are classified as assets when their fair value is positive or as liabilities when their fair value is negative, this includes embedded derivatives which are bifurcated from the host contract when they meet the definition of a derivative on a standalone basis.

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

Hedge accounting

When derivatives are held for risk management purposes they are designated in hedge relationships where the required criteria for documentation and hedge effectiveness are met. The Bank enters into fair value hedges, cash flow hedges or hedges of net investments in foreign operations as appropriate to the risk being hedged.

Fair value hedge

Changes in the fair value of derivatives are recorded in the income statement, along with changes in the fair value of the hedged assets or liabilities attributable to the hedged risk. If a hedge relationship no longer meets the criteria for hedge accounting, hedge accounting is discontinued; the cumulative adjustment to the carrying amount of the hedged item is amortised to the income statement on a recalculated effective interest rate over the residual period to maturity, unless the hedged item has been derecognised, in which case it is recognised in the income statement immediately.

Notes to the Financial Statements (continued)

Cash flow hedge

The effective portion of changes in the fair value of derivatives is recognised in other comprehensive income; the ineffective portion of the change in fair value is recognised immediately in the income statement within 'Net trading income'. The accumulated gains and losses recognised in other comprehensive income are reclassified to the income statement in the same periods in which the hedged item affects profit or loss. In hedges of forecast transactions that result in recognition of a non-financial asset or liability, previous gains and losses recognised in other comprehensive income are included in the initial measurement of the asset or liability. When a hedge relationship is discontinued, any cumulative gain or loss recognised in other comprehensive income remains in equity until the forecast transaction is recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss previously recognised in other comprehensive income is immediately reclassified to the income statement.

Derivatives that do not qualify for hedge accounting

Non-qualifying hedges are derivatives entered into as economic hedges of assets and liabilities for which hedge accounting was not applied.

(j) 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.

(k) Intangible assets

Intangible assets include computer software, core deposit relationships, customer relationships and preferential lease intangible. Computer software includes both purchased and internally generated software. The cost of internally generated software comprises all directly attributable costs necessary to create, produce and prepare the software to be capable of operating in the manner intended by management. Costs incurred in the on-going maintenance of software are expensed immediately as incurred.

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

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

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

Internally generated software	between 3 and 5 years
Purchased software	between 3 and 5 years
Core deposit intangible	7 years
Customer relationship	7 years
Preferential lease intangible	8 years

Critical accounting estimates and judgements

Management is required to exercise judgement in valuing intangible assets recognised. The following intangible assets were identified and measured as a result of the business combinations in previous years:

Core deposit intangible: The core deposit intangible is valued using an income approach which calculates the present value of the difference between the cost of existing deposits and the cost of obtaining alternative funds over the useful life of the deposit base.

Customer relationships: The customer relationship is valued using an income approach which considers the interest income on future loans of existing customers along with the non-interest income expected to be derived from them.

Preferential lease: The preferential lease contract is valued using an income approach which considers the benefit to the lesser of obtaining a rental lease at lower than the market rate, over the term of the lease.

The exercise of judgement requires the use of estimations and assumptions which are highly subjective and very sensitive to the risk factors, in particular to changes in economic conditions and the regulatory environment. Further, the attainment of the predicted results depends upon successful implementation of the underlying strategies by management and the realisation of the underlying assumptions including any operational improvements. Events and circumstances frequently do not occur as expected and actual results are likely to be affected by events beyond the control of management resulting in differences between the predicted and the actual results. Such differences are normal and may be material.

Notes to the Financial Statements (continued)

(l) Property, plant and equipment

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

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 Bank 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.

(m) 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 Bank 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 Bank 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 Bank 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 Bank 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.

(n) Income tax

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

Current tax is the tax expected to be payable on the taxable profit for the year and any adjustment to tax payable in respect of previous years. The Bank provides for potential current tax liabilities that may arise on the basis of the amounts expected to be paid to the tax authorities.

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 is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled.

Current and deferred tax is calculated based on tax rates and laws enacted, or substantively enacted, by the balance sheet date.

Deferred tax assets

Critical accounting estimates and judgements

The recognition of a deferred tax asset relies on an assessment of the probability and sufficiency of future taxable profits, future reversals of existing taxable temporary differences and ongoing tax planning strategies. In the absence of a history of taxable profits, the most significant judgements relate to expected future profitability and to the applicability of tax planning strategies, including corporate reorganisations.

(o) Pension and other post-employment benefits

The Bank contributes to the UAE Nationals Pension and Social Security Scheme as per the requirements of the Government of the United Arab Emirates.

Notes to the Financial Statements (continued)

For locally recruited employees (non UAE Nationals), end of service benefits are calculated and paid in accordance with the UAE Federal Labour Law. The Bank's net obligation in respect of such end of service benefits is the amount of future benefits that employees have earned in return for their service in current and prior periods.

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

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

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

(p) Share-based payments

Shares in HSBC Holdings plc are awarded to employees in certain cases. Equity-settled share-based payment arrangements entitle employees to receive equity instruments of HSBC.

The cost of equity-settled share-based payment arrangements with employees is measured by reference to the fair value of equity instruments on the date they are granted and recognised as an expense on a straight-line basis over the vesting period, with a corresponding credit to 'Other reserve'. The vesting period is the period during which all the specified vesting conditions of the arrangement are to be satisfied. The fair value of equity instruments that are made available immediately, with no vesting period attached to the award, are expensed immediately.

Fair value is determined by using appropriate valuation models, taking into account the terms and conditions of the award. Vesting conditions include service conditions and performance conditions; any other features of a share-based payment arrangement are non-vesting conditions. 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 vesting conditions are satisfied.

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

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

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

(q) Foreign currencies

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

Notes to the Financial Statements (continued)

(r) 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.

Critical accounting estimates and judgements

Judgement is involved in determining whether a present obligation exists and in estimating the probability, timing and amount of any outflows. Professional expert advice is taken on the assessment of litigation, property (including onerous contracts) and similar obligations. Provisions for legal proceedings and regulatory matters typically require a higher degree of judgement than other types of provisions. When matters are at an early stage, accounting judgements can be difficult because of the high degree of uncertainty associated with determining whether a present obligation exists, and estimating the probability and amount of any outflows that may arise. As matters progress, management and legal advisers evaluate on an ongoing basis whether provisions should be recognised, revising previous judgements and estimates as appropriate. At more advanced stages, it is typically easier to make judgements and estimates around a better defined set of possible outcomes. However, the amount provisioned can remain very sensitive to the assumptions used. There could be a wide range of possible outcomes for any pending legal proceedings, investigations or inquiries. As a result, it is often not practicable to quantify a range of possible outcomes for individual matters. It is also not practicable to meaningfully quantify ranges of potential outcomes in aggregate for these types of provisions because of the diverse nature and circumstances of such matters and the wide range of uncertainties involved. Provisions for customer remediation also require significant levels of estimation and judgement. The amounts of provisions recognized depend on a number of different assumptions, for example, the volume of inbound complaints, the projected period of inbound complaint volumes, the decay rate of complaint volumes, the population identified as systemically mis-sold and the number of policies per customer complaint.

(s) Contingent liabilities, contractual commitments and guarantees

Contingent liabilities

Contingent liabilities, which include certain guarantees and letters of credit pledged as collateral security and contingent liabilities related to legal proceedings or regulatory matters, are not recognised in the financial statements but are disclosed unless the probability of settlement is remote.

Financial guarantee contracts

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

(t) Debt securities issued and deposits by customers and banks

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

(u) Cash and cash equivalents

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

Notes to the Financial Statements (continued)

4 Net (expense)/income from financial instruments designated at fair value

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 liabilities designated at fair value through profit or loss, including derivatives that are managed in conjunction with those financial assets and liabilities, and liabilities under investment contracts. Interest income, interest expense and dividend income in respect of those financial instruments are also included, except for interest arising from debt securities issued by the Bank and derivatives managed in conjunction with those debt securities, which is recognised in 'Interest expense'.

Net (expense)/income on long-term debt issued and related derivatives

	2016 AED000	2015 AED000
changes in own credit spread on long-term debt	(185)	32,824
other changes in fair value	(582)	(6,176)
Net (expense)/income from instruments designated at fair value	(767)	26,648

5 Interest income and expense

	2016 AED000	2015 AED000
Interest income		
Loans and advances to banks	198,953	111,466
Loans and advances to customers	2,643,128	2,718,813
Investments	88,811	64,299
Others.....	74,736	89,887
Total interest income	3,005,628	2,984,465

	2016 AED000	2015 AED000
Interest expense		
Deposits by banks	(292,161)	(258,550)
Customer accounts	(70,641)	(79,731)
Debt issued	(124,893)	(146,295)
Total interest expense	(487,695)	(484,576)
Net interest income	2,517,933	2,499,889

6 Fee income and expense

	2016 AED000	2015 AED000
Fee income		
Personal banking fees	471,979	492,996
Corporate banking fees	446,598	515,207
Investment banking fees	529,291	505,602
Total	1,447,868	1,513,805
Fee expense		
Personal banking fees	(106,055)	(97,370)
Corporate banking fees	(21,852)	(23,903)
Investment banking fees	(57,919)	(59,066)
Total	(185,826)	(180,339)
Net fee income	1,262,042	1,333,466

7 Other operating income

	2016 AED000	2015 AED000
Recovery of operational/support cost from other HSBC Group entities (refer note 40).....	287,827	360,012
(Loss)/ gain on disposal of property plant and equipment.....	(375)	166
Others.....	(3,116)	44,571
Total	284,336	404,749

Notes to the Financial Statements (continued)

8 Loan impairment charges and other credit risk provisions

	2016 AED000	2015 AED000
Loan impairment charge and other credit risk provisions		
Net impairment charge on loans and advances to customers	(423,099)	(1,030,585)
Net impairment (charge)/release in respect of other credit risk.....	(12,306)	2,981
Total	(435,405)	(1,027,604)

9 Employee compensation and benefits

	2016 AED000	2015 AED000
Wages and salaries	(1,037,408)	(1,113,703)
Social security costs	(10,748)	(10,332)
Post-employment benefits.....	(81,818)	(80,020)
Others	(392,501)	(499,905)
Total	(1,522,475)	(1,703,960)

Post-employment benefit plans*Income statement charge in respect of defined benefit plans*

	2016 AED000	2015 AED000
Defined benefit pension plans	(78,772)	(73,435)
	(78,772)	(73,435)

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

	2016 AED000	2015 AED000
Defined benefit pension plans	488,402	457,008

Defined benefit pension plans

Arrangements for staff retirement benefits are made in accordance with local regulations and custom. The staff indemnity schemes for local staff include 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.

	2016 AED000	2015 AED000
Present value of defined benefit obligations		
At 1 January	457,008	390,861
Current service cost	70,144	65,487
Other movements	1,923	1,781
Interest cost	8,628	7,948
Actuarial losses	315	28,490
Benefits paid	(49,616)	(37,559)
Net liability	488,402	457,008

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

	2016 AED000	2015 AED000
Current service cost	(70,144)	(65,487)
Interest cost	(8,628)	(7,948)
Total expense	(78,772)	(73,435)

Notes to the Financial Statements (continued)

Post-employment defined benefit plans' principal actuarial assumptions

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

Principal actuarial assumptions

	Discount rate %	Rate of pay increase %	Combined rate of resignation and employment termination %
At 31 December 2016			
United Arab Emirates	1.8	5.0	12.3
At 31 December 2015			
United Arab Emirates	1.8	4.5	8.0

The Bank determines discount rates to be applied to its obligations in consultation with the plans' local actuaries, on the basis of current average yields of long term, high quality corporate bonds.

	2016 AED000	2015 AED000
Discount rate		
Change in scheme obligation at year end from a 25bps increase.....	(8,336)	(9,960)
Change in scheme obligation at year end from a 25bps decrease.....	8,607	10,356
Change in following year scheme cost from a 25bps increase.....	(266)	(819)
Change in following year scheme cost from a 25bps decrease.....	269	837
Rate of pay increase		
Change in scheme obligation at year end from a 25bps increase.....	8,608	10,558
Change in scheme obligation at year end from a 25bps decrease.....	(8,842)	(10,210)
Change in following year scheme cost from a 25bps increase.....	1,636	2,182
Change in following year scheme cost from a 25bps decrease.....	(1,591)	(2,112)

10 Share-based payments

Income statement charge

This charge, which was computed from the fair values of the share-based payment transaction when contracted, arose under employee share awards made in accordance with HSBC's reward structures (discussed further below).

The share-based payments charge is recognised in 'Others' within the Employee compensation and benefits (Note 9).

Deferred share awards

These awards are granted to employees after the performance year. These awards confer the right to the employees concerned to own shares of HSBC Holdings plc upon completion of minimum number of years of service from the date of award. Should the employee not satisfy this condition, subject to certain exceptions, the award would lapse.

The following table identifies the charge recognised in the current year, or expected to be recognised in future years, and the performance year to which the deferred awards relate.

Income statement impact of deferred share awards on current and future years

	Charge recognised in 2016 in respect of performance year:		Charge expected to be recognised in 2017 or later in respect of performance year:	
	2016 AED000	Pre-2016 AED000	2016 AED000	Pre-2016 AED000
HSBC deferred share awards	(9,155)	(28,665)	(14,408)	(21,672)
	Charge recognised in 2015 in respect of performance year:		Charge expected to be recognised in 2016 or later in respect of performance year:	
	2015 AED000	Pre-2015 AED000	2015 AED000	Pre-2015 AED000
HSBC deferred share awards	(10,444)	(28,088)	(21,742)	(16,499)

Notes to the Financial Statements (continued)

11 Tax expense

	2016 AED000	2015 AED000
Current tax		
Tax – on current year profit.....	(250,087)	(379,914)
Tax – adjustments in respect of prior years.....	1,356	(6,930)
Deferred tax	(87,089)	125,842
Other	(7,564)	(13,873)
Tax expense	<u>(343,384)</u>	<u>(274,875)</u>

Analysis of tax expense

	2016 AED000	2015 AED000
Accounting profit.....	1,905,247	1,319,575
Taxation at UAE corporate tax rate of 20% (2015: 20%).....	(381,049)	(263,594)
Exempt income in respect of Jebel Ali and Ras Al Khaimah branches	48,177	73,984
Expenses not deductible for tax purposes	(4,304)	(37,270)
Adjustment in respect of prior period liabilities	1,356	(6,930)
Other	(7,564)	(41,065)
Overall tax expense	<u>(343,384)</u>	<u>(274,875)</u>

The tax charge is determined by applying the official tax rate of 20% to the taxable profits arising in the Emirates of Abu Dhabi, Dubai, Sharjah and Fujairah.

Notes to the Financial Statements (continued)

12 Analysis of financial assets and liabilities by measurement basis

Financial assets and financial liabilities are measured on an ongoing basis either at fair value or at amortised cost. The summary of significant accounting policies in Note 3 describes how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognized. The following table analyses the carrying amounts of the financial assets and liabilities by category as defined in IAS 39 and by balance sheet heading.

At 31 December 2016						
	Held for trading AED000	Designated at fair value AED000	Available-for-sale securities AED000	Financial assets and liabilities at amortised cost AED000	Derivatives designated as hedging instruments AED000	Total AED000
Financial assets						
Cash and balances at central bank	-	-	-	8,109,427	-	8,109,427
Trading assets	624,212	-	-	-	-	624,212
Derivatives	4,415,988	-	-	-	142,751	4,558,739
Loans and advances to banks	-	-	-	15,472,758	-	15,472,758
Loans and advances to customers	-	-	-	62,933,189	-	62,933,189
Reverse repurchase agreements – non-trading	-	-	-	3,859,692	-	3,859,692
Financial investments	-	-	16,110,930	-	-	16,110,930
Other assets	-	-	-	1,389,784	-	1,389,784
Total financial assets	<u>5,040,200</u>	<u>-</u>	<u>16,110,930</u>	<u>91,764,850</u>	<u>142,751</u>	<u>113,058,731</u>
Total non-financial assets						914,294
Total assets						<u>113,973,025</u>
Financial liabilities						
Deposits by banks	-	-	-	14,591,571	-	14,591,570
Customer accounts	-	-	-	60,867,651	-	60,867,651
Trading liabilities	5,496,794	-	-	-	-	5,496,794
Financial liabilities designated at fair value	-	1,475,028	-	-	-	1,475,028
Derivatives	4,326,162	-	-	-	570,704	4,896,866
Debt securities in issue	-	-	-	2,757,742	-	2,757,742
Subordinated Liabilities	-	-	-	5,139,667	-	5,139,667
Other liabilities	-	-	-	3,878,369	-	3,878,369
Total financial liabilities	<u>9,822,956</u>	<u>1,475,028</u>	<u>-</u>	<u>87,234,999</u>	<u>570,704</u>	<u>99,103,687</u>
Total non-financial liabilities						1,386,159
Total liabilities						<u>100,489,846</u>

Notes on the Financial Statements (continued)

At 31 December 2015						
	Held for trading AED000	Designated at fair value AED000	Available-for-sale securities AED000	Financial assets and liabilities at amortised cost AED000	Derivatives designated as hedging instruments AED000	Total AED000
Financial assets						
Cash and balances at central bank.....	-	-	-	8,891,364	-	8,891,364
Trading assets	429,871	-	-	-	-	429,871
Derivatives	3,284,376	-	-	-	45,436	3,329,812
Loans and advances to banks	-	-	-	13,553,668	-	13,553,668
Loans and advances to customers	-	-	-	67,861,215	-	67,861,215
Reverse repurchase agreements – non-trading	-	-	-	2,963,845	-	2,963,845
Financial investments	-	-	17,649,352	-	-	17,649,352
Other assets	-	-	-	1,946,474	-	1,946,474
Total financial assets	<u>3,714,247</u>	<u>-</u>	<u>17,649,352</u>	<u>95,216,566</u>	<u>45,436</u>	<u>116,625,601</u>
Total non-financial assets						<u>1,247,846</u>
Total assets						<u>117,873,447</u>
Financial liabilities						
Deposits by banks	-	-	-	12,619,282	-	12,619,282
Customer accounts	-	-	-	67,167,079	-	67,167,079
Trading liabilities	5,010,003	-	-	-	-	5,010,003
Financial liabilities designated at fair value.....	-	3,115,575	-	-	-	3,115,575
Derivatives	3,493,723	-	-	-	113,405	3,607,128
Subordinated liabilities	-	-	-	2,757,354	-	2,757,354
Debt securities in issue	-	-	-	5,643,810	-	5,643,810
Other liabilities	-	-	-	4,949,499	-	4,949,499
Total financial liabilities	<u>8,503,726</u>	<u>3,115,575</u>	<u>-</u>	<u>93,137,024</u>	<u>113,405</u>	<u>104,869,730</u>
Total non-financial liabilities						<u>1,130,301</u>
Total liabilities.....						<u>106,000,031</u>

13 Cash and balances at central bank

	2016 AED000	2015 AED000
Cash in hand.....	636,835	788,895
Statutory reserves with central bank	<u>7,472,592</u>	<u>8,102,469</u>
	<u>8,109,427</u>	<u>8,891,364</u>

14 Loans and advances to banks

	2016 AED000	2015 AED000
Loans and advances to banks	<u>15,472,758</u>	<u>13,553,668</u>
	<u>15,472,758</u>	<u>13,553,668</u>

15 Loans and advances to customers

	2016 AED000	2015 AED000
Overdrafts	5,203,616	5,937,872
Credit cards	2,326,775	2,430,259
Term lending	48,994,554	52,986,264
Bills discounted	1,836,157	2,822,914
Others.....	<u>8,541,327</u>	<u>7,867,383</u>
	<u>66,902,429</u>	<u>72,044,692</u>
Less: Allowance for impairment losses	<u>(3,969,240)</u>	<u>(4,183,477)</u>
	<u>62,933,189</u>	<u>67,861,215</u>

Notes on the Financial Statements (continued)

16 Trading assets

	2016 AED000	2015 AED000
Trading assets:		
– not subject to re-pledge or resale by counterparties	624,212	429,871
	624,212	429,871
Treasury and other eligible bills.....	-	-
Debt securities	335,451	365,794
Others	288,761	64,077
	624,212	429,871

17 Derivatives

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

	Assets			Liabilities		
	Trading AED000	Hedging AED000	Total AED000	Trading AED000	Hedging AED000	Total AED000
At 31 December 2016						
Foreign exchange	2,640,873	45,641	2,686,514	2,646,987	549,038	3,196,025
Interest rate	1,579,228	97,110	1,676,338	1,478,373	21,666	1,500,039
Equity	5,050	-	5,050	5,050	-	5,050
Credit	3,198	-	3,198	8,118	-	8,118
Commodity and other	187,639	-	187,639	187,635	-	187,635
Total.....	4,415,988	142,751	4,558,739	4,326,163	570,704	4,896,867
	Assets			Liabilities		
	Trading AED000	Hedging AED000	Total AED000	Trading AED000	Hedging AED000	Total AED000
At 31 December 2015						
Foreign exchange	1,676,445	26,798	1,703,243	1,837,208	137,417	1,974,625
Interest rate	1,387,506	17,866	1,405,372	1,353,510	15,494	1,369,004
Equity	34,159	-	34,159	34,159	-	34,159
Credit	5,958	-	5,958	48,261	-	48,261
Commodity and other	181,080	-	181,080	181,079	-	181,079
Total.....	3,285,148	44,664	3,329,812	3,454,217	152,911	3,607,128

Derivatives are financial instruments that derive their value from the price of underlying items such as equities, bonds, interest rates, foreign exchange, credit spreads, commodities and equity or other indices. Derivatives enable users to increase, reduce or alter exposure to credit or market risks.

Derivatives are carried at fair value and shown in the balance sheet as separate totals of assets and liabilities. A description of how the fair value of derivatives is derived is set out in Note 29. Derivative assets and liabilities on different transactions are only set off (netted) if the transactions are with the same counterparty, a legal right of set off exists and the cash flows are intended to be settled on a net basis.

Use of derivatives

The Bank transacts derivatives for three primary purposes: to create risk management solutions for clients, to manage the portfolio risks arising from client business and to manage and hedge the Bank's own risks. The Bank'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. When entering into derivative transactions, the Bank employs the same credit risk management framework to assess and approve potential credit exposures that it uses for traditional ending.

Notes on the Financial Statements (continued)

Trading derivatives

Most of the Bank'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 include market-making and risk management. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume. Risk management activity is undertaken to manage the risk arising from client transactions, with the principal purpose of retaining client margin. Other derivatives classified as held for trading include non-qualifying hedging derivatives.

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 AED Nil (2015: AED Nil).

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

	2016 AED000	2015 AED000
Foreign exchange.....	238,562,278	280,187,777
Interest rate	182,003,764	161,344,145
Equity	272,548	365,538
Credit	865,800	1,088,808
Commodity and other	238,035	92,642
	421,942,425	443,078,910

Credit derivatives

The Bank trades credit derivatives and acts as a principal counterparty to a broad range of users, structuring deals to produce risk management products for its customers, or making markets in certain products. Risk is typically controlled through entering into offsetting credit derivative contracts with other counterparties.

The Bank manages the credit risk arising on buying and selling credit derivative protection by including the related credit exposures within its overall credit limit structure for the relevant counterparty. Trading of credit derivatives is restricted to a small number of offices which have the control infrastructure and market skills to manage effectively the credit risk inherent in the products.

Hedging instruments

The Bank 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 Bank to optimise the overall cost to the Bank of accessing debt capital markets, and to mitigate the market risk which would otherwise arise from structural imbalances in the maturity and other profiles of its assets and liabilities.

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

The notional contract amounts of derivatives held for hedging purposes indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

Notional contract amounts of derivatives held for hedge accounting purposes by product type

	2016 Fair value hedge AED000	2016 Cash flow hedge AED000	2015 Fair value hedge AED000	2015 Cash flow hedge AED000
Foreign exchange	-	6,537,753	-	7,281,845
Interest rate.....	3,973,018	10,741,141	1,708,563	3,411,331
	3,973,018	17,278,894	1,708,563	10,693,176

Notes on the Financial Statements (continued)

Fair value hedges

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

Fair value of derivatives designated as fair value hedges

	At 31 December 2016		At 31 December 2015	
	Assets AED000	Liabilities AED000	Assets AED000	Liabilities AED000
Interest rate	49,291	13,194	10,160	7,850
	49,291	13,194	10,160	7,850

Gains or losses arising from fair value hedges

	2016 AED000	2015 AED000
Gains/(losses) on:		
- hedging instruments	35,316	7,998
- on the hedged items attributable to the hedged risk	(34,915)	(6,455)
	401	1,543

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

During the year ended 31 December 2016, a gain of USD 1.54m (2015: 0.32m) was recognised due to hedge ineffectiveness in relation to fair value hedges.

Cash flow hedges

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

Fair value of derivatives designated as cash flow hedges

	At 31 December 2016		At 31 December 2015	
	Assets AED000	Liabilities AED000	Assets AED000	Liabilities AED000
Foreign Exchange	45,641	549,038	26,798	137,417
Interest rate	47,819	8,472	7,706	7,644

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

	3 months or less AED000	More than 3 months but less than 1 year AED000	5 years or less but more than 1 year AED000	More than 5 years AED000
At 31 December 2016				
Assets	60,072,482	32,017,828	12,302,104	-
Liabilities	3,378,476	3,378,476	-	-
Net cash inflow exposure	56,694,006	28,639,352	12,302,104	-

Notes on the Financial Statements (continued)

	3 months or less AED000	More than 3 months but less than 1 year AED000	5 years or less but more than 1 year AED000	More than 5 years AED000
At 31 December 2015				
Assets	38,754,457	35,430,859	25,198,833	399,168
Liabilities	510,885	510,885	510,885	-
Net cash inflow exposure	38,243,571	34,919,974	24,687,948	399,168

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

The gains and losses on ineffective portions of such derivatives are recognised immediately in 'Net trading income'.

During the years ended 31 December 2016 and 31 December 2015, no gains or losses were recognised due to hedge ineffectiveness relating to cash flow hedges.

18 Financial investments

	2016 AED000	2015 AED000
Financial investments:		
– not subject to repledge or resale by counterparties	16,110,930	17,649,352
Treasury and other eligible bills		
– available-for-sale	548,473	5,559,098
Debt securities		
– available-for-sale	15,562,457	12,090,254
Total financial investments	16,110,930	17,649,352

Notes on the Financial Statements (continued)

19 Intangible assets

Movement of intangible assets

	Internally generated software AED000	Purchased software AED000	Customer relationship AED000	Core deposits AED000	Preferential lease payment AED000	Total AED000
Cost						
At 1 January 2016	93,241	30,016	13,100	41,798	5,315	183,470
Additions ¹	9,641	1,063	-	-	-	10,704
Disposals	-	(2,920)	-	-	-	(2,920)
Other changes	-	-	-	-	-	-
At 31 December 2016	102,882	28,159	13,100	41,798	5,315	191,254
Accumulated amortisation						
At 1 January 2016	(71,201)	(29,535)	(5,926)	(18,908)	(2,102)	(127,672)
Charge for the year ²	(10,467)	(1,075)	(1,872)	(5,971)	(664)	(20,049)
Impairment	-	-	-	-	-	-
Disposals	-	2,886	-	-	-	2,886
Other changes	(577)	-	-	-	(1)	(579)
At 31 December 2016	(82,245)	(27,724)	(7,798)	(24,879)	(2,767)	(145,412)
Net carrying amount at 31 December 2016³	20,637	435	5,302	16,919	2,548	45,842
Cost						
At 1 January 2015	94,420	29,999	13,100	41,798	5,315	184,632
Additions ¹	7,741	18	-	-	-	7,759
Disposals	(8,920)	(1)	-	-	-	(8,921)
Other changes	-	-	-	-	-	-
At 31 December 2015	93,241	30,016	13,100	41,798	5,315	183,470
Accumulated amortisation						
At 1 January 2015	(69,527)	(28,930)	(4,055)	(12,936)	(1,438)	(116,886)
Charge for the year ²	(10,025)	(605)	(1,871)	(5,972)	(664)	(19,137)
Impairment	(558)	-	-	-	-	(558)
Disposals	8,911	1	-	-	-	8,912
Other changes	(2)	(1)	-	-	-	(3)
At 31 December 2015	(71,201)	(29,535)	(5,926)	(18,908)	(2,102)	(127,672)
Net carrying amount at 31 December 2015³	22,040	481	7,174	22,890	3,213	55,798

1 At 31 December 2016, the Bank did not have any contractual commitments to acquire intangible assets (2015: nil).

2 The amortisation and impairment charges for the year are recognised within the income statement under 'Amortisation and impairment of intangible assets'.

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

Notes on the Financial Statements (continued)

20 Property, plant and equipment*Movement of property & equipment*

	Short leasehold land and buildings AED000	Equipment, fixtures and fittings AED000	Total AED000
Cost or fair value			
At 1 January 2016	219,873	193,032	412,905
Additions at cost.....	37,868	7,360	45,228
Disposals	(5,411)	(5,475)	(10,886)
Other changes	-	-	-
At 31 December 2016	252,330	194,917	447,247
Accumulated depreciation			
At 1 January 2016	(129,236)	(150,909)	(280,145)
Depreciation charge for the year	(17,388)	(12,084)	(29,472)
Disposals	4,784	5,161	9,945
Impairment losses recognised	-	-	-
Other changes	(187)	225	38
At 31 December 2016	(142,027)	(157,607)	(299,634)
Net carrying amount at 31 December 2016	110,303	37,310	147,613
Cost or fair value			
At 1 January 2015	182,997	192,322	375,319
Additions at cost.....	38,184	24,792	62,976
Disposals	(1,309)	(24,082)	(25,391)
Other changes	1	-	1
At 31 December 2015	219,873	193,032	412,905
Accumulated depreciation			
At 1 January 2015	(116,686)	(156,827)	(273,513)
Depreciation charge for the year	(13,847)	(16,083)	(29,930)
Disposals	1,297	22,001	23,298
Impairment losses recognised	-	-	-
Other changes	-	-	-
At 31 December 2015	(129,236)	(150,909)	(280,145)
Net carrying amount at 31 December 2015	90,637	42,123	132,760

21 Other assets

	2016 AED000	2015 AED000
Interest receivable	94,611	87,844
Prepaid expenses.....	49,627	46,727
Endorsements and acceptances.....	1,070,093	1,564,989
Items in course of collection from other banks	-	1
Other accounts	175,453	246,913
	1,389,784	1,946,474

Notes on the Financial Statements (continued)

22 Deferred tax assets

	2016 AED000	2015 AED000
Deferred tax is applicable to the following		
<i>Recognised in income statement</i>		
Other liabilities.....	23,321	26,568
Allowance for impairment losses	697,518	755,649
	720,839	782,217

23 Customer accounts

	2016 AED000	2015 AED000
Current accounts	38,641,620	41,124,114
Savings accounts	7,651,952	8,102,200
Call deposits	4,363,365	8,078,239
Term deposits	10,193,273	9,812,819
Money market term deposits.....	17,375	49,640
Others	66	67
	60,867,651	67,167,079

24 Trading liabilities

	2016 AED000	2015 AED000
Other debt securities in issue	5,360,689	4,862,920
Others	136,105	147,083
	5,496,794	5,010,003

25 Financial liabilities designated at fair value

	2016 AED000	2015 AED000
Debt securities in issue.....	1,475,028	3,115,575

At 31 December 2016, the accumulated amount of change in fair value attributable to changes in credit risk was a gain of AED 2.76 million (2015: AED 2.95 million gain).

26 Debt securities in issue

	2016		2015	
	Carrying amount AED000	Fair value AED000	Carrying amount AED000	Fair value AED000
Medium term notes	11,975,384	11,972,458	13,622,305	13,617,759
Of which debt securities in issue reported as				
- trading liabilities	(5,360,689)	(5,360,689)	(4,862,920)	(4,862,920)
- financial liabilities designated at fair value.....	(1,475,028)	(1,475,028)	(3,115,575)	(3,115,575)
	5,139,667	5,136,741	5,643,810	5,639,264

Notes on the Financial Statements (continued)

27 Other liabilities

	2016 AED000	2015 AED000
Items in course of transmission to other banks	122,470	1,037,505
Marginal deposits.....	933,994	1,157,308
Banker's drafts	22,715	134,794
Endorsements and acceptances	1,070,093	1,564,989
Other liabilities.....	1,729,097	1,054,903
	3,878,369	4,949,499

28 Provisions for liabilities and charges

	2016 AED000	2015 AED000
At 1 January	501,151	424,319
Charge for the year	130,909	133,295
Provisions utilised	(76,077)	(56,211)
Exchange differences and other movements	17,932	(252)
At 31 December	573,915	501,151

AED 67,029 thousand (2015: AED 8,689 thousand) relates to costs arising from contingent liabilities and contractual commitments, AED 488,402 thousand (2015: AED 457,008 thousand) relates to provisions for pension and post retirement obligations (see note 9) and AED 18,484 thousand (2015: AED 35,454 thousand) relates to restructuring provisions.

29 Fair value of financial instruments carried at fair value

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.

Where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is used. For inactive markets, the Bank sources alternative market information, with greater weight given to information that is considered to be more relevant and reliable. Examples of the factors considered are price observability, instrument comparability, consistency of data sources, underlying data accuracy and timing of prices.

For fair values ` using valuation models, the control framework includes development or validation by independent support functions of the model logic, inputs, model outputs and adjustments. Valuation models are subject to a process of due diligence before becoming operational and are calibrated against external market data on an ongoing basis.

Changes in fair value are generally subject to a profit and loss analysis process and are disaggregated into high-level categories including portfolio changes, market movements and other fair value adjustments.

Financial liabilities measured at fair value

In certain circumstances, the Bank records its own debt in issue at fair value, based on quoted prices in an active market for the specific instrument. When quoted market prices are unavailable, the own debt in issue is valued using valuation techniques, the inputs for which are based either on quoted prices in an inactive market for the instrument or are estimated by comparison with quoted prices in an active market for similar instruments. In both cases, the fair value includes the effect of applying the credit spread which is appropriate to the Bank's liabilities.

Structured notes issued and certain other hybrid instruments are included within trading liabilities and are measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the Bank issues structured notes.

Fair value hierarchy

Fair values of financial assets and liabilities are determined according to the following hierarchy:

- Level 1 – valuation technique using quoted market price: financial instruments with quoted prices for identical instruments in active markets that the Bank can access at the measurement date.
- Level 2 – valuation technique using observable inputs: financial instruments with quoted prices for similar instruments in active markets or quoted prices for identical or similar instruments in inactive markets and financial instruments valued using models where all significant inputs are observable.
- Level 3 – valuation technique with significant unobservable inputs: financial instruments valued using valuation techniques where one or more significant inputs are unobservable.

Notes on the Financial Statements (continued)

Financial instruments carried at fair value and bases of valuation

	Valuation techniques:			
	Quoted market price Level 1 AED000	Using observable inputs Level 2 AED000	With significant non-observable inputs Level 3 AED000	Total AED000
At 31 December 2016				
Assets				
Trading assets	-	624,212	-	624,212
Derivatives	-	4,532,187	26,552	4,558,739
Financial investments: available-for-sale	-	16,110,930	-	16,110,930
Liabilities				
Trading liabilities	-	5,496,794	-	5,496,794
Financial liabilities designated at fair value	-	1,475,028	-	1,475,028
Derivatives	-	4,870,315	26,552	4,896,867
At 31 December 2015				
Assets				
Trading assets	-	429,871	-	429,871
Derivatives	-	3,321,652	8,160	3,329,812
Financial investments: available-for-sale	-	17,649,352	-	17,649,352
Liabilities				
Trading liabilities	-	5,010,003	-	5,010,003
Financial liabilities designated at fair value	-	3,115,575	-	3,115,575
Derivatives	-	3,529,999	77,129	3,607,128

There were no material transfers between Level 1, Level 2 and Level 3 in the period.

Fair value adjustments

Fair value adjustments are adopted when the Bank considers that there are additional factors that would be considered by a market participant which are not incorporated within the valuation model. The Bank classifies fair value adjustments as either 'risk-related' or 'model-related'.

Movements in the level of fair value adjustments do not necessarily result in the recognition of profits or losses within the income statement. For example, as models are enhanced, fair value adjustments may no longer be required. Similarly, fair value adjustments will decrease when the related positions are unwound, but this may not result in profit or loss.

Risk-related adjustments

Bid-offer

IFRS 13 requires use of the price within the bid-offer spread that is most representative of fair value. Valuation models will typically generate mid-market values. The bid-offer adjustment reflects the extent to which bid-offer cost would be incurred if substantially all residual net portfolio market risks were closed using available hedging instruments or by disposing of or unwinding the position.

Uncertainty

Certain model inputs may be less readily determinable from market data, and/or the choice of model itself may be more subjective. In these circumstances, there exists a range of possible values that the financial instrument or market parameter may assume and an adjustment may be necessary to reflect the likelihood that in estimating the fair value of the financial instrument, market participants would adopt more conservative values for uncertain parameters and/or model assumptions than those used in the valuation model.

Credit valuation adjustment ('CVA')

The credit valuation adjustment is an adjustment to the valuation of OTC derivative contracts to reflect within fair value the possibility that the counterparty may default and that the Bank may not receive the full market value of the transactions (see below).

Notes on the Financial Statements (continued)

Debit valuation adjustment ('DVA')

The debit valuation adjustment is an adjustment to the valuation of OTC derivative contracts to reflect within fair value the possibility that the Bank may default, and that the Bank may not pay full market value of the transactions (see below).

Funding fair value adjustment

The funding fair value adjustment is calculated by applying future market funding spreads to the expected future funding exposure of any uncollateralised component of the OTC derivative portfolio. This includes the uncollateralised component of collateralised derivatives in addition to derivatives that are fully uncollateralised. The expected future funding exposure is calculated by a simulation methodology, where available. The expected future funding exposure is adjusted for events that may terminate the exposure such as the default of the Bank or the counterparty.

Model-related adjustments

Model limitation

Models used for portfolio valuation purposes may be based upon a simplifying set of assumptions that do not capture all material market characteristics. Additionally, markets evolve, and models that were adequate in the past may require development to capture all material market characteristics in current market conditions. In these circumstances, model limitation adjustments are adopted. As model development progresses, model limitations are addressed within the valuation models and a model limitation adjustment is no longer needed.

Inception profit (Day 1 P&L reserves)

Inception profit adjustments are adopted where the fair value estimated by a valuation model is based on one or more significant unobservable inputs.

Credit valuation adjustment/debit valuation adjustment methodology

The Bank calculates a separate CVA and debit valuation adjustment DVA for each counter-party to which it has exposure.

The Bank calculates the CVA by applying the probability of default ('PD') of the counterparty conditional on the non- default of the Bank to the expected positive exposure to the counterparty and multiplying the result by the loss expected in the event of default. Conversely, the Bank calculates the DVA by applying the PD of the Bank, conditional on the non-default of the counterparty, to the expected positive exposure of the counterparty to the Bank and multiplying by the loss expected in the event of default. Both calculations are performed over the life of the potential exposure.

Fair value valuation bases

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

	Assets AED000	Liabilities AED000
At 31 December 2016		
Other derivatives.....	<u>26,552</u>	<u>26,552</u>
At 31 December 2015		
Other derivatives.....	<u>8,160</u>	<u>77,129</u>

Derivatives

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

Notes on the Financial Statements (continued)

Derivative products valued using valuation techniques with significant unobservable inputs included certain types of correlation products, such as foreign exchange basket options, equity basket options, foreign exchange interest rate hybrid transactions and long-dated option transactions. Examples of the latter are equity options, interest rate and foreign exchange options and certain credit derivatives. Credit derivatives include certain tranching CDS transactions.

Other portfolios

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

Movement in Level 3 financial instruments

	Assets		Liabilities
	Available-for-sale AED000	Derivatives AED000	Derivatives AED000
At 1 January 2016	-	8,160	77,129
Total gains/(losses) recognised in profit or loss.....	-	5,912	(64,640)
Total gains/(losses) recognised in other comprehensive income.....	-	-	-
Purchases	-	-	-
Sales	-	-	-
Transfers out	-	-	-
Transfers in	-	12,480	14,063
At 31 December 2016	-	26,552	26,552
Total unrealised gains/(losses) recognised in profit or loss relating to assets and liabilities held on 31 December 2016.....	-	26,552	(26,552)
At 1 January 2015	795	9,211	41,868
Total gains/(losses) recognised in profit or loss.....	(60)	(1,051)	35,261
Total gains/(losses) recognised in other comprehensive income.....	-	-	-
Purchases	-	-	-
Sales	(735)	-	-
Transfers out	-	-	-
Transfers in	-	-	-
At 31 December 2015	-	8,160	77,129
Total unrealised gains/(losses) recognised in profit or loss relating to assets and liabilities held on 31 December 2015.....	-	8,160	(77,992)

Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period.

Effect of changes in significant unobservable assumptions to reasonably possible alternatives

Sensitivity of Level 3 fair values to reasonably possible alternative assumptions

	2016		2015	
	Reflected in profit or loss		Reflected in profit or loss	
	Favourable changes AED000	Unfavourable changes AED000	Favourable changes AED000	Unfavourable changes AED000
Derivatives, trading assets and trading liabilities ¹	2,655	(2,655)	4,264	(4,264)

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

Notes on the Financial Statements (continued)

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

	2016		2015	
	Reflected in profit or loss		Reflected in profit or loss	
	Favourable changes	Unfavourable changes	Favourable changes	Unfavourable changes
	AED000	AED000	AED000	AED000
Other Derivatives.....	2,655	(2,655)	4,264	(4,264)

Favourable and unfavourable changes are determined on the basis of changes in the value of the instrument as a result of varying the levels of the unobservable parameters using statistical techniques. The statistical techniques aim to apply a 95% confidence interval.

When parameters are not amenable to statistical analysis, the quantification of uncertainty is judgemental, but is also guided by the 95% confidence interval.

When the fair value of a financial instrument is affected by more than one unobservable assumption, the above table reflects the most favourable or the most unfavourable change from varying the assumptions individually.

Key unobservable inputs to Level 3 financial instruments

	Fair Value		2016				2015			
	Assets	Liabilities	Full range of inputs		Core range of inputs ¹		Full range of inputs		Core range of inputs ¹	
	AED000	AED000	Lower	Higher	Lower	Higher	Lower	Higher	Lower	Higher
Interest rate derivatives.....	121	121	45.3%	98.5%	57.1%	98.0%	43.0%	98.0%	43.0%	98.0%
FX derivatives.....	26,431	26,431	0.6%	3.6%	0.6%	3.6%	4.0%	10.4%	4.7%	10.2%

¹ The core range of inputs is the estimated range within which 90% of the inputs fall.

A description of the categories of key unobservable inputs is given below.

Prepayment rates

Prepayment rates are a measure of the anticipated future speed at which a loan portfolio will be repaid in advance of the due date.

They vary according to the nature of the loan portfolio and expectations of future market conditions, and may be estimated using a variety of evidence, such as prepayment rates implied from proxy observable security prices, current or historical prepayment rates and macroeconomic modelling.

Market proxy

Market proxy pricing may be used for an instrument for which specific market pricing is not available, but evidence is available in respect of instruments that have common characteristics. In some cases it might be possible to identify a specific proxy, but more generally evidence across a wider range of instruments will be used to understand the factors that influence current market pricing and the manner of that influence.

Volatility

Volatility is a measure of the anticipated future variability of a market price. It varies by underlying reference market price, and by strike and maturity of the option.

Certain volatilities, typically those of a longer-dated nature, are unobservable and are estimated from observable data. The range of unobservable volatilities reflects the wide variation in volatility inputs by reference market price. The core range is significantly narrower than the full range because these examples with extreme volatilities occur relatively rarely within the Bank portfolio.

Correlation

Correlation is a measure of the inter-relationship between two market prices and is expressed as a number between minus one and one. It is used to value more complex instruments where the payout is dependent upon more than one market price. There is a wide range of instruments for which correlation is an input, and consequently a wide range of both same-asset correlations and cross-asset correlations is used. In general, the range of same-asset correlations will be narrower than the range of cross-asset correlations.

Unobservable correlations may be estimated based upon a range of evidence, including consensus pricing services, group trade prices, proxy correlations and examination of historical price relationships. The range of unobservable correlations quoted in the table reflects the wide variation in correlation inputs by market price pair.

Notes on the Financial Statements (continued)

Credit spread

Credit spread is the premium over a benchmark interest rate required by the market to accept a lower credit quality. In a discounted cash flow model, the credit spread increases the discount factors applied to future cash flows, thereby reducing the value of an asset. Credit spreads may be implied from market prices. Credit spreads may not be observable in more illiquid markets.

Inter-relationships between key unobservable inputs

Key unobservable inputs to Level 3 financial instruments may not be independent of each other. As described above, market variables may be correlated. This correlation typically reflects the manner in which different markets tend to react to macro-economic or other events. Furthermore, the impact of changing market variables upon the Bank portfolio will depend upon the Bank's net risk position in respect of each variable.

Fair values of financial instruments not carried at fair value

Fair values of financial instruments which are not carried at fair value and bases of valuation

At 31 December 2016					
Fair value					
Valuation techniques					
	Carrying amount AED000	Quoted market price Level 1 AED000	Using observable inputs Level 2 AED000	With significant unobservable inputs Level 3 AED000	Total AED000
Assets and liabilities not held for sale					
Assets					
Loans and advances to banks	15,518,670	-	15,553,377	-	15,553,377
Loans and advances to customers	62,887,277	-	-	62,630,809	62,630,809
Reverse repurchase agreements- non-trading	3,859,692	-	3,859,692	-	3,859,692
Liabilities					
Deposits by banks	14,591,570	-	14,590,281	-	14,590,281
Customer accounts	60,867,651	-	61,519,484	-	61,519,484
Debt securities in issue	5,139,667	-	5,136,741	-	5,136,741
At 31 December 2015					
Fair value					
Valuation techniques					
	Carrying amount AED000	Quoted market price Level 1 AED000	Using observable inputs Level 2 AED000	With significant unobservable inputs Level 3 AED000	Total AED000
Assets and liabilities not held for sale					
Assets					
Loans and advances to banks	13,553,668	-	13,557,525	-	13,557,525
Loans and advances to customers	67,861,215	-	-	67,305,414	67,305,414
Reverse repurchase agreements- non-trading	2,963,845	-	2,963,845	-	2,963,845
Liabilities					
Deposits by banks	12,619,282	-	12,618,546	-	12,618,546
Customer accounts	67,167,079	-	67,538,064	-	67,538,064
Debt securities in issue	5,643,810	-	5,639,264	-	5,639,264

Valuation

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

Notes on the Financial Statements (continued)

Loans and advances to banks and customers

The fair value of loans and advances is based on observable market transactions, where available. In the absence of observable market transactions, fair value is estimated using valuation models that incorporate a range of input assumptions. These assumptions may include value estimates from third party brokers which reflect over-the-counter trading activity; forward looking discounted cash flow models using assumptions which the Bank believes are consistent with those which would be used by market participants in valuing such loans; and trading inputs from other market participants which includes observed primary and secondary trades.

Loans are grouped, as far as possible, into homogeneous groups and stratified by loans with similar characteristics to improve the accuracy of estimated valuation outputs. The stratification of a loan book considers all material factors, including vintage, origination period, estimates of future interest rates, prepayment speeds, delinquency rates, loan-to-value ratios, the quality of collateral, default probability, and internal credit risk ratings.

The fair value of a loan reflects both loan impairments at the balance sheet date and estimates of market participants' expectations of credit losses over the life of the loans, and the fair value effect of repricing between origination and the balance sheet date.

Deposits by banks and customer accounts

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

Debt securities in issue and subordinated liabilities

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

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

30 Maturity analysis of assets and liabilities

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

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

Maturity analysis of assets and liabilities

	At 31 December 2016			At 31 December 2015		
	Due within one year AED000	Due after more than one year AED000	Total AED000	Due within one year AED000	Due after more than one year AED000	Total AED000
Assets						
Loans and advances to banks	13,452,322	2,020,436	15,472,758	11,803,985	1,749,683	13,553,668
Loans and advances to customers	37,166,098	25,767,091	62,933,189	34,922,811	32,938,404	67,861,215
Reverse repurchase agreements- non-trading	3,859,692	-	3,859,692	2,963,845	-	2,963,845
Financial investments	12,191,261	3,919,669	16,110,930	14,639,483	3,009,869	17,649,352
Other financial assets	1,389,362	422	1,389,784	1,941,896	4,578	1,946,474
	68,058,735	31,707,618	99,766,353	66,272,020	37,702,534	103,974,554
Liabilities						
Deposits by banks	9,370,785	5,220,785	14,591,570	12,619,282	-	12,619,282
Customer accounts	60,850,276	17,375	60,867,651	67,156,867	10,212	67,167,079
Financial liabilities designated at fair value	-	1,475,028	1,475,028	1,640,081	1,475,494	3,115,575
Debt securities in issue	3,131,794	2,007,873	5,139,667	444,815	5,198,995	5,643,810
Other financial liabilities	3,733,241	145,128	3,878,369	4,777,520	171,979	4,949,499
	77,086,096	8,866,189	85,952,285	86,638,565	6,856,680	93,495,245

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

Notes on the Financial Statements (continued)

	On demand AED000	Due within 3 months AED000	Due between 3 and 12 months AED000	Due between 1 and 5 years AED000	Due after 5 years AED000
At 31 December 2016					
Deposits by banks	1,081,137	3,441,057	4,848,591	5,220,786	-
Customer accounts	54,126,857	4,513,995	2,209,424	17,375	-
Trading liabilities	312,091	173,221	425,630	3,372,258	1,213,594
Financial liabilities designated at fair value.....	-	-	40,346	1,549,696	-
Derivatives.....	4,326,156	555	550,546	19,610	-
Debt securities in issue	-	1,006,146	2,125,648	1,857,571	150,301
Subordinated loan from Head Office	-	-	-	2,757,742	-
Other financial liabilities	3,093,347	388,117	251,778	145,128	-
	62,939,588	9,523,091	10,451,963	14,940,166	1,363,895
Guarantees and off balance sheet commitments	70,736,577	-	-	-	-
	133,676,165	9,523,091	10,451,963	14,940,166	1,363,895
At 31 December 2015					
Deposits by banks	911,030	11,671,527	36,725	-	-
Customer accounts	60,891,860	3,675,869	2,589,138	10,212	-
Trading liabilities	147,081	-	790,184	2,914,326	1,158,412
Financial liabilities designated at fair value.....	-	-	1,695,274	1,590,042	-
Derivatives.....	3,607,128	-	-	-	-
Debt securities in issue	-	-	444,815	4,839,628	359,367
Subordinated loan from Head Office	-	-	-	-	2,757,354
Other financial liabilities	3,747,604	662,621	367,296	171,979	-
	69,304,703	16,010,017	5,868,238	9,411,640	4,275,133
Guarantees and off balance sheet commitments	74,091,915	-	-	-	-
	143,396,618	16,010,017	5,868,238	9,411,640	4,275,133

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

Further discussion of the Bank's liquidity and funding management can be found in Note 35 'Risk management'.

31 Offsetting of financial assets and financial liabilities

The 'Amounts not set off in the balance sheet' in the following table for derivatives and loans and advances to customers and similar agreements include transactions where:

- the counterparty has an offsetting exposure with the Bank and a master netting or similar arrangement is in place with a right of set off only in the event of default, insolvency or bankruptcy, or the offset criteria are otherwise not satisfied; and
- cash and non-cash collateral has been received/pledged in respect of the transactions described above.

The 'Amounts not set off in the balance sheet' relate to transactions where the customer has an offsetting exposure with the Bank and an agreement is in place with the right of offset but the offset criteria are otherwise not satisfied. For risk management purposes, the net amounts of such exposures are subject to limits which are monitored and the relevant customer agreements are subject to review and updated, as necessary, to ensure that the legal right of offset remains appropriate.

Notes on the Financial Statements (continued)

Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements

	Gross amounts of recognised financial assets AED000	Gross amounts offset in the balance sheet AED000	Amounts presented in the balance sheet AED000	Amounts not set off in the balance sheet Cash collateral received AED000	Net amount AED000
At 31 December 2016					
Derivatives	4,558,739	-	4,558,739	-	4,558,739
Reverse repurchase, securities borrowing and similar agreements classified as:	3,859,692	-	3,859,692	-	3,859,692
- loans and advances to banks at amortised cost....	3,771,279	-	3,771,279	-	3,771,279
- loans and advances to customers at amortised cost	88,413	-	88,413	-	88,413
Loans and advances to customers excluding reverse repos at amortised cost	2,452,206	-	2,452,206	(565,472)	1,886,734
	10,870,637	-	10,870,637	(565,472)	10,305,165
At 31 December 2015					
Derivatives	3,329,812	-	3,329,812	-	3,329,812
Reverse repurchase, securities borrowing and similar agreements classified as:	2,963,845	-	2,963,845	-	2,963,845
- loans and advances to banks at amortised cost....	2,963,845	-	2,963,845	-	2,963,845
- loans and advances to customers at amortised cost	-	-	-	-	-
Loans and advances to customers excluding reverse repos at amortised cost	3,621,552	-	3,621,552	(646,924)	2,974,628
	9,915,209	-	9,915,209	(646,924)	9,268,285

Financial liabilities subject to offsetting, enforceable master netting arrangements and similar agreements

	Gross amounts of recognised financial liabilities AED000	Gross amounts offset in the balance sheet AED000	Amounts presented in the balance sheet AED000	Amounts not set off in the balance sheet Cash collateral pledged AED000	Net amount AED000
At 31 December 2016					
Derivatives	4,896,867	-	4,896,867	-	4,896,867
At 31 December 2015					
Derivatives	3,607,128	-	3,607,128	-	3,607,128

Financial assets and financial liabilities are offset and the net amount is 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 ('the offset criteria').

Notes on the Financial Statements (continued)

Derivatives and reverse repurchase/repurchase agreements included in the amounts not set off in the balance sheet column relate to transactions where:

- the counterparty has an offsetting exposure with the Bank and a master netting or similar arrangement is in place with a right of set off only in the event of default, insolvency or bankruptcy, or the offset criteria are otherwise not satisfied; and
- cash and non-cash collateral received/pledged in respect of the transactions described above. The Bank offsets certain loans and advances to customers and customer accounts when the offset criteria are met and the amounts presented above represent this subset of the total amounts recognised in the balance sheet. Of this subset, the loans and advances to customers and customer accounts included in amounts not set off in the balance sheet column primarily relate to transactions where the counterparty has an offsetting exposure with the Bank and an agreement is in place with the right of offset but the offset criteria are otherwise not satisfied.

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

Collateral accepted as security for assets:

The fair value of financial assets accepted as collateral that the Bank is permitted to sell or repledge in the absence of default is AED 3,859,692 thousand (2015: AED 2,963,845 thousand). The fair value of any such collateral that have been sold or repledged is AED Nil (2015: AED Nil). The Bank is obliged to return these assets. These transactions are conducted under terms that are usual and customary to standard securities borrowing and reverse repurchase agreements.

33 Subordinated liabilities

On 23 December 2009, a sub-ordinated loan of AED 2,754 million was provided by the Bank's Head Office. The loan carries an interest rate of Libor plus 320bps (2015: Libor plus 320bps) payable annually and full principal amount of the facility is to be repaid in December 2019. The loan was repriced to an interest rate of Libor plus 366bps on 23 December 2016. The Bank has the option to repay the loan, all or part only (together with accrued interest thereon), on any interest payment date falling in or after December 2016. The Central Bank of the UAE has approved the loan to be considered as Tier 2 capital for regulatory purposes. The balance includes accrued interest payable of AED 3,367 thousand (2015: AED 2,979 thousand).

34 Cash and cash equivalents

	2016 AED000	2015 AED000
Cash and balances at central bank	8,109,427	8,891,364
Loans and advances to banks maturing within 3 months.....	11,326,177	9,359,902
Central Bank certificates of deposit and other financial investments maturing within three months.....	6,687,458	11,944,461
	26,123,062	30,195,727

35 Risk management

All the Bank's activities involve, to varying degrees, the analysis, evaluation, acceptance and active management of risks or combinations of risks. The key financial risks that the Bank is exposed to are credit risk (including cross-border country risk), market risk (predominantly foreign exchange and interest rate risks) and liquidity risk. The Bank is also exposed to operational risk in various forms (including technology, projects, process, people, security and fraud risks). The Bank continues to enhance its capabilities and coverage of financial crime control. Other risks that the Bank is actively managing include legal risk, reputational risk, pensions risk, strategic risk (direction and execution) and ensuring the Bank complies with various regulatory requirements or takes necessary actions where it is not yet doing so.

Risk governance and ownership

An established risk governance and ownership structure ensures oversight of, and accountability for, the effective management of risk at the HSBC Group, regional and global business level. The risk management framework fosters the continuous monitoring of the risk environment and an integrated evaluation of risks and their interactions. Integral to the Bank's risk management framework are the enterprise tools of Risk Appetite, Top and Emerging ('T&E') Risks, Risk Map and Stress Testing.

Notes on the Financial Statements (continued)

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

Risk culture

The Bank's strong risk governance reflects the importance placed by the Board on managing risks effectively. It is supported by a clear policy framework of risk ownership and by the accountability of all staff for identifying, assessing and managing risks within the scope of their assigned responsibilities. This personal accountability, reinforced by the governance structure, experience and mandatory learning, helps to foster a disciplined and constructive culture of risk management and control throughout the Bank. Personal accountability is also reinforced by the Bank's values, with staff expected to be:

- dependable, doing the right thing;
- open to different ideas and culture; and
- connected to our customers, regulators and each other.

Risk appetite

Risk appetite, a key component of the Bank's risk management framework, is approved by the Board and describes the types and levels of risk that the Bank is prepared to accept in executing the Bank's strategy. The Bank's risk appetite is set out in the Bank's Risk Appetite Statement and is central to the annual planning process. Global businesses as well as countries are required to articulate their Risk Appetite Statements which are aligned with the Bank strategy.

Risk Appetite metrics are broadly categorized as Quantitative (earnings, risk weighted assets, revenue, funding, credit risk, traded risk, operational & business risk, financial crime and regulatory compliance) and Qualitative (financials, operating model and business practice) metrics. Measurements against the metrics serve to:

- guide underlying business activity, ensuring it is aligned to risk appetite statements;
- determine risk-adjusted remuneration;
- enable the key underlying assumptions to be monitored and, where necessary, adjusted through subsequent business planning cycles; and
- promptly identify business decisions needed to mitigate risk.

Credit risk

Credit risk management

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

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

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

Within the Bank, the Credit Risk function is headed by the Regional Heads of Credit & Market Risk (for wholesale) and Retail Banking & Wealth Management Risk (for retail) who report to the MENA CRO.

Notes on the Financial Statements (continued)

The Bank's local management is responsible for:

- Formulating and recording detailed credit policies and procedures, consistent with HSBC Group policy.
- Issuing policy guidelines to subsidiaries and offices on appetite for credit risk exposure to specified market sectors, activities and banking products and controlling exposures to certain high-risk sectors.
- Undertaking independent review and objective assessment of risk. Credit Risk assesses all commercial non-bank credit facilities and exposures over designated limits, prior to the facilities being committed to customers or transactions being undertaken.
- Monitoring the performance and management of portfolios.
- Maintaining policy on large credit exposures, ensuring that concentrations of exposure by counterparty, sector or geography do not become excessive in relation to the Bank's capital base and remain within internal and regulatory limits.
- Maintaining and developing the governance and operation of HSBC Group's risk rating framework and systems, to classify exposures.
- Reporting on retail portfolio performance, high risk portfolios, risk concentrations, country limits and cross-border exposures, large impaired accounts, impairment allowances and stress testing results and recommendations to the RMM, the Audit and Risk Committee and the HBME Board of Directors.
- Acting on behalf of the Bank as the primary interface, for credit-related issues, with external parties including the rating agencies, corporate analysts, trade associations etc.

The Bank is required to implement credit policies, procedures and lending guidelines that meet local requirements while conforming to the HSBC Group standards.

Credit quality

The Bank'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 Bank's retail business, risk is assessed and managed using a wide range of risk and pricing models to generate portfolio data.

The Bank's risk rating system facilitates the Internal Ratings Based ('IRB') approach for portfolio management purposes.

Special attention is paid to problem exposures in order to accelerate remedial action. Where appropriate, the Bank uses specialist units to provide customers with support in order to help them avoid default wherever possible.

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

Impairment assessment

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

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

Write-off of loans and advances

Loans are normally written off, either partially or in full, when there is no realistic prospect of further recovery. For secured loans, write-off generally occurs 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. Write-off periods may be extended, generally to no more than 360 days past due but in very exceptional circumstances exceeding that figure, where local regulation or legislation constrain earlier writeoff, or where the realisation of collateral for secured real estate lending extends to this time.

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.

Notes on the Financial Statements (continued)

Refinance risk

Many types of lending require the repayment of a significant proportion of the principal at maturity. Typically, the mechanism of repayment for the customer is through the acquisition of a new loan to settle the existing debt. Refinance risk arises where a customer is unable to repay such term debt on maturity, or to refinance debt at commercial rates. When there is evidence that this risk may apply to a specific contract, the Bank may need to refinance the loan on concessionary terms that it would not otherwise have considered, in order to recoup the maximum possible cash flows from the contract and potentially avoid the customer defaulting on the repayment of principal. When there is sufficient evidence that borrowers, based on their current financial capabilities, may fail at maturity to repay or refinance their loans, these loans are disclosed as impaired with recognition of a corresponding impairment allowance where appropriate.

Cross-border exposures

Management assesses the vulnerability of countries to foreign currency payment restrictions, including economic and political factors, when considering impairment allowances on cross-border exposures. Impairment allowances are assessed in respect of all qualifying exposures within these countries unless these exposures and the inherent risks are:

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

Credit exposure

Maximum exposure to credit risk

The Bank's exposure to credit risk is spread across a broad range of asset classes, including derivatives, trading assets, loans and advances to customers, loans and advances to banks, and financial investments.

The following table presents our 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 enhancements meet accounting offsetting requirements). For financial assets recognised on the balance sheet, the maximum exposure to credit risk equals their carrying amount; for financial guarantees and similar contracts granted, it is the maximum amount that we would have to pay if the guarantees were called upon. For loan commitments and other credit-related commitments, it is generally the full amount of the committed facilities.

The offset in the table relate to amounts where there is a legally enforceable right of offset in the event of counterparty default and where, as a result, there is a net exposure for credit risk purposes. However, as there is no intention to settle these balances on a net basis under normal circumstances, they do not qualify for net presentation for accounting purposes.

Notes on the Financial Statements (continued)

In the case of derivatives and reverse repos the offset column also includes collateral received in cash and other financial assets.

	At 31 December 2016			At 31 December 2015		
	Maximum exposure AED000	Offset AED000	Exposure to credit risk (net) AED000	Maximum exposure AED000	Offset AED000	Exposure to credit risk (net) AED000
Cash and balances at central bank	8,109,427	-	8,109,427	8,891,364	-	8,891,364
Trading assets	624,212	-	624,212	429,871	-	429,871
debt securities	335,451	-	335,451	365,794	-	365,794
loans and advances to customers ..	288,761	-	288,761	64,077	-	64,077
Derivatives	4,558,739	-	4,558,739	3,329,812	-	3,329,812
Loans and advances held at amortised cost	78,405,947	(565,472)	77,840,475	81,414,883	(646,924)	80,767,959
loans and advances to banks	15,472,758	-	15,472,758	13,553,668	-	13,553,668
loans and advances to customers ...	62,933,189	(565,472)	62,367,717	67,861,215	(646,924)	67,214,291
Reverse repurchase agreements- non-trading	3,859,692	-	3,859,692	2,963,845	-	2,963,845
Financial investments	16,110,930	-	16,110,930	17,649,352	-	17,649,352
other investments	-	-	-	-	-	-
debt securities.....	16,110,930	-	16,110,930	17,649,352	-	17,649,352
Other assets	1,389,784	-	1,389,784	1,946,474	-	1,946,474
endorsements and acceptances	1,070,093	-	1,070,093	1,564,989	-	1,564,989
accrued income and other	319,691	-	319,691	381,485	-	381,485
Financial guarantees and similar contracts	13,107,161	-	13,107,161	13,421,802	-	13,421,802
Loan commitments and other credit-related commitments.....	42,936,085	-	42,936,085	48,074,182	-	48,074,182
	169,101,977	(565,472)	168,536,505	178,121,585	(646,924)	177,474,661

Collateral and other credit enhancements held

Loans and advances held at amortised cost

Although collateral can be an important mitigant of credit risk, it is the Bank's practice to lend on the basis of the customer's ability to meet their obligations out of cash flow resources rather than rely on the value of security offered. Depending on the customer's standing and the type of product, facilities may be provided without security. However, for other lending a charge over collateral is obtained and considered in determining the credit decision and pricing. In the event of default, the bank may utilise the collateral as a source of repayment. Depending on its form, collateral can have a significant financial effect in mitigating the Bank's exposure to credit risk.

The tables below provide a quantification of the value of fixed charges the Bank holds over a borrower's specific asset (or assets) where the Bank has a history of enforcing, and are able to enforce, the collateral in satisfying a debt in the event of the borrower failing to meet its contractual obligations, and where the collateral is cash or can be realised by sale in an established market. The collateral valuation in the tables below excludes any adjustments for obtaining and selling the collateral.

The Bank may also manage its risk by employing other types of collateral and credit risk enhancements, such as second charges, other liens and unsupported guarantees, but the valuation of such mitigants is less certain and therefore the level of collateral on the remaining balance of loans and advances to customers has not been quantified. In particular, loans shown in the tables below as not collateralised or partially collateralised may benefit from such credit mitigants.

Notes on the Financial Statements (continued)

Personal lending – Residential mortgages by level of collateral:

	2016 AED000	2015 AED000
Non-impaired loans and advances		
Uncollateralised	23,956	22,701
Fully collateralised	6,580,682	6,400,807
Less than 50% loan to value ('LTV')	1,709,790	1,685,342
51% to 60% LTV	1,015,790	1,016,002
61% to 70% LTV	1,448,567	1,291,922
71% to 80% LTV	1,855,770	1,504,140
81% to 90% LTV	467,488	761,890
91% to 100% LTV	83,277	141,511
Partially collateralised		
Greater than 100% LTV (A)	242,442	156,716
101% to 110% LTV	54,454	45,201
111% to 120% LTV	39,887	14,942
Greater than 120% LTV	148,101	96,574
Collateral value on A	140,713	134,421
Total	6,847,080	6,580,224
Impaired loans and advances		
Fully collateralised	174,042	162,396
Less than 50% loan to value ('LTV')	59,580	64,231
51% to 60% LTV	1,791	17,829
61% to 70% LTV	38,837	26,239
71% to 80% LTV	10,046	14,668
81% to 90% LTV	32,058	20,714
91% to 100% LTV	31,730	18,716
Partially collateralised		
Greater than 100% LTV (A)	266,163	66,737
101% to 110% LTV	36,357	4,320
111% to 120% LTV	44,123	9,764
Greater than 120% LTV	185,683	52,653
Collateral value on A	232,114	48,063
Total	440,205	229,132
Total residential mortgages	7,287,285	6,809,356

The above table shows residential mortgage lending including off-balance sheet loan commitments by level of collateral. The collateral included in the table above consists of fixed first charges on real estate.

The LTV ratio is calculated as the gross on-balance sheet carrying amount of the loan and any off-balance sheet loan commitment at the balance sheet date divided by the value of collateral. The methodologies for obtaining residential property collateral values are typically determined through a combination of professional appraisals, house price indices or statistical analysis. The collateral valuation excludes any adjustments for obtaining and selling the collateral. Annual professional appraisals are conducted when a loan is identified and assessed as impaired.

Personal lending – Other personal lending:

The other personal lending consists primarily of credit cards and second lien portfolios. Credit cards and overdrafts are generally unsecured. Second lien lending is supported by collateral but the claim on the collateral is subordinate to the first lien charge.

Corporate and commercial and financial (non-banking) lending:

Collateral held is analysed below for commercial real estate and other corporate, and commercial and financial (non-bank) lending. This reflects the difference in collateral held on the portfolios.

Notes on the Financial Statements (continued)

Commercial real estate:

The following table shows commercial real estate lending including off-balance sheet loan commitments by level of collateral.

	2016 AED000	2015 AED000
Rated CRR/EL 1 to 7.....	1,189,420	1,479,737
Uncollateralised	1,079,609	1,348,221
Fully collateralised	109,811	131,516
Partially collateralised	-	-
- collateral value	-	-
Rated CRR/EL 8 to 10.....	726,497	709,420
Uncollateralised	14,335	19,818
Fully collateralised	712,161	25,168
Partially collateralised	1	664,434
- collateral value	-	325,467

The collateral included in the table above consists of fixed first charges on real estate. The value of commercial real estate collateral is determined through a combination of professional and internal valuations and physical inspection. Indexation for commercial real estate is not generally undertaken because reliable, sufficiently granular indices are not available. Due to the complexity of collateral valuations for commercial real estate these valuations are refreshed less frequently, with local valuation policies determining the frequency of review based on local market conditions. Typically revaluations are sought where, as part of the regular credit assessment of the obligor, material concerns arise in relation to the transaction which may reflect on the underlying performance of the collateral. Revaluations also occur commonly in circumstances where an obligor's credit quality has declined sufficiently to cause concern that the principal payment source may not fully meet the obligation (i.e. the obligor's credit quality classification indicates it is at the lower end e.g. sub-standard, or approaching impaired). The collateral valuations reported above exclude any adjustments for obtaining and selling the collateral.

Other corporate and commercial and financial (non-bank) lending:

The following table shows corporate and commercial and financial (non-bank) lending including off-balance sheet loan commitments by level of collateral.

	2016 AED000	2015 AED000
Rated CRR/EL 8 to 10.....	4,326,732	4,072,461
Uncollateralised	2,275,798	1,958,329
Fully collateralised	479,642	492,184
Partially collateralised	1,571,292	1,621,948
- collateral value	243,949	203,865

The collateral used in the assessment of the above primarily includes first legal charges over real estate and charges over cash in the commercial and industrial sector, and charges over cash and marketable financial instruments in the financial sector. Government sector lending is generally unsecured.

It should be noted that the table above excludes other types of charge which are commonly taken for corporate and commercial lending such as unsupported guarantees and floating charges over the assets of a customer's business. While such mitigants have utility, often providing rights in insolvency, their assignable value is insufficiently certain. They are assigned no value for disclosure purposes.

The collateral valuation will exclude any adjustments with respect to obtaining and selling the collateral.

Loans and advances to banks

Loans and advances to banks including off-balance sheet loan commitments in the CRR/EL 9 - 10 category had nil collateral.

Other credit risk exposures

In addition to collateralised lending described above, other credit enhancements are employed and methods used to mitigate credit risk arising from financial assets. These are described in more detail below.

Government, bank and other financial institution issued securities may benefit from additional credit enhancement, notably through government guarantees that references these assets.

Notes on the Financial Statements (continued)

The Bank's maximum exposure to credit risk includes financial guarantees and similar arrangement that it issues or enters into, and loan commitments that it is irrevocably committed to. Depending on the terms of the arrangement, the Bank may have recourse to additional credit mitigation in the event that a guarantee is called upon or a loan commitment is drawn and subsequently defaults.

Concentration of exposure

Concentrations of credit risk arise when a number of counterparties or exposure have comparable economic characteristics, or such counterparties are engaged in similar activities, or operate in the same geographical areas or industry sectors, so that their collective ability to meet contractual obligations is uniformly affected by changes in economic, political or other conditions. The Bank uses a number of controls and measures to minimize undue concentration of exposure in its portfolios across industry, country and global businesses. These include portfolio and counterparty limits, approval and review controls, and stress testing.

Wrong-way risk is an aggravated form of concentration risk and arises when there is a strong correlation between the counterparty's probability of default and the mark-to-market value of the underlying transaction. We use a range of procedures to monitor and control wrong-way risk, including requiring entities to obtain prior approval before undertaking wrong-way risk transactions outside pre-agreed guidelines.

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

- the majority of the Bank's exposure to credit risk is concentrated in the UAE. Within the UAE, the Bank's credit risk is diversified over a wide range of industrial and economic groupings; and
- the Bank's position as part of a major international banking group means, that it has a significant concentration of exposure to banking counterparties. The majority of credit risk to the banking industry at 31 December 2016 and 31 December 2015 was concentrated in the Middle East and Europe.

Loans and advances

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

Gross loans and advances to customers by industry sector

	Gross loans and advances to customers	
	2016	2015
	AED000	AED000
Personal		
Residential mortgages	7,275,423	6,809,356
Other personal	5,694,163	7,041,881
	12,969,586	13,851,237
Corporate and commercial		
Commercial, industrial and international trade	20,711,962	24,999,906
Commercial real estate	1,851,988	2,189,156
Other property-related	5,064,023	4,548,337
Government	4,537,431	5,745,777
Other commercial	12,087,733	11,254,260
	44,253,137	48,737,436
Financial		
Non-bank financial institutions	9,679,706	9,456,019
	9,679,706	9,456,019
Total gross loans and advances to customers	66,902,429	72,044,692
Impaired loans	5,019,662	4,823,111
- as a percentage of gross loans and advances to customers	7.50%	6.69%

Notes on the Financial Statements (continued)

Credit quality of financial instruments

The five credit quality classifications defined below each encompass a range of more granular, internal credit rating grades assigned to wholesale and retail lending business, as well as the external rating, attributed by external agencies to debt securities.

There is no direct correlation between the internal and external ratings at granular level, except to the extent each falls within a single quality classification.

Credit quality classification

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

¹ We observe the disclosure convention that, in addition to those classified as EL9 to EL10, retail accounts classified EL1 to EL8 that are delinquent by 90 days or more are considered impaired, unless individually they have been assessed as not impaired (see 'Past due but not impaired gross financial instruments').

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.

'Good': exposures require closer monitoring and demonstrate a good capacity to meet financial commitments, with low default risk.

'Satisfactory': exposures require closer monitoring and demonstrate an average to fair capacity to meet financial commitments, with moderate default risk.

'Sub-standard': exposures require varying degrees of special attention and default risk is of greater concern.

'Impaired': exposures have been assessed as impaired. These also include retail accounts classified as EL1 to EL8 that are delinquent by more than 90 days, unless individually they have been assessed as not impaired; and renegotiated loans that have met the requirements to be disclosed as impaired and have not yet met the criteria to be returned to the unimpaired portfolio.

Risk rating scales

The Customer Risk Rating ('CRR') 10-grade scale above summarises a more granular underlying 23-grade scale of obligor probability of default ('PD'). All distinct Bank customers use the 10 or 23-grade scale, depending on the degree of sophistication of the Basel II approach adopted for the exposure.

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

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

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

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

Notes on the Financial Statements (continued)

Distribution of financial instruments by credit quality

31 December 2016

	Neither past due nor impaired				Past due not impaired AED000	Impaired AED000	Impairment allowances AED000	Total AED000
	Strong AED000	Good AED000	Satisfactory AED000	Sub-Standard AED000				
Cash and balances at central bank	8,109,427	-	-	-	-	-	-	8,109,427
Trading assets	251,627	91,868	275,012	5,705	-	-	-	624,212
– treasury and other eligible bills.....	-	-	-	-	-	-	-	-
– debt securities .	208,893	91,868	28,985	5,705	-	-	-	335,451
– loans and advances to banks	-	-	164,649	-	-	-	-	164,649
– loans and advances to customers	42,734	-	81,378	-	-	-	-	124,112
Derivatives	684,779	1,150,283	2,713,556	10,121	-	-	-	4,558,739
Loans and advances held at amortised cost	35,031,916	16,794,586	21,146,583	1,549,910	2,681,218	5,170,976	(3,969,242)	78,405,947
– loans and advances to banks	5,763,422	1,161,979	8,494,886	52,471	-	-	-	15,472,758
– loans and advances to customers	29,268,494	15,632,607	12,651,697	1,497,439	2,681,218	5,170,976	(3,969,242)	62,933,189
Reverse repurchase agreements - non-trading.....	2,042,940	1,816,752	-	-	-	-	-	3,859,692
Financial investments	6,061,588	-	10,049,342	-	-	-	-	16,110,930
– treasury and other eligible bills	-	-	548,473	-	-	-	-	548,473
– debt securities .	6,061,588	-	9,500,869	-	-	-	-	15,562,457
Other assets	41,157	395,716	818,151	53,482	19,403	61,875	-	1,389,784
– endorsements and acceptances	38,541	395,694	504,133	53,482	16,368	61,875	-	1,070,093
– accrued income and other	2,616	22	314,018	-	3,035	-	-	319,691
Total	52,223,434	20,249,205	35,002,644	1,619,218	2,700,621	5,232,851	(3,969,242)	113,058,731

Notes on the Financial Statements (continued)

31 December 2015								
	Neither past due nor impaired				Past due not impaired AED000	Impaired AED000	Impairment allowances AED000	Total AED000
	Strong AED000	Good AED000	Satisfactory AED000	Sub-Standard AED000				
Cash and balances at central bank	8,891,364	-	-	-	-	-	-	8,891,364
Trading assets	243,827	80,304	98,044	7,696	-	-	-	429,871
– treasury and other eligible bills.....	-	-	-	-	-	-	-	-
– debt securities ...	243,827	80,304	33,967	7,696	-	-	-	365,794
– loans and advances to banks	-	-	42,179	-	-	-	-	42,179
– loans and advances to customers	-	-	21,898	-	-	-	-	21,898
Derivatives	648,614	818,704	1,836,389	26,105	-	-	-	3,329,812
Loans and advances held at amortised cost	31,007,899	24,853,137	21,884,795	1,748,500	1,187,068	4,916,961	(4,183,477)	81,414,883
– loans and advances to banks	3,696,089	3,713,131	6,075,902	68,546	-	-	-	13,553,668
– loans and advances to customers	27,311,810	21,140,006	15,808,893	1,679,954	1,187,068	4,916,961	(4,183,477)	67,861,215
Reverse repurchase agreements - non-trading.....	1,625,568	1,338,277	-	-	-	-	-	2,963,845
Financial investments	8,095,163	-	9,554,189	-	-	-	-	17,649,352
– treasury and other eligible bills	4,101,279	-	1,457,819	-	-	-	-	5,559,098
– debt securities ...	3,993,884	-	8,096,370	-	-	-	-	12,090,254
Other assets.....	35,168	731,020	1,088,117	72,279	11,715	8,175	-	1,946,474
– endorsements and acceptances	34,839	730,745	712,585	72,279	6,366	8,175	-	1,564,989
– accrued income and other	329	275	375,532	-	5,349	-	-	381,485
Total.....	50,547,603	27,821,442	34,461,534	1,854,580	1,198,783	4,925,136	(4,183,477)	116,625,601

Past due but not impaired gross financial instruments

Past due but not impaired loans are those for which the customer is in the early stages of delinquency and has failed to make a payment, or a partial payment, in accordance with the contractual terms of the loan agreement. This is typically where a loan is less than 90 days past due and there are no other indicators of impairment.

Examples of exposures past due but not impaired include overdue loans fully secured by cash collateral; mortgages that are individually assessed for impairment, and that are in arrears more than 90 days, but where the value of collateral is sufficient to repay both the principal debt and all potential interest for at least one year; and short-term trade facilities past due more than 90 days for technical reasons such as delays in documentation, but where there is no concern over the creditworthiness of the counterparty.

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.

Notes on the Financial Statements (continued)

	Up to 29 days AED000	30-59 days AED000	60-89 days AED000	90-179 days AED000	Over 180 days AED000	Total AED000
At 31 December 2016	2,229,208	178,354	220,751	24,290	28,616	2,681,219
At 31 December 2015	661,753	145,401	284,076	84,299	11,539	1,187,068

Renegotiated loans and forbearance

A range of forbearance strategies are employed in order to improve the management of customer relationships, maximise collection opportunities and, if possible, avoid default, foreclosure or repossession. They include extended payment terms, a reduction in interest or principal repayments, approved external debt management plans, debt consolidations, the deferral of foreclosures, and other forms of loan modifications and re-ageing.

HSBC Group's policies and practices are based on criteria which enable local management to judge whether repayment is likely to continue. These typically provide a customer with terms and conditions that are more favourable than those provided initially. Loan forbearance is only granted in situations where the customer has showed a willingness to repay the borrowing and is expected to be able to meet the revised obligations. For retail lending our credit risk management policy sets out restrictions on the number and frequency of renegotiations, the minimum period an account must have been opened before any renegotiation can be considered and the number of qualifying payments that must be received. The application of this policy varies according to the nature of the market, the product and the management of customer relationships through the occurrence of exceptional events.

The contractual terms of a loan may be modified for a number of reasons which include changing market conditions, customer retention and other factors not related to the current or potential credit deterioration of a customer. 'Forbearance' describes concessions made on the contractual terms of a loan in response to an obligor's financial difficulties. The Bank classify and report loans on which concessions have been granted under conditions of credit distress as 'renegotiated loans' when their contractual payment terms have been modified, because the Bank has significant concerns about the borrowers' ability to meet contractual payments when due. Concessions on loans made to customers which do not affect the payment structure or basis of repayment, such as waivers of financial or security covenants, do not directly provide concessionary relief to customers in terms of their ability to service obligations as they fall due and are therefore not included in this classification.

Identifying renegotiated loans

Loans are identified as renegotiated loans when the Bank modifies the contractual payment terms due to significant credit distress of the borrower. 'Forbearance' describes concessions made on the contractual terms of a loan in response to an obligor's financial difficulties. The Bank classifies and report loans on which concessions have been granted under conditions of credit distress as 'renegotiated loans' when their contractual payment terms have been modified because the Bank has significant concerns about the borrowers' ability to meet contractual payments when due.

When considering modification terms, the borrower's continued ability to repay is assessed and where they are unrelated to payment arrangements, whilst potential indicators of impairment, these loans are not considered as renegotiated loans. Loans that have been identified as renegotiated retain this designation until maturity or derecognition. A loan that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement is made on substantially different terms or if the terms of an existing agreement are modified such that the renegotiated loan is substantially a different financial instrument. Any new loans that arise following derecognition events will continue to be disclosed as renegotiated loans.

Credit quality classification of renegotiated loans

Under IFRS, an entity is required to assess whether there is objective evidence that financial assets are impaired at the end of each reporting period. A loan is impaired when there is objective evidence of a loss event that has an effect on the cash flows of the loan which can be reliably estimated. When the Bank grants a concession to a customer that the Bank would not otherwise consider, as a result of its financial difficulty, this is objective evidence of impairment and impairment losses are measured accordingly.

A renegotiated loan is presented as impaired when:

- there has been a change in contractual cash flows as a result of a concession which the lender would otherwise not consider, and
- it is probable that without the concession, the borrower would be unable to meet contractual payment obligations in full.

This presentation applies unless the concession is insignificant and there are no other indicators of impairment.

The renegotiated loan will continue to be disclosed as impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, and there are no other indicators of impairment.

Notes on the Financial Statements (continued)

Renegotiated loans are classified as unimpaired where the renegotiation has resulted from significant concern about a borrower's ability to meet their contractual payment terms but the renegotiated terms are based on current market rates and contractual cash flows are expected to be collected in full following the renegotiation. Unimpaired renegotiated loans also include previously impaired renegotiated loans that have demonstrated satisfactory performance over a period of time or have been assessed based on all available evidence as having no remaining indicators of impairment.

Loans that have been identified as renegotiated retain this designation until maturity or derecognition. When a loan is restructured as part of a forbearance strategy and the restructuring results in derecognition of the existing loan, such as in some debt consolidations, the new loan is disclosed as renegotiated.

When determining whether a loan that is restructured should be derecognised and a new loan recognised, we consider the extent to which the changes to the original contractual terms result in the renegotiated loan, considered as a whole, being a substantially different financial instrument.

Renegotiated loans and advances to customers

	At 31 December 2016				At 31 December 2015			
	Neither past due nor impaired AED000	Past due but not impaired AED000	Impaired AED000	Total AED000	Neither past due nor impaired AED000	Past due but not impaired AED000	Impaired AED000	Total AED000
Retail	48,391	4,972	151,792	205,155	104,144	20,252	90,694	215,090
– Residential mortgages	38,340	435	101,946	140,721	40,997	16,442	77,295	134,734
– Other personal	10,051	4,537	49,846	64,434	63,147	3,810	13,399	80,356
Commercial real estate	-	586,201	1,426,963	2,013,164	561,864	-	1,522,356	2,084,220
Corporate and commercial	1,350	111,941	1,287,496	1,400,787	51,829	52,335	1,293,412	1,397,576
Financial	951,567	-	-	951,567	655,651	88,260	-	743,911
Total renegotiated loans and advances to customers	1,001,308	703,114	2,866,251	4,570,673	1,373,488	160,847	2,906,462	4,440,797
Total impairment allowance on renegotiated loans.....				1,582,834				1,781,051

For retail lending, renegotiated loans are segregated from other parts of the loan portfolio for collective impairment assessment to reflect the higher rates of losses often encountered in these segments. When empirical evidence indicates an increased propensity to default and higher losses on such accounts, the use of roll-rate methodology ensures these factors are taken into account when calculating impairment allowances by applying roll rates specifically calculated on the pool of loans subject to forbearance. When the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, a basic formulaic approach based on historical loss rate experience is used. As a result of our roll-rate methodology, we recognise collective impairment allowances on homogeneous groups of loans, including renegotiated loans, where there is historical evidence that there is a likelihood that loans in these groups will progress through the various stages of delinquency, and ultimately prove irrecoverable as a result of events occurring before the balance sheet date. This treatment applies irrespective of whether or not those loans are presented as impaired in accordance with our impaired loans disclosure convention. When the Bank considers that there are additional risk factors inherent in the portfolios that may not be fully reflected in the statistical roll rates or historical experience, these risk factors are taken into account by adjusting the impairment allowances derived solely from statistical or historical experience.

In the corporate and commercial sectors, renegotiated loans are typically assessed individually. Credit risk ratings are intrinsic to the impairment assessment. A distressed restructuring is classified as an impaired loan. The individual impairment assessment takes into account the higher risk of the non-payment of future cash flows inherent in renegotiated loans.

Impaired loans

Impaired loans and advances are those that meet any of the following criteria:

- loans and advances classified as CRR 9, CRR 10, EL 9 or EL 10 (a description of our internal credit rating grades is provided above;
- retail exposures 90 days or more past due, unless individually they have been assessed as not impaired; or

Notes on the Financial Statements (continued)

- renegotiated loans and advances that have been subject to a change in contractual cash flows as a result of a concession which the lender would not otherwise consider, and where it is probable that without the concession the borrower would be unable to meet its contractual payment obligations in full, unless the concession is insignificant and there are no other indicators of impairment. Renegotiated loans remain classified as impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, and there are no other indicators of impairment.

Movement in impairment allowances on loans and advances to customers

	Customers		Total AED000
	Individually assessed AED000	Collectively assessed AED000	
At 1 January 2016	3,321,291	862,186	4,183,477
Amounts written off	(382,895)	(365,266)	(748,161)
Recoveries of loans and advances written off in previous years	17,308	59,559	76,867
Charge to income statement	365,929	57,210	423,139
Exchange and other movements	(4,967)	38,885	33,918
At 31 December 2016	3,316,666	652,574	3,969,240
At 1 January 2015	2,768,605	563,718	3,332,323
Amounts written off	(62,293)	(251,312)	(313,605)
Recoveries of loans and advances written off in previous years	2,951	75,301	78,252
Charge to income statement	556,214	474,371	1,030,585
Exchange and other movements	55,814	108	55,922
At 31 December 2015	3,321,291	862,186	4,183,477

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

	At 31 December	
	2016 %	2015 %
<i>Customers</i>		
Individually assessed impairment allowances	4.96	4.61
Collectively assessed impairment allowances	0.98	1.20
	5.94	5.81

Liquidity and funding risk management framework

The Bank has an internal liquidity and funding risk management framework ('LFRF') which aims to allow it to withstand very severe liquidity stresses. It is designed to be adaptable to changing business models, markets and regulations.

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

Funding risk is the risk that funding considered to be sustainable (and therefore used to fund assets) proves not to be sustainable over time.

The management of liquidity and funding is primarily undertaken locally (by country) in the operating entities in compliance with the Bank's LFRF, and with practices and limits set by the Group Management Board ('GMB') through the RMM and approved by the Holdings Board for 'RMM operating entities'. The UAE branch of the bank is one such operating entity.

Limits for non-RMM operating entities are established by the intermediate parent company ALCO. The HBME ALCO is responsible for setting limits for the Bank non-RMM operating entities. The Bank's general policy is that each defined operating entity should be self-sufficient in funding its own activities. Where transactions exist between operating entities, they are reflected symmetrically in both entities.

As part of the Asset, Liability and Capital Management ('ALCM') structure, the Bank has established ALCOs at Group level, in the regions and in operating entities. The terms of reference of all ALCOs include the monitoring and control of liquidity and funding.

Notes on the Financial Statements (continued)

The primary responsibility for managing liquidity and funding within the Bank's framework and risk appetite resides with the local operating entities' ALCOs, Holdings ALCO and the RMM. Our most significant operating entities are overseen by HBME ALCO, HSBC Group ALCO and the HSBC Group Risk Management Meeting. The remaining smaller operating entities are overseen by HBME ALCO, with appropriate escalation of significant issues to HSBC Group ALCO and the HSBC Group Risk Management Meeting.

Operating entities are predominately defined on a country basis to reflect the Bank's local management of liquidity and funding.

Primary sources of funding

Customer deposits in the form of current accounts and savings deposits payable on demand or at short notice form a significant part of our funding, and the Bank places considerable importance on maintaining their stability. For deposits, stability depends upon maintaining depositor confidence in our capital strength and liquidity, and on competitive and transparent pricing. Of total liabilities of AED 100,489 million at 31 December 2016, funding from customers amounted to AED 60,793million, of which AED 60,776 million was contractually repayable within one year. An analysis of cash flows payable by the Bank under financial liabilities by remaining contractual maturities at the balance sheet date is included in Note 30.

Assets available to meet these liabilities, and to cover outstanding commitments to lend (AED 113, 973million), included cash, central bank balances, items in the course of collection and treasury and other bills (AED 548 million); loans to banks (AED 15,519 million, including AED 13,498million repayable within one year); and loans to customers (AED 62,887 million, including AED 37,120 million repayable within one year). In the normal course of business, a proportion of customer loans contractually repayable within one year will be extended.

The Bank also accesses wholesale funding markets by issuing senior secured and unsecured debt securities (publicly and privately) and borrowing from the secured repo markets against high quality collateral to align asset and liability maturities and currencies and to maintain a presence in local wholesale markets.

Ordinary share capital and retained reserves, non-core capital instruments and intergroup borrowings are also a source of stable funding.

Liquidity coverage ratio ('LCR')

The Bank defines operational deposits as transactional (current) accounts arising from the provision of custody services by HSBC Security Services or Global Liquidity and Cash Management, where the operational component is assessed to be the lower of the current balance and the separate notional values of debits and credits across the account in the previous calculation period.

Unaudited	Liquidity coverage ratio during:	
	2016	2015
	%	%
Year-end	241.0	217.3

Net Stable Funding Ratio

Net Stable Funding Ratio limits for major markets in which the Bank operates are set by ALCO. The ratio describes available stable funding is derived from the liability base to the required stable funding is derived by applying haircuts to the quantum of loan and other asset balances which require funding.

Unaudited	Net Stable Funding Ratio during:	
	2016	2015
	%	%
Year-end.....	140.7	136.4

Depositor concentration and term funding maturity concentration

The LCR and NSFR metrics assume a stressed outflow based on a portfolio of depositors within each deposit segment. The validity of these assumptions is challenged if the portfolio of depositors is not large enough to avoid depositor concentration. Operating entities are exposed to term re-financing concentration risk if the current maturity profile results in future maturities being overly concentrated in any defined period.

At 31 December 2016, the bank was within the risk tolerance levels set for depositor concentration and term funding maturity concentration.

Notes on the Financial Statements (continued)

Market risk management

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

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

Market risk measures

Monitoring and limiting market risk exposures

The Bank's objective is to manage and control market risk exposures while maintaining a market profile consistent with the Bank's risk appetite. The Bank uses a range of tools to monitor and limit market risk exposures, including:

- sensitivity measures include sensitivity of net interest income and sensitivity for structural foreign exchange, which are used to monitor the market risk positions within each risk type;
- value at risk ('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; and
- in recognition of VaR's limitations the Bank augments VaR with stress testing to evaluate the potential impact on portfolio values of more extreme, though plausible, events or movements in a set of financial variables.

Market risk is managed and controlled through limits approved by the Risk Management Meeting of the GMB for HSBC Holdings and our various global businesses. These limits are allocated across business lines and to the HSBC Group's legal entities.

The management of market risk is principally undertaken in Global Markets. VaR limits are set for portfolios, products and risk types, with market liquidity being a primary factor in determining the level of limits set.

VaR limits are set for portfolios, products and risk types, with market liquidity being a primary factor in determining the level of limits set. HSBC Group Risk, an independent unit within HSBC Group, is responsible for our market risk management policies and measurement techniques. The Bank has an independent market risk management and control function that is responsible for measuring market risk exposures in accordance with the policies defined by HSBC Group Risk, and monitoring and reporting these exposures against the prescribed limits on a daily basis.

The Bank assesses the market risks arising on each product in its business and to transfer them to either its Global Markets unit for management, or to separate books managed under the supervision of the local ALCO. Our aim is to ensure that all market risks are consolidated within operations that have the necessary skills, tools, management and governance to manage them professionally. In certain cases where the market risks cannot be fully transferred, the Bank identifies the impact of varying scenarios on valuations or on net interest income resulting from any residual risk positions.

Sensitivity analysis

Sensitivity analysis measures the impact of individual market factor movements on specific instruments or portfolios, including interest rates, foreign exchange rates and equity prices, such as the effect of a one basis point change in yield. We use sensitivity measures to monitor the market risk positions within each risk type. 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 Bank are predominantly based on historical simulation. These models derive plausible future scenarios from past series of recorded market rates and prices, taking into account 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 assess potential market movements with reference to data from the past two years and calculate VAR to a 99% confidence level and for a one-day holding period.

Notes on the Financial Statements (continued)

The Bank 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 Bank would expect to see losses in excess of VAR only 1% of the time over a one-year period. The actual number of excesses over this period can therefore be used to gauge how well the models are performing.

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

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

Trading and non-trading portfolios

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

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

1. The reporting of commodity risk is with foreign exchange risk and is not applicable to non-trading portfolios.

Value at risk of the trading and non-trading portfolios

The Bank VAR, both trading and non-trading, is below:

Value at risk

	2016 AED000	2015 AED000
At 31 December	14,038	8,344
Average	13,184	10,311
Minimum	3,884	6,701
Maximum	21,929	14,527

Trading portfolios

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

Notes on the Financial Statements (continued)

Market-making and position-taking is undertaken within Global Markets. The VAR for such trading intent activity at 31 December 2016 was AED 5.0 million (2015: AED 2.9 million). This is analysed below by risk type:

VAR by risk type for the trading intent activities

	Foreign exchange AED000	Interest rate AED000	Credit AED000	Total ¹ AED000
At 31 December 2016	796	5,260	456	4,979
At 31 December 2015	700	2,738	1,095	2,905
Average				
2016	840	6,044	905	6,203
2015	580	2,413	1,843	3,044
Minimum				
2016	321	854	277	6,165
2015	234	1,015	989	1,416
Maximum				
2016	9,815	12,165	1,872	12,366
2015	1,340	5,052	4,993	5,789

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

Gap risk

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

Given the characteristics of these transactions, they will make little or no contribution to VAR or to traditional market risk sensitivity measures. The Bank captures the risks for such transactions within the stress testing scenarios and monitor gap risk on an ongoing basis. The Bank incurred no material gap losses arising from movements in the underlying market price on such transactions in the 12 months ended 31 December 2016.

De-peg risk

For currencies such as the AED that are pegged or managed, the spot exchange rate is pegged at a fixed rate (typically to USD), or managed within a predefined band around a pegged rate. De-peg risk is the risk of the peg or managed band changing or being abolished, and moving to a floating regime.

Using stressed scenarios on spot rates, the Bank is able to analyse how de-peg events would impact the positions held by the Bank. This complements traditional market risk metrics, such as historical VaR, which may not fully capture the risk involved in holding positions in pegged currencies. Historical VaR relies on past events to determine the likelihood of potential profits or losses.

However, pegged or managed currencies may not have experienced a de-peg event during the historical timeframe being considered.

Non-trading portfolios

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

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

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

Notes on the Financial Statements (continued)

Sensitivity of net interest income

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

For simulation modelling, businesses use a combination of scenarios relevant to their local businesses and markets and standard scenarios which are required throughout the HSBC Group.

Projected net interest income sensitivity figures represent the effect of the pro forma movements in net interest income based on the projected yield curve scenarios and the Bank's current interest rate risk profile. This effect, however, does not incorporate actions which would probably be taken by Global Markets or in the business units to mitigate the effect of interest rate risk. In reality, Global Markets seeks proactively to change the interest rate risk profile to minimise losses and optimise net revenues. The projections also assume that interest rates of all maturities move by the same amount (although rates are not assumed to become negative in the falling rates scenario) and, therefore, do not reflect the potential impact on net interest income of some rates changing while others remain unchanged. In addition, the projections take account of the effect on net interest income of anticipated differences in changes between interbank interest rates and interest rates linked to other bases (such as Central Bank rates or product rates over which the entity has discretion in terms of the timing and extent of rate changes). The projections make other simplifying assumptions, including that all positions run to maturity.

Defined benefit pension scheme

Market risk also arises within the Bank's defined benefit pension schemes to the extent that the obligations of the schemes are not fully matched by assets with determinable cash flows.

Operational risk

Operational risk management

Operational risk is the risk to achieving the strategy or objectives as a result of inadequate or failed internal processes, people and systems, or from external events. Operational risk is relevant to every aspect of the Bank's business and covers a wide spectrum of issues, in particular legal, compliance, security and fraud. Losses arising from breaches of regulation and law, unauthorised activities, error, omission, fraud, systems failure or external events all fall within the definition of operational risk.

Business and Regional Risk Management Meetings, which are a forward-looking holistic forum for all aspects of risk management including operational risk, ensure that all countries and business units maintain an operational risk management framework ('ORMF') that meets the Bank's minimum standards.

Responsibility for minimising operational risk lies with all the Bank's employees. Specifically, all staff are required to manage the operational risks of the business and operational activities for which they are responsible.

A centralised database is used to record the results of the operational risk management process. Operational risk and control 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 USD 10,000.

Operational risk management framework

The Bank's ORMF is the overarching approach for managing operational risk, the purpose of which is to:

- Identify and manage our operational risks in an effective manner.
- Remain within the Bank's operational risk appetite, which helps the organisation understand the level of risk it is willing to accept.
- Drive forward-looking risk awareness and assist management focus during 2016.

The ORMF defines minimum standards and processes, and the governance structure for the management of operational risk and internal control in our geographical regions, global businesses and global functions. The ORMF has been codified in a high-level standards manual, supplemented with detailed policies, which describes our approach to identifying, assessing, monitoring and controlling operational risk and gives guidance on mitigating action to be taken when weaknesses are identified.

Activity to strengthen the Bank's risk culture and better embed the use of the ORMF was further implemented in 2016. In particular, the Bank continued to streamline our operational risk management processes, procedures and tool sets to provide more forward-looking risk insights and more effective operation of the ORMF.

Notes on the Financial Statements (continued)

Three Lines of Defence

All employees are responsible for identifying and managing risk within the scope of their role as part of the three lines of defence model. The group uses an activity-based three lines of defence model to delineate management accountabilities and responsibilities for risk management and the control environment. This creates a robust control environment to manage risks. The model underpins the approach to risk management by clarifying responsibility, encouraging collaboration, and enabling efficient coordination of risk and control activities.

The three lines of defence are summarised below:

- The first line of defence owns the risks and is responsible for identifying, recording, reporting and managing them, and ensuring that the right controls and assessments are in place to mitigate them.
- The second line of defence sets the policy and guidelines for managing specific risk areas, provides advice and guidance in relation to the risk, and challenges the first line of defence on effective risk management.
- The third line of defence is our Internal Audit function, which provides independent and objective assurance of the adequacy of the design and operational effectiveness of the group's risk management framework and control governance process.

Capital management

The Bank's regulator, the Central Bank of the UAE, sets and monitors regulatory capital requirements. The Bank's objectives when managing capital are to:

- Safeguard the Bank's ability to continue as a going concern; and
- Comply with regulatory capital requirements set by the Central Bank of the UAE.

The Bank's regulatory capital adequacy ratio is set by the Central Bank of the UAE at a minimum level of 12% (2015: 12%). The Bank's regulatory capital is analysed into two tiers:

- Tier 1 capital, which includes allocated capital and retained earnings (excluding current year profit); and
- Tier 2 capital, which includes collective impairment provision and subordinated facilities.

Capital structure as at 31 December

(Unaudited)

	2016 Basel II AED000	2015 Basel II AED000
Composition of regulatory capital		
Tier 1 capital	11,875,472	10,772,918
Tier 2 capital	2,577,887	3,150,446
Total regulatory capital	14,453,359	13,923,364
Risk weighted assets		
Credit and counterparty risk	74,020,936	75,755,700
Market risk	2,872,952	3,613,795
Operational risk	9,373,971	8,953,460
	86,267,859	88,322,955
Capital ratios	%	%
Capital adequacy ratio	16.75	15.76

Notes on the Financial Statements (continued)

36 Contingent liabilities, contractual commitments and guarantees

	2016 AED000	2015 AED000
Guarantees and other contingent liabilities		
Guarantees	27,800,492	26,017,733
	27,800,492	26,017,733
Commitments		
Documentary credits and short-term trade-related transactions	732,179	820,711
Undrawn formal standby facilities, credit lines and other commitments to lend	42,203,906	47,253,471
	42,936,085	48,074,182

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

37 Lease commitments

Operating lease commitments

At 31 December 2016, the Bank was obligated under a number of non-cancellable operating leases for properties, plant and equipment for which the future minimum lease payments extend over a number of years.

	Land and buildings	
	2016 AED000	2015 AED000
Future minimum lease payments under non-cancellable operating leases expiring:		
– no later than one year	70,159	71,831
– later than one year and no later than five years	109,936	137,247
– later than five years	14,510	23,020
	194,605	232,098

Finance lease receivables

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

	Present value of financial lease commitments	
	2016 AED000	2015 AED000
Lease receivables:		
– no later than one year	996,226	1,000,810
– later than one year and no later than five years	43,897	33,200
– later than five years	219,910	17,253
	1,260,033	1,051,263

38 Interests in associates and Joint Arrangements

Associates of the Bank

Summarised financial information in respect of associates not individually significant

	2016 AED000	2015 AED000
Carrying value	-	277,071

Notes on the Financial Statements (continued)

Joint arrangement of the Bank

At 31 December 2016				
	Country of incorporation	Principal activity	The Bank's interest in equity capital	Issued equity capital
HSBC Middle East Leasing Partnership	Dubai, UAE	Leasing	15.00%	US\$503 million fully paid

The former structure of HSBC Middle East Leasing Partnership ('MELP'), a strategic aircraft leasing arrangement between HSBC France ('HBFR') and the Bank, was treated as an associate reflecting the significant influence over the partnership established as a result of representation on the Board of Partners.

On 1 December 2016, the partnership agreement of MELP was revised which changed the entity structure to 'Joint Operation' between HBFR and the Bank, which has resulted in respective ownership interest in the underlying assets and liabilities that are beneficially owned and incurred by the parties directly by virtue of MELP's transparent legal form, instead of investment in net assets.

Upon acquisition of joint control, the Bank's accounting has changed to joint operations and therefore has de-recognised its investment in associate and recognised 15% of MELP's assets, liabilities, prospective revenues, and expenses and accounted for them consistently with other directly owned assets. A gain of AED 6,620 thousand was made on the acquisition and is included within 'Other operating income'.

39 Legal proceedings and regulatory matters

The Bank is party to legal proceedings, investigations and regulatory matters in a number of jurisdictions arising out of its normal business operations. Apart from the matters described below, the Bank considers that none of these matters are material. While the outcome of legal proceedings and regulatory matters is inherently uncertain, management believes that, based on the information available to it, appropriate provisions have been made in respect of these matters as at 31 December 2016. Any provision recognised does not constitute an admission of wrongdoing or legal liability. It is not practicable to provide an aggregate estimate of potential liability for our legal proceedings and regulatory matters as a class of contingent liabilities.

Anti-money laundering and sanctions-related

(Matters relevant to HBME and its branches, as a subsidiary of HSBC operating in the Middle East)

In October 2010, HSBC Bank USA entered into a consent order with the Office of the Comptroller of the Currency (the 'OCC'), and HSBC North America Holdings Inc. ('HNAH') entered into a consent order with the Federal Reserve Board (the 'FRB') (each an 'Order' and together, the 'Orders'). These Orders required improvements to establish an effective compliance risk management programme across HSBC's US businesses, including risk management related to the Bank Secrecy Act ('BSA') and anti-money laundering ('AML') compliance. HSBC Bank USA is not currently in compliance with the OCC Order. Steps are being taken to address the requirements of the Orders.

In December 2012, HSBC Holdings, HNAH and HSBC Bank USA entered into agreements with US and UK government agencies regarding past inadequate compliance with the BSA, AML and sanctions laws. Among those agreements, HSBC Holdings and HSBC Bank USA entered into a five-year deferred prosecution agreement with, among others, the DoJ (the 'US DPA'); and HSBC Holdings consented to a cease-and-desist order, and HSBC Holdings and HNAH consented to a civil money penalty order with the FRB. HSBC Holdings also entered into an agreement with the Office of Foreign Assets Control ('OFAC') regarding historical transactions involving parties subject to OFAC sanctions, as well as an undertaking with the UK FCA to comply with certain forward-looking AML and sanctions-related obligations. In addition, HSBC Bank USA entered into civil money penalty orders with the Financial Crimes Enforcement Network of the US Treasury Department and the OCC.

Under these agreements, HSBC Holdings and HSBC Bank USA made payments totalling US\$1.9bn to US authorities and undertook various further obligations, including, among others, to continue to cooperate fully with the DoJ in any and all investigations, not to commit any crime under US federal law subsequent to the signing of the agreement, and to retain an independent compliance monitor (the 'Monitor'). In February 2017, the Monitor delivered his third annual follow-up review report.

Notes on the Financial Statements (continued)

Through his country-level reviews, the Monitor identified potential anti-money laundering and sanctions compliance issues that the DoJ and HSBC are reviewing further. The potential consequences of breaching the US DPA could include the imposition of additional terms and conditions on HSBC, an extension of the agreement, including its monitorship, or the criminal prosecution of HSBC, which could, in turn, entail further financial penalties and collateral consequences. Additional consequences of breaching the DPA orders could have a material adverse effect on HSBC's business, financial condition and results of operations, including loss of business and withdrawal of funding, restrictions on performing dollar-clearing functions through HSBC Bank USA or revocation of bank licenses.

These settlements with US and UK authorities have led to private litigation, and do not preclude further private litigation related to HSBC's compliance with applicable BSA, AML and sanctions laws or other regulatory or law enforcement actions for BSA, AML, sanctions or other matters not covered by the various agreements.

In November 2014, a complaint was filed in the US District Court for the Eastern District of New York on behalf of representatives of US persons alleged to have been killed or injured in Iraq between April 2004 and November 2011. The complaint was filed against HSBC Holdings, HSBC Bank plc, HSBC Bank USA and HSBC Bank Middle East Limited, as well as other non-HSBC banks and the Islamic Republic of Iran (together, the 'Defendants'). The plaintiffs allege that Defendants violated the US Anti-Terrorism Act ('US ATA') by altering or falsifying payment messages involving Iran, Iranian parties and Iranian banks for transactions processed through the US. The Defendants filed a Motion to Dismiss in May 2015 and an amended Motion to Dismiss in September 2016, following the filing by the Plaintiffs of a Second Amended Complaint in July 2016.

In November 2015, a complaint was filed in the US District Court for the Northern District of Illinois on behalf of representatives of US persons alleged to have been killed or injured in terrorist attacks on three hotels in Amman, Jordan in 2005. The complaint was filed against HSBC Holdings, HSBC Bank USA, HNAH, HSI, HSBC Finance, HSBC USA Inc. and HSBC Bank Middle East Limited, as well as a non-HSBC bank, Al Rajhi Bank (together the "Defendants"). The plaintiffs allege that the HSBC defendants violated the US ATA by failing to enforce due diligence methods to prevent its financial services from being used to support the terrorist attacks. In early January 2017, the Defendants filed various Motions, including a Motion to Dismiss from the Plaintiffs' Complaint HSBC Bank Middle East Limited and another HSBC defendant, and a Motion to Transfer what remains of the action to the Southern District of New York.

In November 2016, a complaint was filed in the Southern District of Illinois on behalf of representatives of U.S. soldiers killed or injured whilst serving in Iraq. The complaint was filed against HSBC Holdings plc, HSBC Bank plc, HSBC Bank Middle East Limited, HSBC Bank USA, N.A and other non-HSBC Banks, Deutsche Bank AG, Barclays Bank plc, Standard Chartered Bank, Royal Bank of Scotland, N.V., Credit Suisse AG, Bank Saderat plc and Commerzbank AG (together the "Defendants"). The plaintiffs allege that the HSBC defendants violated the US ATA by altering or falsifying payment messages involving Iran, Iranian parties and Iranian banks for transactions processed through the US. In December 2016, the Defendants filed a Motion to Transfer the action to the Eastern District of New York. In January 2017, the Plaintiffs filed a First Amended Complaint which named an additional HSBC defendant, HSBC North America Holdings Inc. This action is at an early stage.

40 Related party transactions

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

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

HSBC Holdings plc
8 Canada Square
London
E14 5HQ

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

Notes on the Financial Statements (continued)

Transactions with related parties

	2016	2015
	Balance at the year end ¹ AED000	Balance at the year end ¹ AED000
Assets		
Loans and advances to customers	1,131,128	1,278,155
Loans and advances to banks	7,571,936	5,737,903
Reverse repurchase agreements – non-trading	32,024	102,973
Liabilities		
Deposits by banks	12,008,054	11,116,782
Customer accounts	147,118	21,188
Subordinated loan from Head Office	2,757,742	2,757,354
 Irrevocable commitments and contingencies	 2,012,536	 2,193,125
	For the year ended 31 December 2016 AED000	For the year ended 31 December 2015 AED000
Income Statement		
Interest income	105,763	42,718
Interest expense	(260,716)	(240,931)
Fee income	197,473	159,541
Fee expense	(56,558)	(57,741)
Other operating income	287,826	360,012
General and administrative expenses	(231,092)	(318,179)

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

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

41 Social contributions

During the year ended 31 December 2016, the Bank made social contributions of AED 11,263 thousand.

42 Events after the balance sheet date

These accounts were approved by management on 9 March 2017 and authorised for issue.

43 Comparative figures

Certain comparative figures have been reclassified to conform to the presentation adopted in these financial statements.

HSBC Bank Middle East Limited - UAE Operations

Pillar III disclosures under Basel II

31 December 2016

HSBC Bank Middle East Limited - UAE Operations
Basel II - Pillar III Disclosures
for the year ended 31 December 2016

Capital structure as at 31 December 2016

Composition of regulatory capital

2016
AED million

Tier 1 capital

Paid up share capital.....	4,495
Legal reserve.....	1,752
General reserve.....	5,893
Other reserve.....	(218)
Total core capital	11,921

Less: Deductions

Intangibles.....	46
Own shares held.....	-
Current year's loss.....	-
Total net deductions	46

Total tier 1 capital (A)

11,875

Tier 2 capital

Undisclosed reserves/ General Provisions.....	925
Subordinated term loans.....	1,653
Total tier 2 capital (B)	2,578

Total capital base (A) + (B)

14,453

Capital requirements as per the standardised approach

as at 31 Dec 2016

	RWA	Capital
	AED million	requirement
		AED million
Credit risk.....	74,020	8,882
Market risk.....	2,873	345
Operational risk.....	9,374	1,125
Total	86,267	10,352

Capital ratios

%

Total Capital adequacy ratio.....	16.75%
Tier 1 capital ratio.....	13.77%

HSBC Bank Middle East Limited - UAE Operations
Basel II - Pillar III Disclosures
for the year ended 31 December 2016

External Ratings

Qualitative information

Currently, the Bank has used the following three external rating agencies for determining risk weighted assets for all its exposures (which utilise external ratings): a) Moody's Investors Service; b) Standard & Poor's; and c) Fitch ratings.

Quantitative information

Loan portfolio as per the standardised approach

Loan Portfolio	AED million									
	Gross credit exposures					Exposures subject to deduction				
	Rated	Unrated	Total	Post CRM	RWA post CRM	Rated	Unrated	Total	Post CRM	RWA post CRM
Claims on sovereigns.....	25,951	-	25,951	25,951	731	25,951	-	25,951	25,951	731
Claims on public sector entities.....	122	632	754	754	-	122	632	754	754	-
Claims on multilateral development banks.....	1,227	455	1,682	1,682	-	1,227	455	1,682	1,682	-
Claims on securities firms.....	-	-	-	-	-	-	-	-	-	-
Claims on banks.....	22,039	4,752	26,790	26,790	6,794	22,039	4,752	26,790	26,790	6,794
Claims on corporate.....	2,138	104,379	106,518	62,864	51,300	2,138	104,379	106,518	62,864	51,300
Regulatory and other retail exposure.....	-	12,950	12,950	5,272	3,956	-	12,950	12,950	5,272	3,956
Residential retail exposure.....	-	7,286	7,286	6,690	2,641	-	7,286	7,286	6,690	2,641
Commercial real estate.....	262	3,856	4,119	4,119	4,119	262	3,856	4,119	4,119	4,119
Past due loans.....	-	3,871	3,871	1,771	1,964	-	3,871	3,871	1,771	1,964
Other assets.....	339	8,624	8,962	7,873	2,342	339	8,624	8,962	7,873	2,342
Claims on securitised assets.....	-	-	-	-	-	-	-	-	-	-
Credit derivatives (Banks selling protection).....	866	-	866	866	173	866	-	866	866	173
Total	52,944	146,805	199,750	144,634	74,020	52,944	146,805	199,750	144,634	74,020

HSBC Bank Middle East Limited - UAE Operations
Basel II - Pillar III Disclosures
for the year ended 31 December 2016

Equity risk

Market risk as per the standardised approach

	AED million
Specific interest rate risk.....	10
General interest rate risk.....	301
Foreign exchange risk.....	30
Total market risk capital charge	342

HSBC Bank Middle East Limited - UAE Operations
Basel II - Pillar III Disclosures
for the year ended 31 December 2016

Interest rate risk in the banking book (IRRBB)

	AED million	
Shift in yield curves	Net interest income	Regulatory capital
+200 basis point.....	588	11,875
- 200 basis point.....	(735)	11,875

HSBC Bank Middle East Limited - UAE Operations
Basel II - Pillar III Disclosures
for the year ended 31 December 2016

Gross credit exposures by residual contractual maturity

AED million

Contractual maturity	Loans	Debt securities	Other assets	Total funded	Commitments*	OTC derivatives*	Other off-balance sheet exposures*	Total non funded*	Total
Less than 3 months.....	52,630	6,687	16,158	75,475	1,779	2,432	-	4,211	79,686
3 months to one year.....	9,024	5,536	76	14,637	4,597	2,123	-	6,719	21,357
One to five years.....	16,511	3,602	-	20,113	13,404	3,626	-	17,030	37,142
Over five years.....	8,623	621	-	9,244	-	495	-	495	9,738
Total	86,788	16,446	16,234	119,468	19,780	8,675	-	28,454	147,923

Note:

* these are converted to on balance sheet equivalent amounts

HSBC Bank Middle East Limited - UAE Operations
Basel II - Pillar III Disclosures
for the year ended 31 December 2016

Gross credit exposures by currency type

	AED million								
Currency type	Loans	Debt securities	Other assets	Total funded	Commitments*	OTC derivatives*	Other off- balance sheet exposures*	Total non funded*	Total
Foreign Currency.....	50,420	6,946	8,123	65,488	9,339	7,859	-	17,199	82,687
AED.....	36,368	9,501	8,111	53,980	10,440	815	-	11,256	65,236
Total	86,788	16,446	16,234	119,468	19,780	8,675	-	28,454	147,923

Note:

* these are converted to on balance sheet equivalent amounts

HSBC Bank Middle East Limited - UAE Operations
Basel II - Pillar III Disclosures
for the year ended 31 December 2016

Gross credit exposures by geography

AED million

Geography	Loans	Debt securities	Other assets	Total funded	Commitments*	OTC derivatives*	Other off- balance sheet exposures*	Total non funded*	Total
United Arab Emirates ("UAE").....	61,870	10,179	9,732	81,781	16,395	2,242	-	18,637	100,418
GCC Excluding UAE.....	12,618	484	351	13,453	842	912	-	1,754	15,207
Arab League (excluding GCC).....	1,873	560	2	2,435	91	6	-	98	2,533
Asia.....	1,455	1,091	1	2,547	83	215	-	298	2,846
Africa.....	4	2	-	6	1	-	-	1	6
North America.....	1,623	1,239	8	2,870	99	18	-	117	2,987
South America.....	962	-	0	962	-	-	-	-	962
Caribbean.....	-	-	-	-	-	-	-	-	-
Europe.....	5,078	2,892	2,626	10,596	1,859	5,281	-	7,140	17,736
Australia.....	27	-	1	28	7	0	-	7	35
Others.....	1,277	-	3,514	4,790	403	-	-	403	5,193
Total	86,788	16,446	16,234	119,468	19,780	8,675	-	28,454	147,923

Note:

* these are converted to on balance sheet equivalent amounts

HSBC Bank Middle East Limited - UAE Operations
Basel II - Pillar III Disclosures
for the year ended 31 December 2016

Credit risk mitigation: Disclosures for standardised approach

	AED million	
	Exposures	Risk weighted assets
Gross Exposures prior to credit risk mitigation.....	181,345	74,020
Less: Exposures covered by on-balance sheet netting.....	-	-
Less: Exposures covered by eligible financial collateral.....	565	-
Less: Exposures covered by guarantees.....	36,145	-
Less: Exposures covered by credit derivatives.....	-	-
Net exposures after credit risk mitigation	144,634	74,020

HSBC Bank Middle East Limited - UAE Operations
Basel II - Pillar III Disclosures
for the year ended 31 December 2016

Gross credit exposures by industry segment

AED million

Industry segment	Loans	Debt securities	Other assets	Total funded	Commitments*	OTC derivatives*	Other off-balance sheet exposures*	Total non funded*	Total
Agriculture, Fishing & related activities.....	3	-	-	3	9	3	-	12	15
Crude Oil, Gas, Mining & Quarrying.....	561	-	-	561	2,636	2	-	2,638	3,199
Manufacturing.....	8,270	-	-	8,270	1,374	80	-	1,454	9,723
Electricity & Water.....	2,410	-	-	2,410	-	213	-	213	2,623
Construction.....	6,519	-	-	6,519	3,330	0	-	3,330	9,849
Trade.....	10,043	-	-	10,043	-	731	-	731	10,775
Transport, Storage & Communication.....	6,431	-	-	6,431	854	281	-	1,135	7,566
Financial Institutions.....	27,582	484	-	28,066	1,735	7,114	-	8,849	36,915
Services.....	5,231	-	-	5,231	1,568	58	-	1,626	6,856
Government.....	4,537	13,703	-	18,241	56	167	-	222	18,463
Retail/Consumer banking.....	13,662	-	-	13,662	3,669	-	-	3,669	17,331
All Others.....	1,538.16	2,259	16,234	20,032	4,550	26	-	4,576	24,608
Total	86,788	16,446	16,234	119,468	19,780	8,675	-	28,455	147,923

Note:

* these are converted to on balance sheet equivalent amounts

HSBC Bank Middle East Limited - UAE Operations
Basel II - Pillar III Disclosures
for the year ended 31 December 2016

Credit risk as per the standardised approach

Asset classes	AED million					
	On balance sheet	Off balance sheet	Total	Specific provisions and suspended interest	Net exposure before CRM	Risk weighted assets
	Gross outstanding	Net exposure after Credit Conversion Factors (CCF)	Gross exposure before CRM			
Claims on sovereigns.....	25,821	130	25,951	-	25,951	731
Claims on non-central Government public sector entities (PSEs).....	754	-	754	-	754	-
Claims on multilateral development banks.....	1,682	-	1,682	-	1,682	-
Claims on banks.....	19,813	6,977	26,790	-	26,790	6,794
Claims on securities firms.....	-	-	-	-	-	-
Claims on corporates.....	72,661	33,857	106,518	(199)	106,319	51,300
Claims included in the regulatory retail portfolio.....	13,072	122	12,950	(127)	12,823	3,956
Claims secured by residential property.....	7,878	592	7,286	(594)	6,692	2,641
Claims secured by commercial real estate.....	4,119	-	4,119	-	4,119	4,119
Past due loans.....	5,971	2,100	3,871	(2,100)	1,771	1,964
Higher-risk categories.....	-	-	-	-	-	-
Other assets.....	10,052	1,089	8,962	(1,089)	7,873	2,342
Claims on securitised assets.....	-	-	-	-	-	-
Credit derivatives (banks selling protection).....	-	866	866	-	866	173
Total claims	161,824	37,926	199,750	(4,108)	195,641	74,020
Settlement risk.....						1
Total credit risk						74,021