HSBC Bank Middle East Limited – UAE Operations

Financial Statements

For the year ended 31 December 2018

Annual Report and Accounts 2018

Contents

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.

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Independent auditor's report to the shareholder 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 in respect of its UAE Operations (the "Bank") as at 31 December 2018, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

What we have audited

The Bank's financial statements comprise:

- the income statement for the year ended 31 December 2018;
- the statement of comprehensive income for the year ended 31 December 2018;
- the statement of financial position as at 31 December 2018;
- 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 Bank 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 the financial statements in the United Arab Emirates. We have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code.

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 their preparation in compliance with the applicable provisions of the UAE Federal Law No. (2) of 2015, 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.

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

In preparing the financial statements, management is responsible for assessing the Bank'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 Bank or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Bank'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.
- 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 Bank'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 Bank'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 Bank 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.

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

Report on other legal and regulatory requirements

Further, as required by Article (114) of the Decretal Federal Law No. (14) of 2018, we report that we have obtained all the information and explanations we considered necessary for the purpose of our audit.

PricewaterhouseCoopers
12 March 2019

Douglas O' Mahony
Registered Auditor Number 834
Place: Dubai, United Arab Emirates

Financial Statements

Income statement for the year ended 31 December 2018

	Notes	2018 AED'000	2017 AED'000
Interest income	5	**3,662,931**	3,066,636
Interest expense	5	**(741,096)**	(511,857)
Net interest income		**2,921,835**	2,554,779
Fee income	6	**1,431,595**	1,481,594
Fee expense	6	**(340,849)**	(304,536)
Net fee income		**1,090,746**	1,177,058
Net income from financial instruments held for trading or managed on a fair value basis		**513,983**	566,686
Changes in fair value of long-term debt and related derivatives	4	**5,722**	18,321
Net (losses) from financial investments		**(26,128)**	(7,858)
Other operating income	7	**379,810**	377,863
Net operating income before changes in expected credit losses and other credit impairment		**4,885,968**	4,686,849
Changes in expected credit losses and other credit impairment charges	8	**(411,845)**	NA
Loan impairment charges and other credit risk provisions	8	**NA**	(414,326)
Net operating income		**4,474,123**	4,272,523
Employee compensation and benefits	9	**(1,647,142)**	(1,529,562)
General and administrative expenses		**(937,720)**	(1,001,824)
Depreciation and impairment of property, plant and equipment		**(38,964)**	(33,272)
Amortisation and impairment of intangible assets		**(21,885)**	(19,550)
Total operating expenses		**(2,645,711)**	(2,584,208)
Profit before tax		**1,828,412**	1,688,315
Tax expense	11	**(309,672)**	(268,216)
Profit for the year		**1,518,740**	1,420,099

The accompanying notes on pages 11 to 85 form an integral part of these financial statements.

Financial Statements

Statement of comprehensive income for the year ended 31 December 2018

	Notes	2018 AED'000	2017 AED'000
Profit for the year		**1,518,740**	1,420,099
Other comprehensive income/(expense)			
Items that will be reclassified subsequently to profit or loss when specific conditions are met:			
Available-for-sale investments		**NA**	(1,664)
– fair value losses		**NA**	(4,704)
– others		**NA**	2,855
– income taxes		**NA**	185
Debt instruments at fair value through other comprehensive income		**(10,892)**	NA
– fair value losses		**(16,454)**	NA
– expected credit losses recognised in income statement		**(28)**	NA
– fair value losses transferred to the income statement on disposal		**4,383**	NA
– income taxes		**1,207**	NA
Cash flow hedges		**(44,232)**	(14,682)
– fair value (losses)		**(49,147)**	(16,313)
– income taxes		**4,915**	1,631
Items that will not be reclassified subsequently to profit or loss:			
Re-measurement of defined benefit asset/liability		**82,623**	(60,021)
– before income taxes	*9*	**82,623**	(60,021)
Changes in fair value of financial liabilities designated at fair value upon initial recognition arising from changes in own credit risk		**69,057**	(13,137)
– fair value gains/(losses)		**69,057**	(13,137)
Total comprehensive income for the year		**1,615,296**	1,330,595

The accompanying notes on pages 11 to 85 form an integral part of these financial statements.

Financial Statements

Statement of financial position at 31 December 2018

	Notes	2018 AED'000	2017 AED'000
Assets			
Cash and balances at central bank	13	**9,020,737**	7,098,868
Trading assets	16	**904,206**	1,618,520
Derivatives	17	**3,260,349**	3,278,003
Loans and advances to banks	14	**11,244,198**	14,023,961
Loans and advances to customers	15	**60,673,319**	54,824,297
Reverse repurchase agreements – non-trading		**2,773,621**	5,095,730
Financial investments	18	**14,584,868**	16,428,916
Other assets	19	**2,527,680**	1,536,965
Property, plant and equipment	38	**1,037,029**	110,725
Intangible assets	38	**107,606**	35,283
Deferred tax assets	20	**697,204**	702,702
Total assets		**106,830,817**	104,753,970
Liabilities and equity			
Liabilities			
Deposits by banks		**7,430,144**	8,498,803
Repurchase agreements – non-trading		**11,018**	-
Customer accounts	21	**61,049,029**	61,334,342
Trading liabilities	22	**180,208**	4,811,443
Financial liabilities designated at fair value	23	**7,412,596**	2,716,091
Derivatives	17	**3,260,224**	3,235,496
Debt securities in issue	24	**5,294,261**	3,825,214
Subordinated liabilities	31	**2,754,375**	2,756,823
Other liabilities	25	**4,181,409**	3,819,778
Current tax liabilities		**298,020**	282,862
Accruals and deferred income		**648,949**	490,042
Provisions for liabilities & charges	26	**699,452**	790,417
Total liabilities		**93,219,685**	92,561,311
Head Office funds			
Allocated capital		**4,495,255**	4,495,255
Legal reserves		**2,202,002**	2,050,128
Other reserves		**370,552**	(318,629)
Retained earnings		**6,543,323**	5,965,905
Total Head Office funds		**13,611,132**	12,192,659
Total Head Office funds and liabilities		**106,830,817**	104,753,970

The accompanying notes on pages 11 to 85 form an integral part of these financial statements.

Abdulfattah Sharaf

Chief Executive Officer - UAE

HSBC Bank Middle East Limited P.O. Box : 66 Dubai U.A.E.

12 MAR 2019

Financial Statements

Statement of cash flows for the year ended 31 December 2018

	Note	2018 AED'000	2017 AED'000
Cash flows from operating activities			
Profit before tax		**1,828,412**	1,688,315
Adjustments for:			
– Provision for liabilities and charges		**62,204**	230,849
– Change in expected credit losses and other credit impairment charges		**411,845**	NA
– Loan impairment losses gross of recoveries and other credit risk provisions		**NA**	414,326
– Depreciation and amortisation		**60,849**	52,822
– Share based payment expense including options		**34,049**	33,015
– Fair value movement on own debt		**157,107**	(18,321)
– Loss on investment in shares		**26,128**	7,858
– Loss/(gain) on disposal of property and equipment		**38**	(65,362)
Net cash generated before changes in operating assets / liabilities		**2,580,632**	2,343,502
– Change in loans and advances to banks and reverse repurchase agreements – non-trading		**3,916,034**	(9,334,741)
– Change in loans and advances to customers		**(6,458,413)**	7,694,566
– Change in other assets and derivatives		**(961,265)**	1,118,874
– Change in deposits by banks		**(1,057,641)**	(6,092,768)
– Change in customer accounts		**(285,313)**	466,691
– Change in other liabilities, accruals and deferred income and derivatives		**(103,573)**	(1,922,723)
– Retirement benefits and other charges paid		**(132,493)**	(59,945)
– Tax paid		**(245,650)**	(336,943)
Net cash absorbed in operating activities		**(2,747,682)**	(6,123,487)
Cash flows from investing activities			
– Sale/(Purchase) of financial assets and liabilities classified as fair value through profit and loss (net)		**622,478**	(420,275)
– Net cash flows from purchase and sale/maturity of financial investments		**(774,581)**	(1,318,347)
– Purchase of property and equipment and intangible assets		**(1,144,075)**	(45,500)
– Sale of property and equipment and intangible assets		**84,560**	105,488
Net cash absorbed in investing activities		**(1,211,618)**	(1,678,634)
Cash flows from financing activities			
– Debt securities issued/(repaid) (net)		**1,466,599**	(1,315,372)
– Dividend paid to Head Office		**-**	(2,605,830)
Net cash generated from/(used in) financing activities		**1,466,599**	(3,921,202)
Net decrease in cash and cash equivalents		**(2,492,701)**	(11,723,323)
Cash and cash equivalents as at 1 January		**14,399,738**	26,123,061
Cash and cash equivalents as at 31 December	*32*	**11,907,037**	14,399,738

The accompanying notes on pages 11 to 85 form an integral part of these financial statements.

Financial Statements

Statement of changes in equity for the year ended 31 December 2018

	2018							
			Other reserves					
	Allocated capital AED'000	Legal Reserve AED'000	Financial assets at FVOCI reserves[1] AED'000	Cash flow hedging reserve AED'000	Actuarial gains/(losses) reserve AED'000	Other reserve[2] AED'000	Unremitted profits AED'000	Total Head Office funds AED'000
At 31 Dec 2017	4,495,255	2,050,128	(14,505)	(27,011)	(293,648)	16,535	5,965,905	12,192,659
Impact on transition to IFRS 9			433			496,841	(694,387)	(197,113)
At 1 January 2018	4,495,255	2,050,128	(14,072)	(27,011)	(293,648)	513,376	5,271,518	11,995,546
Profit for the year	-	-	-	-	-	-	1,518,740	1,518,740
Other comprehensive income (net of tax)								
Debt instruments at fair value through other comprehensive income	-	-	(10,892)	-	-	-	-	(10,892)
Cash flow hedges	-	-	-	(44,232)	-	-	-	(44,232)
Changes in fair value of financial liabilities designated at fair value due to movement in own credit risk	-	-	-	-	-	69,057	-	69,057
Actuarial gains on defined benefit plans	-	-	-	-	82,623	-	-	82,623
Total comprehensive income for the year	-	-	(10,892)	(44,232)	82,623	69,057	-	96,556
Transfer to legal reserve	-	151,874	-	-	-	-	(151,874)	-
Transfer to General Impairment Reserve[2]	-	-	-	-	-	156,020	(156,020)	-
Other movements	-	-	-	-	-	(60,669)	60,959	290
At 31 December 2018	4,495,255	2,202,002	(24,964)	(71,243)	(211,025)	677,784	6,543,323	13,611,132

[1] *AED 14.5m at 31 December 2017 represents the IAS 39 Available-for-sale fair value reserves as at 31 December 2017.*

[2] *Other reserve includes the General Impairment Reserve (AED 653m) (AED 497m as at 1 January 2018) as per the requirements of the Central Bank of the UAE. This impairment reserve was created in relation to the difference between the IFRS 9 model ECLs for Stages 1 and 2 and the minimum general provision requirements of the UAECB as an appropriation of retained earnings and is not distributable.*

The accompanying notes on pages 11 to 85 form an integral part of these financial statements.

Financial Statements

Statement of changes in equity for the year ended 31 December 2017

	2017							
			Other reserves					
	Allocated capital AED'000	Legal Reserve AED'000	Available-for-sale fair value reserve AED'000	Cash flow hedging reserve AED'000	Actuarial gains/(losses) reserve AED'000	Other reserve AED'000	Unremitted profits AED'000	Total Head Office funds AED'000
At 1 January 2017	4,495,255	1,908,118	(12,841)	(12,329)	(233,627)	40,390	7,298,213	13,483,179
Profit for the year	-	-	-	-	-	-	1,420,099	1,420,099
Other comprehensive income (net of tax)								
Available-for-sale investments	-	-	(1,664)	-	-	-	-	(1,664)
Cash flow hedges	-	-	-	(14,682)	-	-	-	(14,682)
Changes in fair value of financial liabilities designated at fair value due to movement in own credit risk	-	-	-	-	-	(13,137)	-	(13,137)
Actuarial losses on defined benefit plans	-	-	-	-	(60,021)	-	-	(60,021)
Total comprehensive income for the year	-	-	(1,664)	(14,682)	(60,021)	(13,137)	-	(89,504)
Transfer of profits to Head Office	-	-	-	-	-	-	(2,605,830)	(2,605,830)
Other movements	-	142,010	-	-	-	(10,718)	(146,577)	(15,285)
At 31 December 2017	4,495,255	2,050,128	(14,505)	(27,011)	(293,648)	16,535	5,965,905	12,192,659

The accompanying notes on pages 11 to 85 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'). HBME has its place of incorporation and head office in Dubai International Financial Centre ('DIFC'), in the United Arab Emirates, under a category 1 licence issued by the Dubai Financial Services Authority ('DFSA').

The immediate parent company of HBME is HSBC Middle East Holdings BV and 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 ('UAECB').

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 its 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 2018

The Bank has adopted the requirements of IFRS 9 'Financial instruments' from 1 January 2018, with the exception of the provisions relating to the presentation of gains and losses on financial liabilities designated at fair value, which were adopted from 1 January 2017. The effect of its adoption is not significant. IFRS 9 includes an accounting policy choice to continue with IAS 39 hedge accounting, which the Bank has exercised. The classification and measurement and impairment requirements are applied retrospectively by adjusting the opening balance sheet at the date of initial application. As permitted by IFRS 9, the Bank has not restated comparatives. Adoption reduced net assets at 1 January 2018 by AED 198m as set out in Note 37.

In addition, the Bank has adopted the requirements of IFRS 15 'Revenue from contracts with customers' and a number of interpretations and amendments to standards which have had an insignificant effect on the financial statements of the Bank.

IFRS 9 transitional requirements

The transition requirements of IFRS 9 have necessitated a review of the designation of financial instruments at fair value. IFRS 9 requires that the designation is revoked where there is no longer an accounting mismatch at 1 January 2018 and permits designations to be revoked or additional designations created at 1 January 2018 if there are accounting mismatches at that date. As a result:

- fair value designations for financial liabilities have been revoked where the accounting mismatch no longer exists, as required by IFRS 9;
- fair value designations have been revoked for certain long-dated securities where accounting mismatches continue to exist, but where group has revoked the designation as permitted by IFRS 9 since it will better mitigate the accounting mismatch by undertaking fair value hedge accounting.

The results of these changes are included in the reconciliation set out in Note 37.

Notes to the Financial Statements (continued)

Changes in accounting policy

While not necessarily required by the adoption of IFRS 9, the following voluntary changes in accounting policy and presentation have been made as a result of reviews carried out in conjunction with its adoption. The effect of presentational changes at 1 January 2018 is included in the reconciliation set out in Note 37 and comparatives have not been restated.

- The Bank considered market practices for the presentation of certain financial liabilities which contain both deposit and derivative components. The Bank concluded that a change in accounting policy and presentation from 'trading customer accounts and other debt securities in issue' would be appropriate, since it would better align with the presentation of similar financial instruments by peers and therefore provide more relevant information about the effect of these financial liabilities on our financial position and performance. As a result, rather than being classified as held for trading, the Bank will designate these financial liabilities as at fair value through profit or loss since they are managed and their performance evaluated on a fair value basis. A further consequence of this change in presentation is that the effects of changes in the liabilities' credit risk will be presented in other comprehensive income with the remaining effect presented in profit or loss in accordance with the accounting policy adopted in 2017 (following the adoption of the requirements in IFRS 9 relating to the presentation of gains and losses on financial liabilities designated at fair value).
- Settlement accounts have been reclassified from 'Trading assets' to 'Other assets' and from 'Trading liabilities' to 'Other liabilities'. The change in presentation for financial assets is in accordance with IFRS 9 and the change in presentation for financial liabilities is considered to provide more relevant information, given the change in presentation for the financial assets. The change in presentation for financial liabilities has had no effect on measurement of these items and therefore on retained earnings or profit for any period.

Future accounting developments

Minor amendments to IFRSs

The IASB has published a number of minor amendments to IFRSs which are effective from 1 January 2019. The Bank expects they will have an insignificant effect, when adopted, on the financial statements of the Bank.

Major new IFRSs

IFRS 16 'Leases'

IFRS 16 'Leases' has an effective date for 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 ('ROU') 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 under IAS 17. At 1 January 2019, the Bank expects to adopt the standard using a modified retrospective approach where the cumulative effect of initially applying the standard is recognised as an adjustment to the opening balance of retained earnings and comparatives are not restated.

The implementation is expected to increase assets (ROU assets) by AED 156.1m and increase financial liabilities by the same amount with no effect on net assets or retained earnings.

IFRS 17 'Insurance contracts'

IFRS 17 'Insurance contracts' was issued in May 2017, and sets out the requirements that an entity should apply in accounting for insurance contracts it issues and reinsurance contracts it holds. IFRS 17 is effective from 1 January 2021. The Bank has assessed the impact of IFRS 17 and expects that the standard will have no significant effect, when applied, on the financial statements of the Bank.

Amendment to IAS 12 'Income Taxes'

An amendment to IAS 12 was issued in December 2017 as part of the Annual Improvement Cycle. The amendment clarifies that an entity should recognise the tax consequences of dividends where the transactions or events that generated the distributable profits are recognised. This amendment will be effective for annual periods beginning on or after 1 January 2019 and is applied to the income tax consequences of distributions recognised on or after the beginning of the earliest comparative period. As a consequence, income tax related to distributions on perpetual subordinated contingent convertible capital securities will be presented in profit or loss rather than equity.

Notes to the Financial Statements (continued)

(b) Foreign currencies

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.

(c) 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 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 these 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.

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 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.

(b) Non-interest income and expense

The Bank generates fee income from services provided at a fixed price over time, such as account service and card fees, or when the Bank delivers a specific transaction at a point in time such as broking services and import/export services. With the exception of certain fund management and performance fees, all other fees are generated at a fixed price. Fund management and performance fees can be variable depending on the size of the customer portfolio and the Bank's performance as fund manager. Variable fees are recognised when all uncertainties are resolved. Fee income is generally earned from short term contracts with payment terms that do not include a significant financing component.

The Bank acts as principal in the majority of contracts with customers, with the exception of broking services. For most brokerage trades the Bank acts as agent in the transaction and recognises broking income net of fees payable to other parties in the arrangement.

The Bank recognises fees earned on transaction-based arrangements at a point in time when we have fully provided the service to the customer. Where the contract requires services to be provided over time, income is recognised on a systematic basis over the life of the agreement. Where the Bank offers a package of services that contains multiple non-distinct performance obligations, such as those included in account service packages, the promised services are treated as a single performance obligation. If a package of services contains distinct performance obligations, such as those including both account and insurance services, the corresponding transaction price is allocated to each performance obligation based on the estimated stand-alone selling prices.

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.

Notes to the Financial Statements (continued)

Net income/(expense) from financial instruments measured at fair value through profit or loss includes the following:

- ‘Net income from financial instruments held for trading or managed on a fair value basis’. This element is comprised of the net trading income, which includes all gains and losses from changes in the fair value of financial assets and financial liabilities held for trading, together with the related interest income, expense and dividends; and it also includes all gains and losses from changes in the fair value of derivatives that are managed in conjunction with financial assets and liabilities measured at fair value through profit or loss;
- ‘Net income/(expense) from assets and liabilities of insurance businesses, including related derivatives, measured at fair value through profit or loss’. This includes interest income, interest expense and dividend income in respect of financial assets and liabilities measured at fair value through profit or loss; and those derivatives managed in conjunction with the above which can be separately identifiable from other trading derivatives;
- ‘Changes in fair value of long-term debt and related derivatives’. Interest paid on the external long-term debt and interest cash flows on related derivatives is presented in interest expense; and
- ‘Changes in fair value of other financial instruments mandatorily measured at fair value through profit or loss’. This includes interest on instruments which fail the SPPI test.

(c) Valuation of financial instruments

All financial instruments are recognised initially 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 (a ‘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 either 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 Bank measures the fair value of the group of financial instruments on a net basis but presents the underlying financial assets and liabilities separately in the financial statements, unless they satisfy the IFRS 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, and for them 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 27.

(d) Joint arrangements

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.

(e) Financial instruments measured at amortised cost

Financial assets that are held to collect the contractual cash flows and that contain contractual terms that give rise on specified dates to cash flows that are solely payments of principal and interest, such as most loans and advances to banks and customers and some debt securities, are measured at amortised cost. In addition, most financial liabilities are measured at amortised cost. The Bank accounts for regular way amortised cost financial instruments using trade date accounting. The carrying value of these financial assets at initial recognition includes any directly attributable transactions costs. If the initial fair value is lower than the cash amount advanced, such as in the case of some leveraged finance and syndicated lending activities, the difference is deferred and recognised over the life of the loan through the recognition of interest income.

Notes to the Financial Statements (continued)

The Bank may commit to underwriting loans on fixed contractual terms for specified periods of time. When the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a derivative. When the Bank intends to hold the loan, the loan commitment is included in the impairment calculations.

Non-trading reverse repurchase and repurchase agreements

When securities are sold subject to a commitment to repurchase them at a predetermined price ('repos'), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to resell ('reverse repos') are not recognised on the balance sheet and an asset is recorded in respect of the initial consideration paid. Non-trading repos and reverse repos are measured at amortised cost. The difference between the sale and repurchase price or between the purchase and resale price is treated as interest and recognised in net interest income over the life of the agreement.

Contracts that are economically equivalent to reverse repurchase or repurchase agreements (such as sales or purchases of debt securities entered into together with total return swaps with the same counterparty) are accounted for similarly to, and presented together with, reverse repurchase or repurchase agreements.

(f) Financial assets measured at fair value through other comprehensive income ('FVOCI')

Financial assets held for a business model that is achieved by both collecting contractual cash flows and selling and that contain contractual terms that give rise on specified dates to cash flows that are solely payments of principal and interest are measured at FVOCI. These comprise primarily debt securities. They are recognised on the trade date when the Bank enters into contractual arrangements to purchase and are normally derecognised when they are either sold or redeemed. They are subsequently remeasured at fair value and changes therein (except for those relating to impairment, interest income and foreign currency exchange gains and losses) are recognised in other comprehensive income until the assets are sold. Upon disposal, the cumulative gains or losses in other comprehensive income are recognised in the income statement as 'Gains less losses from financial instruments'. Financial assets measured at FVOCI are included in the impairment calculations and impairment is recognised in profit or loss.

(g) Financial instruments designated at fair value through profit or loss

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 irrevocably at inception:

– the use of the designation removes or significantly reduces an accounting mismatch;
– when a group of financial assets, liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy; and
– where the financial liability contains one or more non-closely related embedded derivatives.

Designated financial assets are recognised when the Bank enters into contracts with counterparties, which is generally on trade date, and are normally derecognised when the rights to the cash flows expire or are transferred. Designated financial liabilities are recognised when the Bank enters into contracts with counterparties, which is generally on settlement date, and are normally derecognised when extinguished. Subsequent changes in fair values are recognised in the income statement in 'Net income from financial instruments held for trading or managed on a fair value basis'.

Under this criterion, the main classes of financial instruments designated by the Bank are:

Long-term debt issues

The interest and/or foreign exchange exposure on certain fixed rate debt securities issued has been matched with the interest and/or foreign exchange exposure on certain swaps as part of a documented risk management strategy.

(h) 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 through profit and loss. Derivatives are classified as assets when their fair value is positive or as liabilities when their fair value is negative. This includes embedded derivatives in financial liabilities which are bifurcated from the host contract when they meet the definition of a derivative on a standalone basis.

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.

Notes to the Financial Statements (continued)

Hedge accounting

When derivatives are not part of fair value designated relationships, if held for risk management purposes they are designated in hedge accounting relationships where the required criteria for documentation and hedge effectiveness are met. The Bank uses these derivatives or, where allowed, other non-derivative hedging instruments in fair value hedges, cash flow hedges or hedges of net investments in foreign operations as appropriate to the risk being hedged.

Fair value hedge

Fair value hedge accounting does not change the recording of gains and losses on derivatives and other hedging instruments, but results in recognising changes in the fair value of the hedged assets or liabilities attributable to the hedged risk that would not otherwise be recognised in the income statement. 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, unless the hedged item has been derecognised, in which case it is recognised in the income statement immediately.

Cash flow hedge

The effective portion of gains and losses on hedging instruments is recognised in other comprehensive income; the ineffective portion of the change in fair value of derivative hedging instruments that are part of a cash flow hedge relationship is recognised immediately in the income statement within 'Net income from financial instruments held for trading or managed on a fair value basis'. 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, or partially 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.

Net investment hedge

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

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.

Critical accounting estimates and judgements

Various jurisdictions are in the process of replacing existing interbank benchmark unsecured interbank lending rates with alternative risk free rates, and different jurisdictions are moving at different speeds with different solutions for replacements. There is uncertainty as to the timing and the method of transition for many products, and whether some existing benchmarks will continue to be supported in some way. Judgement is needed to determine how the existing hedge accounting relationships are impacted by the transition. On balance, there is sufficient support for continuing hedge accounting for those relationships which are impacted.

(i) Impairment of amortised cost and FVOCI financial assets

Expected credit losses are recognised for loans and advances to banks and customers, non-trading reverse repurchase agreements, other financial assets held at amortised cost, debt instruments measured at fair value through other comprehensive income, and certain loan commitments and financial guarantee contracts. At initial recognition, allowance (or provision in the case of some loan commitments and financial guarantees) is required for ECL resulting from default events that are possible within the next 12 months (or less, where the remaining life is less than 12 months) ('12-month ECL'). In the event of a significant increase in credit risk, 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'. Purchased or originated credit-impaired financial assets (POCI) are treated differently as set out below.

Notes to the Financial Statements (continued)

Credit-impaired (stage 3)

The Bank determines that a financial instrument is credit-impaired and in stage 3 by considering relevant objective evidence, primarily whether:

- contractual payments of either principal or interest are past due for more than 90 days;
- there are other indications that the borrower is unlikely to pay such as that a concession has been granted to the borrower for economic or legal reasons relating to the borrower's financial condition; and
- the loan is otherwise considered to be in default.

If such unlikeliness to pay is not identified at an earlier stage, it is deemed to occur when an exposure is 90 days past due, even where regulatory rules permit default to be defined based on 180 days past due. Therefore the definitions of credit-impaired and default are aligned as far as possible so that stage 3 represents all loans which are considered defaulted or otherwise credit-impaired.

Interest income is recognised by applying the effective interest rate to the amortised cost amount, i.e. gross carrying amount less ECL allowance.

Write-off

Financial assets (and the related impairment allowances) 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.

Renegotiation

Loans are identified as renegotiated and classified as credit-impaired when we modify the contractual payment terms due to significant credit distress of the borrower. Renegotiated loans remain classified as credit-impaired until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows and retain the designation of renegotiated 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 a substantially different financial instrument. Any new loans that arise following derecognition events in these circumstances are considered to be purchased or originated credit-impaired (POCI) and will continue to be disclosed as renegotiated loans.

Other than originated credit-impaired loans, all other modified loans could be transferred out of stage 3 if they no longer exhibit any evidence of being credit impaired and, in the case of renegotiated loans, there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, over the minimum observation period, and there are no other indicators of impairment. These loans could be transferred to stage 1 or 2 based on the mechanism as described below by comparing the risk of a default occurring at the reporting date (based on the modified contractual terms) and the risk of a default occurring at initial recognition (based on the original, unmodified contractual terms). Any amount written off as a result of the modification of contractual terms would not be reversed.

Loan modifications that are not credit-impaired

Loan modifications that are not identified as renegotiated are considered to be commercial restructuring. Where a commercial restructuring results in a modification (whether legalised through an amendment to the existing terms or the issuance of a new loan contract) such that the Bank's rights to the cash flows under the original contract have expired, the old loan is derecognised and the new loan is recognised at fair value. The rights to cash flows are generally considered to have expired if the commercial restructure is at market rates and no payment-related concession has been provided.

Significant increase in credit risk (stage 2)

An assessment of whether credit risk has increased significantly since initial recognition is performed at each reporting period by considering the change in the risk of default occurring over the remaining life of the financial instrument. The assessment explicitly or implicitly compares the risk of default occurring at the reporting date compared to that at initial recognition, taking into account reasonable and supportable information, including information about past events, current conditions and future economic conditions. The assessment is unbiased, probability-weighted, and to the extent relevant, uses forward-looking information consistent with that used in the measurement of ECL. The analysis of credit risk is multifactor. The determination of whether a specific factor is relevant and its weight compared with other factors depends on the type of product, the characteristics of the financial instrument and the borrower, and the geographical region. Therefore, it is not possible to provide a single set of criteria that will determine what is considered to be a significant increase in credit risk and these criteria will differ for different types of lending, particularly between retail and wholesale. However, unless identified at an earlier stage, all financial assets are deemed to have suffered a significant increase in credit risk when 30 days past due. In addition, wholesale loans that are individually assessed, typically corporate and commercial customers, and included on a watch or worry list are included in stage 2.

Notes to the Financial Statements (continued)

For wholesale portfolios, the quantitative comparison assesses default risk using a lifetime probability of default which encompasses a wide range of information including the obligor's customer risk rating, macroeconomic condition forecasts and credit transition probabilities. Significant increase in credit risk is measured by comparing the average PD for the remaining term estimated at origination with the equivalent estimation at reporting date (or that the origination PD has doubled in the case of origination CRR greater than 3.3). The significance of changes in PD was informed by expert credit risk judgement, referenced to historical credit migrations and to relative changes in external market rates. The quantitative measure of significance varies depending on the credit quality at origination as follows:

Origination CRR	Significance trigger – PD to increase by
0.1–1.2	15bps
2.1–3.3	30 bps
Greater than 3.3 and not	2x

For loans originated prior to the implementation of IFRS 9, the origination PD does not include adjustments to reflect expectations of future macroeconomic conditions since these are not available without the use of hindsight. In the absence of this data, origination PD must be approximated assuming through-the-cycle ('TTC') PDs and TTC migration probabilities, consistent with the instrument's underlying modelling approach and the CRR at origination. For these loans, the quantitative comparison is supplemented with additional CRR deterioration based thresholds as set out in the table below:

Origination CRR	Additional significance criteria – Number of CRR grade notches deterioration required to identify as significant credit deterioration (stage 2) (> or equal to)
0.1	5 notches
1.1–4.2	4 notches
4.3–5.1	3 notches
5.2–7.1	2 notches
7.2–8.2	1 notch
8.3	0 notch

Further information about the 23-grade scale used for CRR can be found in Note 33.

For certain portfolios of debt securities where external market ratings are available and credit ratings are not used in credit risk management, the debt securities will be in stage 2 if their credit risk increases to the extent they are no longer considered investment grade. Investment grade is where the financial instrument has a low risk of incurring losses, the structure has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil their contractual cash flow obligations.

For retail portfolios, default risk is assessed using a reporting date 12-month PD derived from credit scores which incorporate all available information about the customer. This PD is adjusted for the effect of macroeconomic forecasts for periods longer than 12 months and is considered to be a reasonable approximation of a lifetime PD measure. Retail exposures are first segmented into homogeneous portfolios, generally by country, product and brand. Within each portfolio, the stage 2 accounts are defined as accounts with an adjusted 12-month PD greater than the average 12-month PD of loans in that portfolio 12 months before they become 30 days past due. The expert credit risk judgement is that no prior increase in credit risk is significant. This portfolio-specific threshold identifies loans with a PD higher than would be expected from loans that are performing as originally expected and higher than that which would have been acceptable at origination. It therefore approximates a comparison of origination to reporting date PDs.

Unimpaired and without significant increase in credit risk (stage 1)

ECL resulting from default events that are possible within the next 12 months ('12-month ECL') are recognised for financial instruments that remain in stage 1.

Purchased or originated credit-impaired ('POCI')

Financial assets that are purchased or originated at a deep discount that reflects the incurred credit losses are considered to be POCI. This population includes the recognition of a new financial instrument following a renegotiation where concessions have been granted for economic or contractual reasons relating to the borrower's financial difficulty that otherwise would not have been considered. The amount of change-in-lifetime ECL is recognised in profit or loss until the POCI is derecognised, even if the lifetime ECL are less than the amount of ECL included in the estimated cash flows on initial recognition.

Notes to the Financial Statements (continued)

Movement between stages

Financial assets can be transferred between the different categories (other than POCI) depending on their relative increase in credit risk since initial recognition. Financial instruments are transferred out of stage 2 if their credit risk is no longer considered to be significantly increased since initial recognition based on the assessments described above. Except for renegotiated loans, financial instruments are transferred out of stage 3 when they no longer exhibit any evidence of credit impairment as described above. Renegotiated loans that are not POCI will continue to be in stage 3 until there is sufficient evidence to demonstrate a significant reduction in the risk of non-payment of future cash flows, observed over a minimum one-year period and there are no other indicators of impairment. For loans that are assessed for impairment on a portfolio basis, the evidence typically comprises a history of payment performance against the original or revised terms, as appropriate to the circumstances. For loans that are assessed for impairment on an individual basis, all available evidence is assessed on a case-by-case basis.

Measurement of ECL

The assessment of credit risk, and the estimation of ECL, are unbiased and probability-weighted, and incorporate all available information which is relevant to the assessment including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date. In addition, the estimation of ECL should take into account the time value of money.

In general, the Bank calculates ECL using three main components, a probability of default, a loss given default and the exposure at default ('EAD').

The 12-month ECL is calculated by multiplying the 12-month PD, LGD and EAD. Lifetime ECL is calculated using the lifetime PD instead. The 12-month and lifetime PDs represent the probability of default occurring over the next 12 months and the remaining maturity of the instrument respectively.

The EAD represents the expected balance at default, taking into account the repayment of principal and interest from the balance sheet date to the default event together with any expected drawdowns of committed facilities. The LGD represents expected losses on the EAD given the event of default, taking into account, among other attributes, the mitigating effect of collateral value at the time it is expected to be realised and the time value of money.

The Bank leverages the Basel II IRB framework where possible, with recalibration to meet the differing IFRS 9 requirements as follows.

Model	Regulatory capital	IFRS 9
PD	– Through the cycle (represents long-run average PD throughout a full economic cycle) – The definition of default includes a backstop of 90+ days past due, although this has been modified to 180+ days past due for some portfolios, particularly UK and US mortgages	– Point in time (based on current conditions, adjusted to take into account estimates of future conditions that will impact PD) – Default backstop of 90+ days past due for all portfolios
EAD	– Cannot be lower than current balance	– Amortisation captured for term products
LGD	– Downturn LGD (consistent losses expected to be suffered during a severe but plausible economic downturn) – Regulatory floors may apply to mitigate risk of underestimating downturn LGD due to lack of historical data – Discounted using cost of capital – All collection costs included	– Expected LGD (based on estimate of loss given default including the expected impact of future economic conditions such as changes in value of collateral) – No floors – Discounted using the original effective interest rate of the loan – Only costs associated with obtaining/selling collateral included
Other		– Discounted back from point of default to balance sheet date

While 12-month PDs are recalibrated from Basel models where possible, the lifetime PDs are determined by projecting the 12-month PD using a term structure. For the wholesale methodology, the lifetime PD also takes into account credit migration, i.e. a customer migrating through the CRR bands over its life.

Notes to the Financial Statements (continued)

The ECL for wholesale stage 3 is determined on an individual basis using a discounted cash flow ('DCF') methodology. The expected future cash flows are based on the credit risk officer's estimates as at the reporting date, reflecting reasonable and supportable assumptions and projections of future recoveries and expected future receipts of interest. Collateral is taken into account if it is likely that the recovery of the outstanding amount will include realisation of collateral based on its estimated fair value of collateral at the time of expected realisation, less costs for obtaining and selling the collateral. The cash flows are discounted at a reasonable approximation of the original effective interest rate. For significant cases, cash flows under four different scenarios are probability-weighted by reference to the three economic scenarios applied more generally by the Bank and the judgement of the credit risk officer in relation to the likelihood of the workout strategy succeeding or receivership being required. For less significant cases, the effect of different economic scenarios and work-out strategies is approximated and applied as an adjustment to the most likely outcome.

Period over which ECL is measured

Expected credit loss is measured from the initial recognition of the financial asset. The maximum period considered when measuring ECL (be it 12-month or lifetime ECL) is the maximum contractual period over which the Bank is exposed to credit risk. For wholesale overdrafts, credit risk management actions are taken no less frequently than on an annual basis and therefore this period is to the expected date of the next substantive credit review. The date of the substantive credit review also represents the initial recognition of the new facility. However, where the financial instrument includes both a drawn and undrawn commitment and the contractual ability to demand repayment and cancel the undrawn commitment does not serve to limit the Bank's exposure to credit risk to the contractual notice period, the contractual period does not determine the maximum period considered. Instead, ECL is measured over the period the Bank remains exposed to credit risk that is not mitigated by credit risk management actions. This applies to retail overdrafts and credit cards, where the period is the average time taken for stage 2 exposures to default or close as performing accounts, determined on a portfolio basis and ranging from between two and six years. In addition, for these facilities it is not possible to identify the ECL on the loan commitment component separately from the financial asset component. As a result, the total ECL is recognised in the loss allowance for the financial asset unless the total ECL exceeds the gross carrying amount of the financial asset, in which case the ECL is recognised as a provision.

Forward-looking economic inputs

The Bank will in general apply three forward-looking global economic scenarios determined with reference to external forecast distributions representative of our view of forecast economic conditions, the Consensus Economic Scenario approach. This approach is considered sufficient to calculate unbiased expected loss in most economic environments. They represent a 'most likely outcome' (the Central scenario) and two, less likely, 'Outer' scenarios, referred to as the Upside and Downside scenarios. The Central scenario is used by the annual operating planning process and, with regulatory modifications, will also be used in enterprise-wide stress tests. The Upside and Downside are constructed following a standard process supported by a scenario narrative reflecting the Bank's current top and emerging risks and by consulting external and internal subject matter experts. The relationship between the Outer scenarios and Central scenario will generally be fixed with the Central scenario being assigned a weighting of 80% and the Upside and Downside scenarios 10% each, with the difference between the Central and Outer scenarios in terms of economic severity being informed by the spread of external forecast distributions among professional industry forecasts. The Outer scenarios are economically plausible, internally consistent states of the world and will not necessarily be as severe as scenarios used in stress testing. The period of forecast is five years, after which the forecasts will revert to a view based on average past experience. The spread between the central and outer scenarios is grounded on consensus distributions of projected gross domestic product of the UAE. The economic factors include, but are not limited to, gross domestic product, unemployment, interest rates, inflation and commercial property prices across all the countries in which the Bank operates.

In general, the consequences of the assessment of credit risk and the resulting ECL outputs will be probability-weighted using the standard probability weights. This probability weighting may be applied directly or the effect of the probability weighting determined on a periodic basis, at least annually, and then applied as an adjustment to the outcomes resulting from the central economic forecast. The central economic forecast is updated quarterly.

The Bank recognises that the Consensus Economic Scenario approach using three scenarios will be insufficient in certain economic environments. Additional analysis may be requested at management's discretion, including the production of extra scenarios. If conditions warrant, this could result in a management overlay for economic uncertainty which is included in the ECL.

Critical accounting estimates and judgements

In determining ECL, management is required to exercise judgement in defining what is considered to be a significant increase in credit risk and in making assumptions and estimates to incorporate relevant information about past events, current conditions and forecasts of economic conditions. Judgement has been applied in determining the lifetime and point of initial recognition of revolving facilities.

Notes to the Financial Statements (continued)

The PD, LGD and EAD models which support these determinations are reviewed regularly in light of differences between loss estimates and actual loss experience, but given that IFRS 9 requirements have only just been applied, there has been little time available to make these comparisons. Therefore, the underlying models and their calibration, including how they react to forward-looking economic conditions, remain subject to review and refinement. This is particularly relevant for lifetime PDs, which have not been previously used in regulatory modelling and for the incorporation of 'Upside scenarios' which have not generally been subject to experience gained through stress testing.

The exercise of judgement in making estimations requires the use of assumptions which are highly subjective and very sensitive to the risk factors, in particular to changes in economic and credit conditions across a large number of geographical areas. Many of the factors have a high degree of interdependency and there is no single factor to which loan impairment allowances as a whole are sensitive.

(j) Employee compensation and benefits

Share-based payments

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

The vesting period for these schemes may commence before the grant date if the employees have started to render services in respect of the award before the grant date. Expenses are recognised when the employee starts to render service to which the award relates.

Cancellations result from the failure to meet a non-vesting condition during the vesting period, and are treated as an acceleration of vesting recognised immediately in the income statement. Failure to meet a vesting condition by the employee is not treated as a cancellation, and the amount of expense recognised for the award is adjusted to reflect the number of awards expected to vest.

Pension and post-employment benefit plans

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

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.

Defined benefit pension obligations are calculated using the projected unit credit method. The net charge to the income statement mainly comprises the service cost and the net interest on the net defined benefit asset or liability, and is presented in operating expenses.

Re-measurements of the net defined benefit asset or liability, which comprise actuarial gains and losses, return on plan assets excluding interest and the effect of the asset ceiling (if any, excluding interest), are recognised immediately in other comprehensive income. The net defined benefit asset or liability represents the present value of defined benefit obligations reduced by the fair value of plan assets, after applying the asset ceiling test, where the net defined benefit surplus is limited to the present value of available refunds and reductions in future contributions to the plan.

The cost of obligations arising from other post-employment plans are accounted for on the same basis as defined benefit pension plans.

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

(k) 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.

Notes to the Financial Statements (continued)

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.

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.

(l) Debt securities issued

Financial liabilities for debt securities issued are recognised when the Bank enters into contractual arrangements with counterparties and are 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 method to amortise the difference between proceeds received, net of directly attributable transaction costs incurred, and the redemption amount over the expected life.

(m) Provisions

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

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 recognised depend on a number of different assumptions, such as 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.

(n) 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.

(o) Acceptances and endorsements

Acceptances arise when the Bank is under an obligation to make payments against documents drawn under letters of credit. Acceptances specify the amount of money, the date, and the person to which the payment is due. After acceptance, the instrument becomes an unconditional liability (time draft) of the Bank and is therefore recognised as a financial liability with a corresponding contractual right of reimbursement from the customer recognised as a financial asset.

Notes to the Financial Statements (continued)

(p) Accounting policies applicable prior to 1 January 2018

Financial instruments measured at amortised cost

Loans and advances to banks and customers, held-to-maturity investments and most financial liabilities are measured at amortised cost. The carrying value of these financial assets at initial recognition includes any directly attributable transactions costs. If the initial fair value is lower than the cash amount advanced, such as in the case of some leveraged finance and syndicated lending activities, the difference is deferred and recognised over the life of the loan (as described in sub-section (c) above) through the recognition of interest income, unless the loan becomes impaired.

The Bank may commit to underwriting loans on fixed contractual terms for specified periods of time. When the loan arising from the lending commitment is expected to be held for trading, the commitment to lend is recorded as a derivative. When the Bank intends to hold the loan, a provision on the loan commitment is only recorded where it is probable that HSBC will incur a loss.

Impairment of loans and advances

Losses for impaired loans are recognised when there is objective evidence that impairment of a loan or portfolio of loans has occurred. Losses which may arise 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 will be individually assessed for impairment, except when volumes of defaults and losses are sufficient to justify treatment under a collective methodology.

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 most recently updated market value at the time the impairment assessment is performed. The value is not adjusted for expected future changes in 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 include 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.

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, which are 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 that the Bank is not able to identify on an individual loan basis, and that can be reliably estimated. When information becomes available that identifies losses on individual loans within a group, those loans are removed from the group and assessed individually.

Homogeneous groups of loans and advances

Statistical methods are used to determine collective impairment losses for homogeneous groups of loans not considered individually significant. The methods used to calculate collective allowances are set out below:

– When appropriate empirical information is available, the Bank utilises roll-rate methodology, which employs statistical analyses of historical data and experience of delinquency and default to reliably estimate the amount of the loans that will eventually be written off as a result of events occurring before the balance sheet date. Individual loans are grouped using ranges of past due days, and statistical estimates are made of the likelihood that loans in each range will progress through the various stages of delinquency and become irrecoverable. Additionally, individual loans are segmented based on their credit characteristics, such as industry sector, loan grade or product. In applying this methodology, adjustments are made to estimate the periods of time between a loss event occurring, for example because of a missed payment, and its confirmation through write-off (known as the loss identification period). Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. In certain highly developed markets, models also take into account behavioural and account management trends as revealed in, for example bankruptcy and rescheduling statistics; and

Notes to the Financial Statements (continued)

– 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 estimated by local management, and is typically between six and 12 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.

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.'

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 required payments has 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 amounts 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.

Non-trading reverse repurchase, repurchase and similar agreements

When debt securities are sold subject to a commitment to repurchase them at a predetermined price ('repos'), they remain on the balance sheet and a liability is recorded in respect of the consideration received. Securities purchased under commitments to resell ('reverse repos') are not recognised on the balance sheet and an asset is recorded in respect of the initial consideration paid. Non-trading repos and reverse repos are measured at amortised cost. The difference between the sale and repurchase price or between the purchase and resale price is treated as interest and recognised in net interest income over the life of the agreement.

Contracts that are economically equivalent to reverse repurchase or repurchase agreements (such as sales or purchases of debt securities entered into together with total return swaps with the same counterparty) are accounted for similarly to, and presented together with, reverse repurchase or repurchase agreements.

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 them, and are normally derecognised when they are either 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 and within 'Gains less losses from financial investments' for equities.

Notes to the Financial Statements (continued)

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.

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 irrevocably at inception:

– the use of the designation removes or significantly reduces an accounting mismatch;
– when a group of financial assets, liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy; and
– where financial instruments contain one or more non-closely related embedded derivatives. Designated financial assets are recognised when the Bank enters into contracts with counterparties, which is generally on trade date, and are normally derecognised when the rights to the cash flows expire or are transferred. Designated financial liabilities are recognized when the Bank enters into contracts with counterparties, which is generally on settlement date, and are normally derecognised when extinguished. Subsequent changes in fair values are recognised in the income statement in 'Net income/(expense) from financial instruments designated at fair value'. Under this criterion, the main classes of financial instruments designated by the Bank are:

Long-term debt issues

The interest and/or foreign exchange exposure on certain fixed rate debt securities issued has been matched with the interest and/or foreign exchange exposure on certain swaps as part of a documented risk management strategy.

4 Changes in fair value of long-term debt and related derivatives

	2018 AED'000	2017 AED'000
Net income arising on:		
other changes in fair value	**5,722**	18,321
	5,722	18,321

5 Interest income and expense

	2018 AED'000	2017 AED'000
Interest income		
Loans and advances to banks	**281,668**	218,203
Loans and advances to customers	**3,024,217**	2,611,994
Investments	**265,641**	95,361
Others	**91,405**	141,078
Total interest income	**3,662,931**	3,066,636

	2018 AED'000	2017 AED'000
Interest expense		
Deposits by banks	**(320,410)**	(290,557)
Customer accounts	**(232,044)**	(118,091)
Debt issued	**(188,642)**	(103,209)
Total interest expense	**(741,096)**	(511,857)
Net interest income	**2,921,835**	2,554,779

Notes to the Financial Statements (continued)

6 Fee income and expense

	2018 AED'000	2017 AED'000
Fee income		
Personal banking fees	**549,530**	529,762
Corporate banking fees	**320,472**	338,517
Investment banking fees	**561,593**	613,315
Total	**1,431,595**	1,481,594
Fee expense		
Personal banking fees	**(237,541)**	(202,916)
Corporate banking fees	**(21,333)**	(18,972)
Investment banking fees	**(81,975)**	(82,648)
Total	**(340,849)**	(304,536)
Net fee income	**1,090,746**	1,177,058

7 Other operating income

	2018 AED'000	2017 AED'000
Recovery of operational/support cost from other HSBC Group entities (refer Note 40)	**374,707**	309,970
(Loss)/gain on disposal of property plant and equipment	**(38)**	65,362
Others	**5,141**	2,531
Total	**379,810**	377,863

8 Expected credit losses and other credit impairment

	2018 AED'000	2017 AED'000
Expected credit loss charges and other credit impairment charges		
- loans and advances to banks and customers	**(449,122)**	NA
- loan commitments and guarantees	**49,845**	NA
- other financial assets	**(12,594)**	NA
- debt instruments measured at fair value through other comprehensive income	**26**	NA
Loan impairment charges and other credit risk provisions		
- Net impairment charge on loans and advances to customers	**NA**	(387,362)
- Net impairment charge in respect of other credit risk	**NA**	(26,964)
Total	**(411,845)**	(414,326)

9 Employee compensation and benefits

	2018 AED'000	2017 AED'000
Wages and salaries	**(1,126,067)**	(1,046,978)
Social security costs	**(13,365)**	(11,106)
Post-employment benefits	**(94,460)**	(75,455)
Others	**(413,250)**	(396,023)
Total	**(1,647,142)**	(1,529,562)

Post-employment benefit plans

Income statement charge in respect of defined benefit plans	2018 AED'000	2017 AED'000
Defined benefit pension plans	**(92,519)**	(73,572)

Net liabilities recognised on balance sheet in respect of defined benefit plans	2018 AED'000	2017 AED'000
Defined benefit pension plans	**562,973**	592,535

Notes to the Financial Statements (continued)

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.

Present value of defined benefit obligations	**2018 AED'000**	2017 AED'000
At 1 January	**592,535**	488,402
Current service cost	**79,008**	64,482
Other movements	**7,791**	7,320
Interest cost	**13,511**	9,090
Actuarial (gains)/losses	**(82,623)**	60,021
Benefits paid	**(47,249)**	(36,780)
Net liability	**562,973**	592,535

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

	2018 AED'000	2017 AED'000
Current service cost	**(79,008)**	(64,482)
Interest cost	**(13,511)**	(9,090)
Total expense	**(92,519)**	(73,572)

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 for each year, and used as the basis for measuring periodic costs under the plans in the following years, were as follows:

Principal actuarial assumptions

	Discount rate %	**Rate of pay increase %**	**Combined rate of resignation and employment termination %**
At 31 December 2018			
United Arab Emirates	**3.1**	**5.1**	**8.0**
At 31 December 2017			
United Arab Emirates	2.2	6.4	9.3

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

The effect of changes in key assumptions on the principal plan

	2018 AED'000	2017 AED'000
Discount rate		
Change in scheme obligation at year end from a 25bps increase	**(8,541)**	(14,924)
Change in scheme obligation at year end from a 25bps decrease	**13,602**	9,706
Change in following year scheme cost from a 25bps increase	**(516)**	(633)
Change in following year scheme cost from a 25bps decrease	**526**	648
Rate of pay increase		
Change in scheme obligation at year end from a 25bps increase	**13,958**	15,019
Change in scheme obligation at year end from a 25bps decrease	**(8,939)**	(9,865)
Change in following year scheme cost from a 25bps increase	**2,220**	2,391
Change in following year scheme cost from a 25bps decrease	**(2,154)**	(2,317)

Notes to the Financial Statements (continued)

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 a minimum number of years of service from the date of the award. Should the employee not satisfy this condition, subject to certain exceptions, the award would lapse.

Deferred cash awards

Deferred cash awards are recognised where there is a service period over which conditions are required to be satisfied in order for an employee to become unconditionally entitled to the cash.

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 awards on current and future years

	Charge recognised in 2018 in respect of performance year:		**Charge expected to be recognised in 2019 or later in respect of performance year:**	
	2018 AED'000	**Pre-2018 AED'000**	**2018 AED'000**	**Pre-2018 AED'000**
HSBC deferred share awards	**(6,676)**	**(13,894)**	**(14,926)**	**(10,222)**
HSBC deferred cash awards	**(2,850)**	**(8,493)**	**(6,835)**	**(5,207)**
	(9,526)	**(22,387)**	**(21,761)**	**(15,429)**
	Charge recognised in 2017 in respect of performance year:		Charge expected to be recognised in 2018 or later in respect of performance year:	
	2017 AED'000	Pre-2017 AED'000	2017 AED'000	Pre-2017 AED'000
HSBC deferred share awards	(6,790)	(15,987)	(15,440)	(12,784)
HSBC deferred cash awards	(4,247)	(5,087)	(9,008)	(5,286)
	(11,037)	(21,074)	(24,448)	(18,070)

Share-based payments

'Wages and salaries' include the effect of share-based payments arrangements, all equity settled, as follows:

	2018 AED'000	2017 AED'000
Restricted share awards	**(34,008)**	(32,949)
Savings-related and other share award option plans	**(41)**	(66)
Year ended 31 Dec	**(34,049)**	(33,015)

HSBC share awards

Award	**Policy**
Deferred share awards (including annual incentive awards delivered in shares) and GPSP	– An assessment of performance over the relevant period ending on 31 December is used to determine the amount of the award to be granted. – Deferred awards generally require employees to remain in employment over the vesting period and are not subject to performance conditions after the grant date. – Deferred share awards generally vest over a period of three years and GPSP awards vest after five years. – Vested shares may be subject to a retention requirement post-vesting. GPSP awards are retained until cessation of employment. – Awards granted from 2010 onwards are subject to a malus provision prior to vesting.

Notes to the Financial Statements (continued)

Movement on HSBC share awards

	2018 Number thousands	2017 Number thousands
Restricted share awards outstanding at 1 Jan	**2,003**	2,308
Additions during the year	**1,178**	1,278
Released and forfeited in the year	**(1,559)**	(1,664)
Restricted share awards outstanding at 31 Dec	**1,622**	1,922
Weighted average fair value of awards granted (USD)	**7.68**	6.96

HSBC share option plans

Award	Policy
Savings-related share option plans ('Sharesave')	– Exercisable within six months following either the third or fifth anniversaries of the commencement of a three-year or five-year contract, respectively. – The exercise price is set at a 20% (2017: 20%) discount to the market value immediately preceding the date of invitation.

Calculation of fair values

The fair values of share options are calculated using a Black-Scholes model. The fair value of a share award is based on the share price at the date of the grant.

Movement on HSBC share option plans

	Savings-related share option plans	
	Number thousands	Weighted Average Exercise price USD
Outstanding at 1 Jan 2018	**62**	**7.12**
Granted during the year	**33**	**7.07**
Exercised during the year	**(29)**	**7.31**
Transferred during the year	**32**	**6.65**
Forfeited, expired and cancelled during the year	**(6)**	**7.84**
Outstanding at 31 Dec 2018	**92**	**6.71**
Weighted average remaining contractual life (years)	**2.32**	
Outstanding at 1 Jan 2017	80	7.21
Granted during the year	11	7.91
Exercised during the year	(21)	7.72
Transferred during the year	1	6.31
Forfeited, expired and cancelled during the year	(9)	5.93
Outstanding at 31 Dec 2017	62	7.12
Weighted average remaining contractual life (years)	1.86	

Notes to the Financial Statements (continued)

11 Tax expense

Current tax	2018 AED'000	2017 AED'000
Tax – on current year profit	**(251,133)**	(249,670)
Tax – adjustments in respect of prior years	**-**	7,245
Deferred tax	**(42,741)**	(18,137)
Other	**(15,798)**	(7,654)
Tax expense	**(309,672)**	(268,216)

Analysis of tax expense

	2018		2017	
	AED'000	%	AED'000	%
Accounting profit	**1,828,412**		1,688,315	
Taxation at UAE corporate tax rate of 20% (2017: 20%)	**(365,682)**	**(20.0)**	(337,663)	(20.0)
Exempt income in respect of Jebel Ali	**69,392**	**3.8**	71,816	4.3
Expenses not deductible for tax purposes	**1,641**	**0.1**	(1,960)	(0.1)
Adjustment in respect of prior period liabilities	**-**	**-**	7,245	0.4
Other	**(15,023)**	**(0.8)**	(7,654)	(0.5)
Overall tax expense	**(309,672)**	**(16.9)**	(268,216)	(15.9)

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, Fujairah and Ras Al Khaimah branches.

Movement of deferred tax assets

	Expected Credit Losses AED'000	Other AED'000	Total AED'000
Assets	**677,643**	**25,059**	**702,702**
At 1 Jan 2018	**677,643**	**25,059**	**702,702**
IFRS 9 transitional adjustment	**37,243**	**-**	**37,243**
Income statement	**(45,268)**	**2,527**	**(42,741)**
At 31 Dec 2018	**669,618**	**27,586**	**697,204**

	Loan impairment allowances AED'000	Other AED'000	Total AED'000
Assets	697,518	23,321	720,839
At 1 Jan 2017	697,518	23,321	720,839
Income statement	(19,875)	1,738	(18,137)
At 31 Dec 2017	677,643	25,059	702,702

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 IFRS 9 (IAS 39 in 2017) and by balance sheet heading.

	At 31 December 2018					
	Financial instruments designated at fair value through profit or loss AED'000	Designated at fair value AED'000	FVOCI AED'000	Financial assets and liabilities at amortised cost AED'000	Derivatives designated as hedging instruments AED'000	Total AED'000
Financial assets						
Cash and balances at central bank	-	-	-	9,020,737	-	9,020,737
Trading assets	904,206	-	-	-	-	904,206
Derivatives	3,013,457	-	-	-	246,892	3,260,349
Loans and advances to banks	-	-	-	11,244,198	-	11,244,198
Loans and advances to customers	-	-	-	60,673,319	-	60,673,319
Reverse repurchase agreements – non-trading	-	-	-	2,773,621	-	2,773,621
Financial investments	-	-	14,584,868	-	-	14,584,868
Other assets	-	-	-	2,507,972	-	2,507,972
Total financial assets	3,917,663	-	14,584,868	86,219,847	246,892	104,969,270
Total non-financial assets						1,861,547
Total assets						106,830,817
Financial liabilities						
Deposits by banks	-	-	-	7,430,144	-	7,430,144
Repurchase agreements – non-trading	-	-	-	11,018	-	11,018
Customer accounts	-	-	-	61,049,029	-	61,049,029
Trading liabilities	180,208	-	-	-	-	180,208
Financial liabilities designated at fair value	-	7,412,596	-	-	-	7,412,596
Derivatives	3,179,566	-	-	-	80,658	3,260,224
Debt securities in issue	-	-	-	5,294,261	-	5,294,261
Subordinated liabilities	-	-	-	2,754,375	-	2,754,375
Other liabilities	-	-	-	4,181,409	-	4,181,409
Total financial liabilities	3,359,774	7,412,596	-	80,720,236	80,658	91,573,264
Total non-financial liabilities						1,646,421
Total liabilities						93,219,685

Notes on the Financial Statements (continued)

	At 31 December 2017					
	Held for trading. AED'000	Designated at fair value AED'000	Available-for-sale securities AED'000	Financial assets and liabilities at amortised cost AED'000	Derivatives designated as hedging instruments AED'000	Total AED'000
Financial assets						
Cash and balances at central bank	-	-	-	7,098,868	-	7,098,868
Trading assets	1,618,520	-	-	-	-	1,618,520
Derivatives	3,175,145	-	-	-	102,858	3,278,003
Loans and advances to banks	-	-	-	14,023,961	-	14,023,961
Loans and advances to customers	-	-	-	54,824,297	-	54,824,297
Reverse repurchase agreements – non-trading	-	-	-	5,095,730	-	5,095,730
Financial investments	-	-	16,428,916	-	-	16,428,916
Other assets	-	-	-	1,472,818	-	1,472,818
Total financial assets	4,793,665	-	16,428,916	82,515,674	102,858	103,841,113
Total non-financial assets						912,857
Total assets						104,753,970
Financial liabilities						
Deposits by banks	-	-	-	8,498,803	-	8,498,803
Customer accounts	-	-	-	61,334,342	-	61,334,342
Trading liabilities	4,811,443	-	-	-	-	4,811,443
Financial liabilities designated at fair value	-	2,716,091	-	-	-	2,716,091
Derivatives	3,207,658	-	-	-	27,838	3,235,496
Debt securities in issue	-	-	-	3,825,214	-	3,825,214
Subordinated liabilities	-	-	-	2,756,823	-	2,756,823
Other liabilities	-	-	-	3,819,778	-	3,819,778
Total financial liabilities	8,019,101	2,716,091	-	80,234,960	27,838	90,997,990
Total non-financial liabilities						1,563,321
Total liabilities						92,561,311

13 Cash and balances at central bank

	2018 AED'000	2017 AED'000
Cash in hand	**504,987**	706,313
Balances with Central Bank	**2,204,900**	-
Statutory reserves with Central Bank	**6,310,850**	6,392,555
	9,020,737	7,098,868

14 Loans and advances to banks

	2018 AED'000	2017 AED'000
Loans and advances to banks	**11,247,974**	14,023,961
Less: Expected credit losses	**(3,776)**	-
	11,244,198	14,023,961

Notes on the Financial Statements (continued)

15 Loans and advances to customers

	2018 AED'000	2017 AED'000
Overdrafts	**5,010,621**	4,841,058
Credit cards	**2,150,093**	2,247,676
Term lending	**46,754,739**	41,849,147
Bills discounted	**2,243,930**	1,789,331
Mortgages	**7,255,521**	6,910,840
Others	**676,223**	796,834
	64,091,127	58,434,886
Less: Expected credit losses/allowance for impairment losses	**(3,417,808)**	(3,610,589)
	60,673,319	54,824,297

16 Trading assets

	2018 AED'000	2017 AED'000
Trading assets:		
– not subject to re-pledge or resale by counterparties	**904,206**	1,618,520
Treasury and other eligible bills	**188,974**	170,051
Debt securities	**715,232**	1,031,255
Loans and advances	**-**	220,939
Others	**-**	196,275
	904,206	1,618,520

17 Derivatives

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

	Assets			**Liabilities**		
At 31 December 2018	**Trading AED'000**	**Hedging AED'000**	**Total AED'000**	**Trading AED'000**	**Hedging AED'000**	**Total AED'000**
Foreign exchange	**1,278,204**	**85,368**	**1,363,572**	**1,410,817**	**217**	**1,411,034**
Interest rate	**1,601,715**	**161,524**	**1,763,239**	**1,636,845**	**80,441**	**1,717,286**
Equity	**1,626**	**-**	**1,626**	**1,626**	**-**	**1,626**
Credit	**2,964**	**-**	**2,964**	**1,196**	**-**	**1,196**
Commodity and other	**128,948**	**-**	**128,948**	**129,082**	**-**	**129,082**
Total	**3,013,457**	**246,892**	**3,260,349**	**3,179,566**	**80,658**	**3,260,224**

	Assets			Liabilities		
At 31 December 2017	Trading AED'000	Hedging AED'000	Total AED'000	Trading AED'000	Hedging AED'000	Total AED'000
Foreign exchange	1,521,235	16,252	1,537,487	1,569,908	89	1,569,997
Interest rate	1,522,050	86,606	1,608,656	1,508,975	27,749	1,536,724
Equity	2,519	-	2,519	2,518	-	2,518
Credit	3,149	-	3,149	861	-	861
Commodity and other	126,192	-	126,192	125,396	-	125,396
Total	3,175,145	102,858	3,278,003	3,207,658	27,838	3,235,496

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

	2018 AED'000	2017 AED'000
Foreign exchange	**296,523,417**	250,394,022
Interest rate	**191,236,085**	186,786,737
Equity	**13,736**	191,140
Credit	**353,884**	799,423
Commodity and other	**2,522,789**	4,292,592
	490,649,911	442,463,914

Notes on the Financial Statements (continued)

The notional contract amounts of derivatives held for trading purposes and derivatives designated in qualifying hedge accounting indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

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 lending.

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 been used for subsequent measurement been applied at initial recognition, less subsequent releases, is AED Nil (2017: AED Nil).

Hedge accounting derivatives

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

	2018 Fair value hedge AED'000	**2018 Cash flow hedge AED'000**	2017 Fair value hedge AED'000	2017 Cash flow hedge AED'000
Foreign exchange	**-**	**7,062,855**	-	4,946,508
Interest rate	**6,171,692**	**14,947,071**	4,568,329	11,427,644
	6,171,692	**22,009,926**	4,568,329	16,374,152

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.

Hedging instrument by hedged risk

	Hedging Instrument				
		Carrying amount			
Hedged Risk	**Notional amount[1] AED'000**	**Assets AED'000**	**Liabilities AED'000**	**Balance sheet presentation**	**Change in fair value[2] AED'000**
Interest rate	**6,171,692**	**42,924**	**33,159**	**Derivatives**	**(21,429)**

[1] The notional contract amounts of derivatives designated in qualifying hedge accounting relationships indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.
[2] Used in effectiveness testing; comprising the full fair value change of the hedging instrument not excluding any component.

Notes on the Financial Statements (continued)

Hedged Risk	Hedged Item					Ineffectiveness		
	Carrying amount		Accumulated fair value hedge adjustments included in carrying amount					
	Assets	Liabilities	Assets	Liabilities	Balance sheet presentation	Change in fair value[1]	Recognised in profit and loss	Profit and loss presentation
	AED'000	AED'000	AED'000	AED'000		AED'000	AED'000	
Interest rate	4,416,117	-	(43,036)	-	FVOCI	19,634	(120)	Net income from financial instruments held for trading or managed on a fair value basis
Interest rate	-	-	-	-	L&A to Bank	(981)		
Interest rate	-	-	-	-	L&A to Cust	1,485		
Interest rate	-	437,648	-	9,206	Debt issued	3,438		
Interest rate	-	954,519	-	-	Deposits by Bank	(2,262)		

[1] *Used in effectiveness assessment; comprising amount attributable to the designated hedged risk that can be a risk component.*

Sources of hedge ineffectiveness may arise from basis risk including but not limited to the discount rates used for calculating the fair value of derivatives, hedges using instruments with a non-zero fair value and notional and timing differences between the hedged items and hedging instruments.

For some debt securities held, the Bank manages interest rate risk in a dynamic risk management strategy. The assets in scope of this strategy are high quality fixed-rate debt securities, which may be sold to meet liquidity and funding requirements.

The interest rate risk of the Bank fixed rate debt securities issued is managed in a non-dynamic risk management strategy.

Cash flow hedges

The Bank's cash flow hedging instruments consist principally of interest rate swaps and cross-currency swaps that are used to manage the variability in future interest cash flows of non-trading financial assets and liabilities, arising due to changes in market interest rates and foreign-currency basis.

The Bank applies macro cash flow hedging for interest-rate risk exposures on portfolios of replenishing current and forecasted issuances of non-trading assets and liabilities that bear interest at variable rates, including rolling such instruments. 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 cash flows representing both principal balances and interest cash flows across all portfolios are used to determine the effectiveness and ineffectiveness. Macro cash flow hedges are considered to be dynamic hedges.

The Bank also hedges the variability in future cash-flows on foreign-denominated financial assets and liabilities arising due to changes in foreign exchange market rates with cross-currency swaps; these are considered non-dynamic hedges.

Hedged Risk	Hedging Instrument					Hedged Item	Ineffectiveness	
		Carrying amount						
	Notional amount[1]	Assets	Liabilities	Balance sheet Presentation	Change in fair value[2]	Change in fair value[3]	Recognised in profit and loss	Profit and loss presentation
	AED'000	AED'000	AED'000		AED'000	AED'000	AED'000	
Foreign currency	7,061,318	85,349	216	Derivatives	(3,823)	-	(18)	Net income from financial instruments held for trading or managed on a fair value basis
Interest rate	14,943,813	118,567	47,265	Derivatives	(45,319)	(48,506)	653	

[1] *The notional contract amounts of derivatives designated in qualifying hedge accounting relationships indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.*

[2] *Used in effectiveness testing; comprising the full fair value change of the hedging instrument not excluding any component.*

[3] *Used in effectiveness assessment; comprising amount attributable to the designated hedged risk that can be a risk component.*

Notes on the Financial Statements (continued)

18 Financial investments

	2018 AED'000	2017 AED'000
Financial investments measured at fair value through other comprehensive income, not subject to repledge or resale by counterparties:		
– Treasury and other eligible bills	**1,818,761**	913,230
– Debt securities	**12,766,107**	15,515,686
Total financial investments	**14,584,868**	16,428,916

19 Other assets

	2018 AED'000	2017 AED'000
Interest receivable	**262,766**	113,986
Prepaid expenses	**19,709**	64,147
Endorsements and acceptances	**1,230,102**	1,129,052
Items in course of collection from other banks	**56,031**	5
Other accounts	**959,072**	229,775
	2,527,680	1,536,965

20 Deferred tax assets

	2018 AED'000	2017 AED'000
Deferred tax is applicable to the following:		
Recognised in income statement		
Other liabilities	**27,586**	25,059
Allowance for impairment losses	**669,618**	677,643
	697,204	702,702

21 Customer accounts

	2018 AED'000	2017 AED'000
Current accounts	**36,482,941**	37,302,473
Savings accounts	**6,691,247**	7,411,977
Call deposits	**4,358,710**	5,254,806
Term deposits	**13,505,917**	11,348,425
Money market term deposits	**10,214**	16,661
	61,049,029	61,334,342

22 Trading liabilities

The sale of borrowed securities is classified as trading liabilities.

	2018 AED'000	2017 AED'000
Debt securities in issue (Note 24)	**-**	4,656,947
Other liabilities – net short positions in securities	**180,208**	154,496
	180,208	4,811,443

Notes on the Financial Statements (continued)

23 Financial liabilities designated at fair value

	2018 AED'000	2017 AED'000
Deposits by banks and customers	**954,519**	-
Debt securities in issue (Note 24)	**6,458,077**	2,716,091
	7,412,596	2,716,091

At 31 December 2018, the accumulated amount of change in fair value attributable to changes in credit risk was a loss of (AED 69.1m) (2017: AED 10.4m loss).

24 Debt securities in issue

	2018		2017	
	Carrying amount AED'000	Fair value AED'000	Carrying amount AED'000	Fair value AED'000
Medium term notes	**11,752,338**	**11,751,203**	11,198,252	11,198,057
Of which debt securities in issue reported as				
- trading liabilities	**-**	**-**	(4,656,947)	(4,656,947)
- financial liabilities designated at fair value	**(6,458,077)**	**(6,458,077)**	(2,716,091)	(2,716,091)
	5,294,261	**5,293,126**	3,825,214	3,825,019

Certain debt securities in issue are managed on a fair value basis as part of the Bank's interest rate risk management policies. The hedged portion of these debt securities is presented within the balance sheet caption 'Financial liabilities designated at fair value', with the remaining portion included within 'Trading liabilities'.

25 Other liabilities

	2018 AED'000	2017 AED'000
Items in course of transmission to other banks	**877,146**	174,430
Marginal deposits	**758,779**	767,140
Banker's drafts	**38,728**	34,083
Endorsements and acceptances	**1,231,129**	1,129,052
Other liabilities	**1,275,627**	1,715,073
	4,181,409	3,819,778

26 Provisions for liabilities and charges

	Restructuring costs AED'000	Contractual commitments AED'000	Legal proceedings and regulatory matters AED'000	Customer remediation AED'000	Other provisions AED'000	Pension AED'000	Total AED'000
At 1 Jan 2017	18,484	20,998	26,239	11,386	8,407	488,402	573,916
Additions	23,993	25,252	73,448	1,377	33,207	73,572	230,849
Amounts utilised	(12,850)	-	(1,695)	(2,535)	(6,086)	(36,780)	(59,946)
Unused Amounts reversed	(5,135)	-	(5,780)	(9,540)	(327)	-	(20,782)
Exchange and other movements	-	(3,565)	2,604	-	-	67,341	66,380
At 31 Dec 2017	24,492	42,685	94,816	688	35,201	592,535	790,417
Impact on transition to IFRS 9	-	54,156	-	-	-	-	54,156
At 1 Jan 2018	**24,492**	**96,841**	**94,816**	**688**	**35,201**	**592,535**	**844,573**
Additions	**17,677**	**-**	**19,772**	**-**	**1,139**	**92,519**	**131,107**
Amounts utilised	**(16,065)**	**-**	**(67,202)**	**(688)**	**(1,288)**	**(47,249)**	**(132,492)**
Unused Amounts reversed	**(11,660)**	**-**	**(8,215)**	**-**	**-**	**-**	**(19,875)**
Net Change in expected credit loss provision	**-**	**(49,029)**	**-**	**-**	**-**	**-**	**(49,029)**
Exchange and other movements	**-**	**-**	**-**	**-**	**-**	**(74,832)**	**(74,832)**
At 31 Dec 2018	**14,444**	**47,812**	**39,171**	**-**	**35,052**	**562,973**	**699,452**

Notes on the Financial Statements (continued)

27 Fair value of financial instruments

Control framework

Fair values are subject to a control framework designed to ensure that they are either determined or validated by a function independent of the risk taker.

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.

The majority of financial instruments measured at fair value are in Global Banking & Markets (“GB&M”). GB&M’s fair value governance structure comprises its Finance function, Valuation Committees and a Valuation Committee Review Group. Finance is responsible for establishing procedures governing valuation and ensuring fair values are in compliance with accounting standards. The fair values are reviewed by the Valuation Committees, which consist of independent support functions. These Committees are overseen by the Valuation Committee Review Group, which considers all material subjective valuations.

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 concerned, where available. An example of this is where own debt in issue is hedged with interest rate derivatives. When quoted market prices are unavailable, the own debt in issue is valued using valuation techniques, the inputs for which are either based upon 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. The change in fair value of issued debt securities attributable to the Bank’s own credit spread is computed as follows: for each security at each reporting date, an externally verifiable price is obtained or a price is derived using credit spreads for similar securities for the same issuer. Then, using discounted cash flow, each security is valued using a Libor-based discount curve. The difference in the valuations is attributable to the Bank’s own credit spread. This methodology is applied consistently across all securities.

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

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

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 AED'000	Using observable inputs Level 2 AED'000	With significant non-observable inputs Level 3 AED'000	Total AED'000
At 31 December 2018				
Assets				
Trading assets	**-**	**610,508**	**293,698**	**904,206**
Derivatives	**-**	**3,260,349**	**-**	**3,260,349**
Financial investments	**7,623,671**	**6,961,197**	**-**	**14,584,868**
Liabilities				
Trading liabilities	**-**	**180,208**	**-**	**180,208**
Financial liabilities designated at fair value	**-**	**7,412,596**	**-**	**7,412,596**
Derivatives	**-**	**3,260,224**	**-**	**3,260,224**
At 31 December 2017				
Assets				
Trading assets	-	1,618,520	-	1,618,520
Derivatives	-	3,266,966	11,037	3,278,003
Financial investments	-	16,428,916	-	16,428,916
Liabilities	-			
Trading liabilities	-	4,811,443	-	4,811,443
Financial liabilities designated at fair value	-	2,716,091	-	2,716,091
Derivatives	-	3,224,459	11,037	3,235,496

Transfers between levels of the fair value hierarchy are deemed to occur at the end of each semi-annual reporting period. Transfers into and out of levels of the fair value hierarchy are primarily attributable to observability of valuation inputs and price transparency.

During 2018 there was a transfer of AED 7,623m from Level 2 to Level 1 Financial Investments. There were no corresponding transfers in 2017. The transfers from Level 2 to Level 3 during the year are shown in 'Movement in Level 3 financial instruments' on page 41.

The transfer between L2 to L1 comes as part of Group review where HQLA assets were classified as L1 as these securities are highly liquid and widely quoted in the market.

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.

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.

Notes on the Financial Statements (continued)

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 and debit valuation adjustment

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.

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 the full market value of the transactions.

The Bank calculates a separate credit valuation adjustment ('CVA') and debit valuation adjustment ('DVA') for each counterparty to which the entity 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.

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 not collateralised. 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 simplified set of assumptions that do not capture all current and future material market characteristics. In these circumstances, model limitation adjustments are adopted.

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.

Fair value valuation bases

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

	Assets AED'000	**Liabilities AED'000**
At 31 December 2018		
Trading Assets	**293,698**	**-**
Other derivatives	**-**	**-**
At 31 December 2017		
Other derivatives	11,037	11,037

Notes on the Financial Statements (continued)

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.

Movement in Level 3 financial instruments

	Assets	Assets	Liabilities
	Trading Assets AED'000	Derivatives AED'000	Derivatives AED'000
At 1 January 2018	**-**	**11,037**	**11,037**
Total gains recognised in profit or loss	**-**	**-**	**-**
Total gains recognised in other comprehensive income	**-**	**-**	**-**
Settlements	**-**	**(11,037)**	**(11,037)**
Sales	**-**	**-**	**-**
Transfers out	**-**	**-**	**-**
Transfers in	**293,698**	**-**	**-**
At 31 December 2018	**293,698**	**-**	**-**
Total unrealised gains/(losses) recognised in profit or loss relating to assets and liabilities held on 31 December 2018	**293,698**	**-**	**-**
At 1 January 2017	-	26,552	26,552
Total gains recognised in profit or loss	-	218,826	218,826
Total gains recognised in other comprehensive income	-	-	-
Purchases	-	-	-
Sales	-	-	-
Transfers out	-	(234,341)	(234,341)
Transfers in	-	-	-
At 31 December 2017	-	11,037	11,037
Total unrealised gains/(losses) recognised in profit or loss relating to assets and liabilities held on 31 December 2017	-	11,037	(11,037)

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

Effect of changes in significant unobservable assumptions to reasonably possible alternatives

Sensitivity of Level 3 fair values to reasonably possible alternative assumptions

	2018		2017	
	Reflected in profit or loss		Reflected in profit or loss	
	Favourable changes	**Unfavourable changes**	Favourable changes	Unfavourable changes
	AED'000	**AED'000**	AED'000	AED'000
Derivatives, trading assets and trading liabilities[1]	**33**	**(6,645)**	1,104	(1,104)

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

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

	2018		2017	
	Reflected in profit or loss		Reflected in profit or loss	
	Favourable changes	**Unfavourable changes**	Favourable changes	Unfavourable changes
	AED'000	**AED'000**	AED'000	AED'000
Other portfolios	**33**	**(6,645)**	-	-
Other derivatives	**-**	**-**	1,104	(1,104)

Notes on the Financial Statements (continued)

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		**2018**				2017			
	Assets	**Liabilities**	**Full range of inputs**		**Core range of inputs[1]**		Full range of inputs		Core range of inputs[1]	
	AED'000	**AED'000**	**Lower**	**Higher**	**Lower**	**Higher**	Lower	Higher	Lower	Higher
Other derivatives	**-**	**-**	**-**	**-**	**-**	**-**	0.4%	5.0%	0.4%	5.0%
EM Bonds	**293,698**	**-**	**100%**	**100%**	**100%**	**100%**	-	-	-	-

[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.

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.

Notes on the Financial Statements (continued)

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 2018				
		Fair value Valuation techniques			
	Carrying amount AED'000	**Quoted market price Level 1 AED'000**	**Using observable inputs Level 2 AED'000**	**With significant unobservable inputs Level 3 AED'000**	**Total AED'000**
Assets and liabilities not held for sale					
Assets					
Loans and advances to banks	**11,244,198**	**-**	**11,192,943**	**-**	**11,192,943**
Loans and advances to customers	**60,673,319**	**-**	**-**	**59,237,347**	**59,237,347**
Reverse repurchase agreements- non-trading	**2,773,621**	**-**	**2,773,621**	**-**	**2,773,621**
Liabilities					
Deposits by banks	**7,430,144**	**-**	**7,429,237**	**-**	**7,429,237**
Customer accounts	**61,049,029**	**-**	**61,324,759**	**-**	**61,324,759**
Debt securities in issue	**5,294,261**	**-**	**5,293,126**	**-**	**5,293,126**

	At 31 December 2017				
		Fair value Valuation techniques			
	Carrying amount AED'000	Quoted market price Level 1 AED'000	Using observable inputs Level 2 AED'000	With significant unobservable inputs Level 3 AED'000	Total AED'000
Assets and liabilities not held for sale					
Assets					
Loans and advances to banks	14,023,961	-	13,992,198	-	13,992,198
Loans and advances to customers	54,824,297	-	-	54,242,115	54,242,115
Reverse repurchase agreements- non-trading	5,095,730	-	5,095,729	-	5,095,729
Liabilities					
Deposits by banks	8,498,803	-	8,494,217	-	8,494,217
Customer accounts	61,334,342	-	61,970,067	-	61,970,067
Debt securities in issue	3,825,214	-	3,825,019	-	3,825,019

Other financial instruments not carried at fair value are typically short-term in nature and re-priced to current market rates frequently. Accordingly, their carrying amount is a reasonable approximation of fair value.

Valuation

The fair value measurement is the Bank's estimate of 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. 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.

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.

Notes on the Financial Statements (continued)

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, and 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.

Financial investments

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

Deposits by banks and customer accounts

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 approximated by its carrying value.

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.

Repurchase and reverse repurchase agreements – non-trading

Fair values approximate carrying amounts as their balances are generally short dated.

28 Maturity Analysis of Assets and Liabilities and off-balance sheet commitments

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 and off-balance sheet commitments

	At 31 December 2018			At 31 December 2017		
	Due within one year AED'000	**Due after more than one year AED'000**	**Total AED'000**	Due within one year AED'000	Due after more than one year AED'000	Total AED'000
Assets						
Loans and advances to banks	**7,559,036**	**3,685,162**	**11,244,198**	11,162,063	2,861,898	14,023,961
Loans and advances to customers	**30,109,724**	**30,563,595**	**60,673,319**	28,779,229	26,045,068	54,824,297
Reverse repurchase agreements-non-trading	**1,844,475**	**929,146**	**2,773,621**	5,095,730	-	5,095,730
Financial investments	**7,465,134**	**7,119,734**	**14,584,868**	10,988,893	5,440,023	16,428,916
Other assets	**2,527,680**	**-**	**2,527,680**	1,528,784	8,181	1,536,965
	49,506,049	**42,297,637**	**91,803,686**	57,554,699	34,355,170	91,909,869
Liabilities						
Deposits by banks	**4,859,394**	**2,570,750**	**7,430,144**	3,285,064	5,213,739	8,498,803
Repurchase agreements-non-trading	**-**	**11,018**	**11,018**			
Customer accounts	**60,868,188**	**180,841**	**61,049,029**	61,334,342	-	61,334,342
Financial liabilities designated at fair value	**3,944,394**	**3,468,202**	**7,412,596**	-	2,716,091	2,716,091
Subordinated liabilities	**2,754,375**	**-**	**2,754,375**	-	2,756,823	2,756,823
Debt securities in issue	**3,146,675**	**2,147,586**	**5,294,261**	1,358,308	2,466,906	3,825,214
Other liabilities	**4,181,409**	**-**	**4,181,409**	3,720,036	99,742	3,819,778
	79,754,435	**8,378,397**	**88,132,832**	69,697,750	13,253,301	82,951,051

Notes on the Financial Statements (continued)

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

	On demand AED'000	Due within 3 months AED'000	Due between 3 and 12 months AED'000	Due between 1 and 5 years AED'000	Due after 5 years AED'000
At 31 December 2018					
Deposits by banks	**1,834,431**	**2,240,535**	**875,414**	**2,779,051**	**-**
Customer accounts	**50,860,137**	**4,904,576**	**5,193,683**	**190,823**	**-**
Trading liabilities	**180,208**	**-**	**-**	**-**	**-**
Financial liabilities designated at fair value	**-**	**203,151**	**3,950,756**	**3,005,069**	**1,108,471**
Derivatives	**3,179,784**	**9,783**	**18,026**	**52,633**	**-**
Debt securities in issue	**-**	**1,009,327**	**2,268,611**	**2,394,550**	**-**
Subordinated liabilities	**-**	**19,199**	**2,811,973**	**-**	**-**
Other liabilities	**3,469,225**	**479,710**	**232,545**	**-**	**-**
	59,523,785	**8,866,281**	**15,351,008**	**8,422,126**	**1,108,471**
Loan and other credit-related commitments	**42,094,088**	**-**	**-**	**-**	**-**
Financial guarantees and similar contracts	**28,396,808**	**-**	**-**	**-**	**-**
	130,014,681	**8,866,281**	**15,351,008**	**8,422,126**	**1,108,471**
At 31 December 2017					
Deposits by banks	961,107	1,108,823	1,351,557	5,636,193	-
Customer accounts	53,277,177	4,556,349	3,565,134	-	-
Trading liabilities	4,811,443	-	-	-	-
Financial liabilities designated at fair value	-	23,130	111,815	2,806,465	-
Derivatives	3,225,028	867	3,103	6,498	-
Debt securities in issue	-	1,312,418	128,156	2,750,591	-
Subordinated liabilties	-	19,216	57,649	3,064,285	-
Other liabilities	3,028,692	313,890	377,566	99,822	-
	65,303,447	7,334,693	5,594,980	14,363,854	-
Loan and other credit-related commitments	44,118,850	-	-	-	-
Financial guarantees and similar contracts	27,950,946	-	-	-	-
	137,373,243	7,334,693	5,594,980	14,363,854	-

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 33 'Risk management'.

Notes on the Financial Statements (continued)

29 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.

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.

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

				Amounts not set off in the balance sheet	
	Gross amounts of recognised financial assets AED'000	Gross amounts offset in the balance sheet AED'000	Net amounts presented in the balance sheet AED'000	Cash collateral received AED'000	Net Amount AED'000
At 31 December 2018					
Derivatives	**3,260,349**	**-**	**3,260,349**	**-**	**3,260,349**
Reverse repurchase, securities borrowing and similar agreements classified as	**2,773,621**	**-**	**2,773,621**	**-**	**2,773,621**
– loans and advances to banks at amortised cost	**2,773,621**	**-**	**2,773,621**	**-**	**2,773,621**
– loans and advances to customers at amortised cost	**-**	**-**	**-**	**-**	**-**
Loans and advances to customers excluding reverse repos at amortised cost	**1,987,161**	**-**	**1,987,161**	**(445,809)**	**1,541,352**
	8,021,131	**-**	**8,021,131**	**(445,809)**	**7,575,322**
At 31 December 2017					
Derivatives	3,278,003	-	3,278,003	-	3,278,003
Reverse repurchase, securities borrowing and similar agreements classified as:	5,095,730	-	5,095,730	-	5,095,730
– loans and advances to banks at amortised cost	4,180,161	-	4,180,161	-	4,180,161
– loans and advances to customers at amortised cost	915,569	-	915,569	-	915,569
Loans and advances to customers excluding reverse repos at amortised cost	1,784,763	-	1,784,763	(372,616)	1,412,147
	10,158,496	-	10,158,496	(372,616)	9,785,880

30 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 3,819m (2017: AED 8,118m). 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.

31 Subordinated liabilities

On 23 December 2009, a sub-ordinated loan of AED 2,754m was provided by the Bank's Head Office. The loan carries an interest rate of Libor plus 366bps (2017: Libor plus 366bps) payable quarterly and the full principal amount of the facility is to be repaid in December 2019. 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 2018. 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 Nil (2017: AED 2m).

Notes on the Financial Statements (continued)

32 Cash and cash equivalents

	2018 AED'000	2017 AED'000
Items in the course of collection from/ transmission to other banks	**(821,115)**	(174,426)
Cash and balances at central bank[1]	**2,709,887**	706,313
Loans and advances to banks maturing within three months and reverse repurchase agreements maturing within one month	**6,903,688**	8,171,232
Central Bank certificates of deposit and other financial investments maturing within three months	**3,114,577**	5,696,619
	11,907,037	14,399,738

[1]Mandatory deposits at central bank have been excluded from the cash and cash equivalents in 2018 and similar change has been reflected for 2017.

33 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 Risk Management Tools: Risk Appetite, Top and Emerging ('T&E') Risks, Risk Map and Stress Testing.

The HBME Board approves HBME's risk appetite framework, plans and performance targets for 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 and the HBME Risk Management Meeting ('Regional RMM'), the separately convened Country Risk Management Meeting ('UAE RMM') chaired by the UAE CRO (who reports to MENACRO) defines risk appetite and oversees the implementation of risk appetite and controls. The RMM together with the Asset and Liability Committee ('ALCO') and Financial Crime Risk Management Committee ('FCRMC') 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 management tools

The Bank uses a range of tools to identify, monitor and manage risk. The key tools are summarised below

Risk appetite

Governed by the Risk Appetite Statement (RAS) is a written articulation of the aggregate level and types of risk that HSBC is willing to accept in order to achieve its business objectives. It provides a baseline for business decisions based on balancing risk and return, and making the best use of our capital

The Bank's risk appetite is set out in the RMM's Risk Appetite Statement and is central to the annual planning process. Risk appetite metrics are reviewed periodically (at least annually) and are fundamental to the development of business line strategies, strategic and business planning and senior management balanced scorecards. Global businesses as well as countries are required to articulate their Risk Appetite Statements which are aligned with the Bank strategy.

The Risk Appetite Profile is used to monitor actual performance of RAS metrics against the medium to long term appetite and tolerance thresholds defined for each metric. Risk dashboards are in place to provide a more tactical view through key risk indicators.

Quantitative and qualitative metrics are organized under; returns, costs, capital, liquidity and funding, loan impairments, market risk, operational and credit risk.

Notes on the Financial Statements (continued)

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.

Risk map

The Bank uses a risk map to provide a point-in-time view of its risk profile across a suite of risk categories. This highlights the potential for these risks to materially affect our financial results, reputation or business sustainability on current and projected bases.

The risks presented on the risk map are regularly assessed against risk appetite, are stress tested and, where longer-term thematic issues arise, are considered for inclusion as top or emerging risks.

Top and emerging risks

The Bank uses a top and emerging risks process to provide a forward-looking view of issues that have the potential to threaten the execution of the Bank's strategy or operations over the medium to long term.

The Bank defines a 'top risk' as a thematic issue that may form and crystallise in between six months and one year, and that has the potential to materially affect the Bank's financial results, reputation or business model. It may arise across any combination of risk types, regions or global businesses. The impact may be well understood by senior management and some mitigating actions may already be in place. Stress tests of varying granularity may also have been carried out to assess the impact.

An 'emerging risk' is a thematic issue with large unknown components that may form and crystallise beyond a one-year time horizon. If it were to materialise, it could have a material effect on the Bank's long-term strategy, profitability and reputation. Existing mitigation plans are likely to be minimal, reflecting the uncertain nature of these risks at this stage. Some high-level analysis and/or stress testing may have been carried out to assess the potential impact.

Stress testing

Stress testing is a critical component of the HSBC Group's strategic, risk and capital management governance as the regulatory expectations and demands in this area continue to expand significantly. It is an important tool which allows the Bank to understand the sensitivities of the core assumptions in our strategic and capital plans, and improve decision-making through balancing risk and return. The tool used to evaluate the potential financial impact of plausible scenarios in the event of an economic downturn or a geopolitical duress. Apart from market-wide events entities also take into account risks that are idiosyncratic to the Bank. The stress testing and scenario analysis programme examines the sensitivities of our capital plans and unplanned demand for regulatory capital under a number of scenarios and ensures that top and emerging risks are appropriately considered. These scenarios include, but are not limited to, adverse macroeconomic events, failures at country, sector and counterparty levels, geopolitical occurrences and a variety of projected major operational risk events. The Bank is included in the annual Group stress test submitted to the Bank of England.

In addition to the HSBC Group-wide risk scenarios, the Bank conducts regular macroeconomic and event-driven scenario analyses specific to the entity. These have increased both in frequency and in the granularity of information required by the supervisor. Assessment by the regulator is on both quantitative and qualitative bases, the latter focusing on portfolio quality, data provision, stress testing capability, forward-looking capital management processes and internal management processes.

Apart from the aforementioned Enterprise Wide Stress Tests the Bank also undertakes Reverse Stress Testing, which is conducted to examine a set of potential scenarios that may render the bank's business model non-viable. Non-viability might occur before the bank's capital is depleted, and could result from a variety of events, including idiosyncratic or systemic events or combinations thereof. Reverse stress testing is used to strengthen our resilience by helping to inform early-warning triggers, management actions and contingency plans designed to mitigate the potential stresses and vulnerabilities which we might face.

The results of aforementioned stress tests feed into the regional recovery plan and forms a part of the Bank's Internal Capital Adequacy Assessment Process ('ICAAP') submission to the regulator.

Notes on the Financial Statements (continued)

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.

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; and
– 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 MENAT CRO.

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; and
– 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.

Adoption of IFRS 9 'Financial Instruments'

The implementation of IFRS 9, did not result in any significant change to the Bank's business model. This included our strategy, product offerings and target customer segments. We have established credit risk management processes in place and we actively assess the impact of economic developments in key markets on specific customers, customer segments or portfolios. If we foresee changes in credit conditions, we take mitigating action, including the revision of risk appetites or limits and tenors, as appropriate. In addition, we continue to evaluate the terms under which we provide credit facilities within the context of individual customer requirements, the quality of the relationship, local regulatory requirements, market practices and our local market position.

Notes on the Financial Statements (continued)

As a result of IFRS 9 adoption, management has additional insight and measures not previously utilised which, over time, may influence our risk appetite and risk management processes.

IFRS 9 process

The IFRS 9 process comprises three main areas: modelling and data, implementation and governance.

Modelling

Prior to the implementation of IFRS 9 the risk function had pre-existing Basel and behavioural scorecards.

These were then enhanced or supplemented to address the IFRS 9 requirements, with appropriate governance and independent review.

Implementation

A centralised impairment engine has been implemented to perform the ECL calculation in a globally consistent manner.

Governance

A series of Regional Management Review Forums has been established in key sites/regions in order to review and approve the impairment results. Regional Management Review Forums have representatives from Credit Risk and Finance. The key site/ regional approvals are reported up to the Global Business Impairment Committee for final approval of the Bank's ECL for the period. The regional Heads of Wholesale Credit and Market Risk and Retail Banking and Wealth Management ('RBWM') Risk, the regional business CFOs and the Group Chief Accounting Officer are required members of the committee.

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

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 write-off, 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.

Summary of credit risk

The disclosure below presents the gross carrying/nominal amount of financial instruments to which the impairment requirements in IFRS 9 are applied and the associated allowance for ECL. Due to the forward-looking nature of IFRS 9, the scope of financial instruments on which ECL are recognised is greater than the scope of IAS 39.

The IFRS 9 allowance for ECL has decreased from AED 3,888m at 1 January 2018 to AED 3,471m at 31 December 2018.

The IFRS 9 allowance for ECL at 31 December 2018 comprises AED 3,423m in respect of assets held at amortised cost, AED 48m in respect of loan commitments and financial guarantees.

Summary of financial instruments to which the impairment requirements in IFRS 9 are applied (Audited)

	31 December 2018		1 January 2018	
	Gross carrying/ nominal amount	**Allowance for ECL**	Gross carrying/ nominal amount	Allowance for ECL
	AED'000	**AED'000**	AED'000	AED'000
Loans and advances to customers at amortized cost.....	**64,091,127**	**(3,417,808)**	58,434,886	(3,786,149)
Loans and advances to banks at amortized cost............	**11,247,974**	**(3,775)**	14,025,928	(1,856)
Other financial assets measured at amortized costs......	**13,717,128**	**(1,068)**	13,639,822	(2,495)
- Cash and balances at central banks	**9,020,737**	**(12)**	7,098,880	-
- Reverse repurchase agreements – non-trading	**2,773,650**	**(29)**	5,095,730	(111)
- Other assets..	**1,922,741**	**(1,027)**	1,445,272	(2,384)
Total gross carrying amount on balance sheet	**89,056,229**	**(3,422,651)**	86,100,696	(3,790,500)
Loans and other credit related commitments................	**16,680,379**	**(9,590)**	20,737,135	(15,598)
Financial guarantees and similar contracts...................	**28,396,808**	**(38,222)**	27,950,946	(81,244)
Total nominal amount off balance sheet	**45,077,187**	**(47,812)**	48,688,081	(96,842)
	Fair Value	**Memorandum allowance for ECL**	Fair Value	Memorandum allowance for ECL
	AED'000	**AED'000**	AED'000	AED'000
Debt instruments measured at fair value through other comprehensive income (FVOCI)	**14,584,868**	**(405)**	16,428,916	(433)

Notes on the Financial Statements (continued)

The following table provides an overview of the Bank's credit risk by stage and industry, and the associated ECL coverage. The financial assets recorded in each stage have the following characteristics:

Stage 1: Unimpaired and without significant increase in credit risk on which a 12-month allowance for ECL is recognised.
Stage 2: A significant increase in credit risk has been experienced since initial recognition on which a lifetime ECL is recognised.
Stage 3: Objective evidence of impairment, and are therefore considered to be in default or otherwise credit-impaired on which a lifetime ECL is recognised.
POCI: Purchased or originated at a deep discount that reflects the incurred credit losses on which a lifetime ECL is recognised.

Summary of credit risk (excluding debt instruments measured at FVOCI) by stage distribution and ECL coverage at 31 December 2018 (Audited)

	Gross carrying/nominal amount					Allowance for ECL				
	Stage 1	**Stage 2**	**Stage 3**	**POCI**	**Total**	**Stage 1**	**Stage 2**	**Stage 3**	**POCI**	**Total**
Loans and advances to customers at amortised cost	**54,891,032**	**4,775,888**	**4,289,111**	**135,096**	**64,091,127**	**(214,722)**	**(254,461)**	**(2,813,529)**	**(135,096)**	**(3,417,808)**
Loans and advances to banks at amortised cost............................	**11,222,733**	**25,241**	**-**	**-**	**11,247,974**	**(3,245)**	**(530)**	**-**	**-**	**(3,775)**
Other financial assets measured at amortised cost............................	**13,557,775**	**159,353**	**-**	**-**	**13,717,128**	**(553)**	**(515)**	**-**	**-**	**(1,068)**
Loan and other credit related commitments..	**16,017,704**	**660,722**	**1,953**	**-**	**16,680,379**	**(6,659)**	**(2,931)**	**-**	**-**	**(9,590)**
Financial guarantees and similar contracts ..	**24,625,968**	**3,488,153**	**282,687**	**-**	**28,396,808**	**(19,097)**	**(19,125)**	**-**	**-**	**(38,222)**
At 31 Dec 2018	**120,315,212**	**9,109,357**	**4,573,751**	**135,096**	**134,133,416**	**(244,276)**	**(277,562)**	**(2,813,529)**	**(135,096)**	**(3,470,463)**

Summary of credit risk (excluding debt instruments measured at FVOCI) by stage distribution and ECL coverage at 31 December 2018 (Continued) (Audited)

	ECL coverage %				
	Stage 1	**Stage 2**	**Stage 3**	**POCI**	**Total**
Loans and advances to customers at amortised cost ..	**0.4%**	**5.3%**	**65.6%**	**100.0%**	**5.3%**
Loans and advances to banks at amortised cost.........	**0.0%**	**2.1%**	**-**	**-**	**0.0%**
Other financial assets measured at amortised cost.....	**0.0%**	**0.3%**	**-**	**-**	**0.0%**
Loan and other credit related commitments...............	**0.0%**	**0.4%**	**-**	**-**	**0.0%**
Financial guarantees and similar contracts	**0.1%**	**0.5%**	**-**	**-**	**0.0%**
At 31 Dec 2018	**0.2%**	**3.0%**	**61.5%**	**100.0%**	**2.6%**

Notes on the Financial Statements (continued)

Summary of credit risk (excluding debt instruments measured at FVOCI) by stage distribution and ECL coverage at 1 January 2018 (Audited)

	Gross carrying/nominal amount					Allowance for ECL				
	Stage 1	Stage 2	Stage 3	POCI	Total	Stage 1	Stage 2	Stage 3	POCI	Total
Loans and advances to customers at amortised cost	47,623,665	6,068,003	4,608,122	135,096	58,434,886	(214,705)	(297,079)	(3,139,269)	(135,096)	(3,786,149)
Loans and advances to banks at amortised cost	14,025,441	487	-	-	14,025,928	(1,826)	(30)	-	-	(1,856)
Other financial assets measured at amortised cost	13,429,129	210,753	-	-	13,639,882	(1,490)	(1,005)	-	-	(2,495)
Loan and other credit-related commitments	20,312,941	418,104	6,090	-	20,737,135	(9,903)	(5,695)	-	-	(15,598)
Financial guarantee and similar contracts	24,323,305	3,291,398	336,243	-	27,950,946	(27,787)	(28,212)	(25,245)	-	(81,244)
At 1 Jan 2018	119,714,481	9,988,745	4,950,455	135,096	134,788,777	(255,711)	(332,021)	(3,164,514)	(135,096)	(3,887,342)

Summary of credit risk (excluding debt instruments measured at FVOCI) by stage distribution and ECL coverage at 1 January 2018

	ECL coverage %				
	Stage 1	Stage 2	Stage 3	POCI	Total
Loans and advances to customers at amortised cost	0.5%	4.9%	68.1%	100.0%	6.5%
Loans and advances to banks at amortised cost	0.0%	6.2%	-	-	0.0%
Other financial assets measured at amortised cost	0.0%	0.5%	-	-	0.0%
Loan and other credit-related commitments	0.0%	1.4%	-	-	0.0%
Financial guarantee and similar contracts	0.1%	0.9%	7.5%	-	0.3%
At 1 Jan 2018	0.2%	3.3%	63.9%	100.0%	2.9%

Measurement uncertainty and sensitivity analysis of ECL estimates

Expected credit loss impairment allowances recognised in the financial statements reflect the effect of a range of possible economic outcomes, calculated on a probability-weighted basis, based on the economic scenarios described below. The recognition and measurement of expected credit losses ('ECL') involves the use of significant judgement and estimation. It is necessary to formulate multiple forward-looking economic forecasts and incorporate them into the ECL estimates. The Bank uses a standard framework to form economic scenarios to reflect assumptions about future economic conditions, supplemented with the use of management judgement, which may result in using alternative or additional economic scenarios and/or management adjustments.

Methodology for Developing Forward Looking Economic Scenarios

The Bank has adopted the use of three scenarios, representative of our view of forecast economic conditions, sufficient to calculate unbiased expected loss in most economic environments. They represent a 'most likely outcome' (the Central scenario), and two, less likely 'outer' scenarios, referred to as the Upside and Downside scenarios. Each outer scenario is consistent with a probability of 10%, while the Central scenario is assigned the remaining 80%, according to the decision of the Bank's senior management. This weighting scheme is deemed appropriate for the unbiased estimation of ECL in most circumstances. Key scenario assumptions are set using the average of forecasts of external economists, helping to ensure that the IFRS 9 scenarios are unbiased and maximise the use of independent information. The Central, Upside and Downside scenarios selected with reference to external forecast distributions using the above approach are termed the 'consensus economic scenarios'.

For the Central scenario, HSBC sets key assumptions such as GDP growth, inflation, unemployment and policy rates using either the average of external forecasts (commonly referred to as consensus forecasts) for most economies or market prices. An external vendor's global macro model, which is conditioned to follow the consensus forecasts, projects the other paths required as inputs to credit models. This vendor model is subject to HSBC's risk governance framework with oversight by a specialist internal unit.

The Upside and Downside scenarios are designed to be cyclical, in that GDP growth, inflation and unemployment usually revert back to the Central scenario after the first three years for major economies. We determine the maximum divergence of GDP growth from the Central scenario using the 10th and the 90th percentile of the entire distribution of forecast outcomes for major economies. We use externally available forecast distributions to help ensure independence in scenario construction. While key economic variables are set with reference to external distributional forecasts, we also align the overall narrative of the scenarios to the macroeconomic risks captured in the Bank's Top and Emerging Risks. This ensures that scenarios remain consistent with the more qualitative assessment of these risks. We project additional variable paths using the external provider's global macro model.

Notes on the Financial Statements (continued)

We apply the following steps to generate the three economic scenarios:

- Economic risk assessment: We develop a shortlist of the upside and downside economic and political risks most relevant to the Bank and the IFRS 9 measurement objective. These include local and global economic and political risks which together affect economies that have a material effect on credit risk for the Bank.
- Scenario generation: For the Central scenario, we obtain a pre-defined set of economic paths from the average taken from the consensus survey of professional forecasters. Paths for the two outer scenarios are benchmarked to the Central scenario and reflect the economic risk assessment. We select scenarios that in management's judgement are representative of the probability weighting scheme, informed by the current economic outlook, data analysis of past recessions, and transitions in and out of recession.
- Variable enrichment: We expand each scenario through enrichment of variables. The external provider expands these scenarios by using as inputs the agreed scenario narratives and the variables aligned to these narratives. Scenarios, once expanded, continue to be benchmarked to latest events and information.

Description of Consensus Economic Scenarios

The following table describes key macroeconomic variables and the probabilities assigned in the each scenario.

Factors	UAE Scenario Average (2019 - 2023)		
	Upside	Central	Downside
GDP growth rate (%)	3.9	3.4	2.9
Inflation (%)	2.9	2.5	2.2
Unemployment (%)	1.7	2.1	2.5
Short term interest rates (%)	3.3	3.2	1.2
House price growth (%)	4.4	3.0	1.4

The Consensus Central Scenario

The Bank's central scenario is one of moderate growth over the forecast period 2019-2023. The Bank notes that:

- Expected average rates of GDP growth over the 2019-2023 period are lower than average growth rates achieved over the 2013-2017 period for the UAE.
- The average unemployment rate over the projection horizon is expected to remain at or below the averages observed in the 2013-2017 period.
- Inflation is expected to be stable despite steady GDP growth.

The Consensus Upside scenario

The economic forecast distribution of risks (as captured by consensus probability distributions of GDP growth) have shown a decrease over the course of 2018. Globally, real GDP growth rises in the first two years of the Upside scenario before converging to the Central scenario. Increased confidence, stronger oil prices as well as calming of geopolitical tensions are the risk themes that support the 2018 year-end upside scenario.

The Consensus Downside scenario

The distribution of risks (as captured by consensus probability distributions of GDP growth) have shown a marginal increase in downside risks over the course of 2018. Globally, real GDP growth declines for two years in the Downside scenario before recovering to the Central scenario. The global slowdown in demand drives commodity prices lower and results in an accompanying fall in inflation. Central Banks remain accommodative.

Notes on the Financial Statements (continued)

How economic scenarios are reflected in the wholesale calculation of ECL

HSBC has developed a globally consistent methodology for the application of economic scenarios into the calculation of ECL by incorporating those scenarios into the estimation of the term structure of probability of default ('PD') and loss given default ('LGD'). For PDs, we consider the correlation of economic guidance to default rates for a particular industry in a segment. For LGD calculations we consider the correlation of economic guidance to collateral values and realisation rates for a particular country and industry. PDs and LGDs are estimated for the entire term structure of each instrument.

For impaired loans, LGD estimates take into account independent recovery valuations provided by external consultants where available, or internal forecasts corresponding to anticipated economic conditions and individual company conditions. In estimating the ECL on impaired loans that are individually considered not to be significant, HSBC incorporates economic scenarios proportionate to the probability-weighted outcome and the central scenario outcome for non-stage 3 populations.

ECL based exposures at 31 December 2018

Reported ECL (AEDm)	**271**
Drawn Amount (AEDm)	**137,888**
Reported ECL Coverage (per cent)	**0.20%**
Upside scenario	**0.18%**
Downside scenario	**0.21%**
Probability weighted ECL	**0.20%**

[1]*Excludes ECL and financial instruments relating to defaulted obligors*

[2]*Includes off-balance sheet financial instruments that are subject to significant measurement uncertainty*

How economic scenarios are reflected in the retail calculation of ECL

HSBC has developed and implemented a globally consistent methodology for incorporating forecasts of economic conditions into ECL estimates. The impact of economic scenarios on PD is modelled at a portfolio level. Historic relationships between observed default rates and macro-economic variables are integrated into ('IFRS 9 ECL') estimates by leveraging economic response models. The impact of these scenarios on PD is modelled over a period equal to the remaining maturity of underlying asset or assets. The impact on (LGD) is modelled for mortgage portfolios by forecasting future loan-to-value ('LTV') profiles for the remaining maturity of the asset by leveraging national level forecasts of the house price index ('HPI') and applying the corresponding LGD expectation.

ECL based exposures at 31 December 2018

Reported ECL (AEDm)	**749**
Drawn Amount (AEDm)	**12,681**
Reported ECL Coverage (per cent)	**5.90%**
Upside scenario	**5.70%**
Downside scenario	**6.10%**
Probability weighted ECL	**5.90%**

Economic scenarios sensitivity analysis of ECL estimates

The ECL outcome is sensitive to judgement and estimations made with regards to the formulation and incorporation of multiple forward looking economic conditions described above. As a result, management assessed and considered the sensitivity of the ECL outcome against the forward looking economic conditions as part of the ECL governance process by recalculating the ECL under each scenario described above for selected portfolios, applying a 100% weighting to each scenario in turn. The weighting is reflected in both the determination of significant increase in credit risk as well as the measurement of the resulting ECL.

Notes on the Financial Statements (continued)

The economic scenarios are generated to capture the group's view of a range of possible forecast economic conditions that is sufficient for the calculation of unbiased and probability-weighted ECL. As a result, the ECL calculated for the Upside and Downside scenarios should not be taken to represent the upper and lower limits of possible actual ECL outcomes. There are a very wide range of possible combinations of inter-related economic factors that could influence actual credit loss outcomes, accordingly the range of estimates provided by attributing 100% weightings to scenarios are indicative of possible outcomes given the assumptions used. A wider range of possible ECL outcomes reflects uncertainty about the distribution of economic conditions and does not necessarily mean that credit risk on the associated loans is higher than for loans where the distribution of possible future economic conditions is narrower. The recalculated ECLs for each of the scenarios should be read in the context of the sensitivity analysis as a whole and in conjunction with the narrative disclosures.

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 relates 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.

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

Notes on the Financial Statements (continued)

	At 31 December 2018			At 31 December 2017		
	Maximum exposure AED'000	**Offset AED'000**	**Exposure to credit risk (net) AED'000**	Maximum exposure AED'000	Offset AED'000	Exposure to credit risk (net) AED'000
Cash and balances at central bank	**9,020,737**	**-**	**9,020,737**	7,098,868	-	7,098,868
Trading assets	**904,206**	**-**	**904,206**	1,618,520	-	1,618,520
– debt securities	**904,206**	**-**	**904,206**	1,201,306	-	1,201,306
– loans and advances to customers	**-**	**-**	**-**	417,214	-	417,214
Derivatives	**3,260,349**	**-**	**3,260,349**	3,278,003	-	3,278,003
Loans and advances held at amortised cost	**71,917,517**	**(445,809)**	**71,471,708**	68,848,258	(372,616)	68,475,642
– loans and advances to banks	**11,244,198**	**-**	**11,244,198**	14,023,961	-	14,023,961
– loans and advances to customers	**60,673,319**	**(445,809)**	**60,227,510**	54,824,297	(372,616)	54,451,681
Reverse repurchase agreements non-trading	**2,773,621**	**-**	**2,773,621**	5,095,730	-	5,095,730
Financial investments	**14,584,868**	**-**	**14,584,868**	16,428,916	-	16,428,916
debt securities	**14,584,868**	**-**	**14,584,868**	16,428,916	-	16,428,916
Other assets	**2,527,680**	**-**	**2,527,680**	1,536,965		1,536,965
endorsements and acceptances	**1,231,129**	**-**	**1,231,129**	1,129,052	-	1,129,052
Others	**1,296,551**	**-**	**1,296,551**	407,913	-	407,913
Financial guarantees and similar contracts	**28,396,808**	**-**	**28,396,808**	27,950,946	-	27,950,946
Loan commitments and other credit-related commitments	**42,094,088**	**-**	**42,094,088**	44,118,850	-	44,118,850
	175,479,874	**(445,809)**	**175,034,065**	175,975,056	(372,616)	175,602,440

Reconciliation of changes in gross carrying/nominal amount and allowances for loans and advances to banks and customers including loan commitments and financial guarantees

The following disclosure provides a reconciliation of the Bank's gross carrying/nominal amount and allowances for loans and advances to banks and customers including loan commitments and financial guarantees.

The transfers of financial instruments represents the impact of stage transfers upon the gross carrying/nominal amount and associated allowance for ECL. The net remeasurement of ECL arising from stage transfers represents the increase in ECL due to these transfers, (net new lending comprises new originations, assets derecognised, further lending and repayments).

Notes on the Financial Statements (continued)

Reconciliation of changes in gross carrying/nominal amount and allowances for loans and advances to banks and customers including loan commitments and financial guarantees
(Audited)

	Non-credit impaired				Credit Impaired					
	Stage 1		Stage 2		Stage 3		POCI		Total	
	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000
At 1 Jan 2018	**106,285,352**	**(254,334)**	**9,777,992**	**(331,015)**	**4,950,455**	**(3,164,514)**	**135,096**	**(135,096)**	**121,148,895**	**(3,884,959)**
Transfers of financial instruments:										
Transfers from Stage 1 to Stage 2………...	**(10,891,223)**	**39,517**	**10,891,223**	**(39,517)**	**-**	**-**	**-**	**-**	**-**	**-**
Transfers from Stage 2 to Stage 1………...	**10,797,827**	**(111,357)**	**(10,797,827)**	**111,357**	**-**	**-**	**-**	**-**	**-**	**-**
Transfers to Stage 3………...	**-**	**-**	**(825,433)**	**195,992**	**825,433**	**(195,992)**	**-**	**-**	**-**	**-**
Transfers from Stage 3………...	**-**	**-**	**164,533**	**(25,262)**	**(164,533)**	**25,262**	**-**	**-**	**-**	**-**
Net remeasurement of ECL arising from transfer of stage……..	**-**	**55,135**	**-**	**(65,329)**	**-**	**(87,108)**	**-**	**-**	**-**	**(97,302)**
Net new and further lending/ (repayments)…	**565,480**	**27,314**	**(260,484)**	**(123,274)**	**(147,286)**	**(278,234)**	**-**	**-**	**157,710**	**(374,194)**
Assets written off…………..	**-**	**-**	**-**	**-**	**(890,318)**	**890,318**	**-**	**-**	**(890,318)**	**890,318**
Others………	**-**	**-**	**-**	**-**	**-**	**(3,258)**	**-**	**-**	**-**	**(3,258)**
At 31 Dec 2018	**106,757,436**	**(243,725)**	**8,950,004**	**(277,048)**	**4,573,751**	**(2,813,526)**	**135,096**	**(135,096)**	**120,416,287**	**(3,469,395)**
ECL release/(charge) for the period...		**82,450**		**(188,603)**		**(365,345)**		**-**		**(471,498)**
Recoveries…...		**-**		**-**		**70,420**		**-**		**70,420**
Others………..		**-**		**-**		**-**		**-**		**-**
Total ECL Charge for the period		**82,450**		**(188,603)**		**(294,925)**				**(401,078)**

	At 31 Dec 2018		Twelve months ended 31 Dec 2018
	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000	ECL charge AED'000
As above…………	**120,416,287**	**(3,469,395)**	**(401,078)**
Other financial assets measured at amortized cost…………	**10,943,478**	**(1,039)**	**(10,764)**
Non-trading reverse purchase agreement commitments…………	**2,773,650**	**(29)**	**(29)**
Summary of financial instruments to which the impairment requirements in IFRS 9 are applied/ Summary income statement…………	**134,133,415**	**(3,470,463)**	**(411,871)**
Debt instruments measured at FVOCI…………	**14,584,868**	**(405)**	**26**
Total allowance for ECL/total income statement ECL charge for the period…………		**(3,470,868)**	**(411,845)**

Notes on the Financial Statements (continued)

Wholesale Lending

Reconciliation of changes in gross carrying/nominal amount and allowances for loans and advances to banks and customers including loan commitments and financial guarantees
(Audited)

	Non-credit impaired				Credit Impaired					
	Stage 1		Stage 2		Stage 3		POCI		Total	
	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000
At 1 Jan 2018	**87,183,067**	**(158,911)**	**9,060,978**	**(148,659)**	**4,029,547**	**(2,614,392)**	**135,096**	**(135,096)**	**100,408,688**	**(3,057,058)**
Transfers of financial instruments…………….	**292,153**	**(56,135)**	**(610,045)**	**58,789**	**317,892**	**(2,650)**	**-**	**-**	**-**	**-**
Net remeasurement of ECL arising from transfer of stage………..	**-**	**40,998**	**-**	**(45,469)**	**-**	**(86,616)**	**-**	**-**	**-**	**(91,087)**
Net new and further lending / (repayments)	**2,047,988**	**33,159**	**(211,800)**	**5,761**	**(91,692)**	**(148,780)**	**-**	**-**	**1,744,497**	**(109,860)**
Assets written off………	**-**	**-**	**-**	**-**	**(558,011)**	**558,011**	**-**	**-**	**(558,011)**	**558,011**
Foreign exchange and others…………………..	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Others ……………..........	**-**	**-**	**-**	**-**	**-**	**677**	**-**	**-**	**-**	**677**
At 31 Dec 2018	**89,523,208**	**(140,889)**	**8,239,133**	**(129,578)**	**3,697,736**	**(2,293,757)**	**135,096**	**(135,096)**	**101,595,174**	**(2,699,322)**
ECL release/(charge) for the period……………….	**-**	**74,157**	**-**	**(39,708)**	**-**	**(235,399)**	**-**	**-**	**-**	**(200,950)**
Recoveries……………....	**-**	**-**	**-**	**-**	**-**	**49**	**-**	**-**	**-**	**49**
Total ECL Charge for the period	**-**	**74,157**	**-**	**(39,708)**	**-**	**(235,350)**	**-**	**-**	**-**	**(200,901)**

Personal Lending

Reconciliation of changes in gross carrying/nominal amount and allowances for loans and advances to banks and customers including loan commitments and financial guarantees
(Audited)

	Non-credit impaired				Credit Impaired					
	Stage 1		Stage 2		Stage 3		POCI		Total	
	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000	Gross carrying/ nominal amount AED'000	Allowance for ECL AED'000
At 1 Jan 2018	**19,102,285**	**(95,423)**	**717,014**	**(182,356)**	**920,908**	**(550,122)**	**-**	**-**	**20,740,207**	**(827,901)**
Transfers of financial instruments…………….	**(385,549)**	**(15,704)**	**42,541**	**183,781**	**343,008**	**(168,077)**	**-**	**-**	**-**	**-**
Net remeasurement of ECL arising from transfer of stage………..	**-**	**14,138**	**-**	**(19,860)**	**-**	**(492)**	**-**	**-**	**-**	**(6,214)**
Net new and further lending / (repayments)	**(1,482,508)**	**(5,845)**	**(48,684)**	**(129,035)**	**(55,594)**	**(129,454)**	**-**	**-**	**(1,586,786)**	**(264,334)**
Assets written off………	**-**	**-**	**-**	**-**	**(332,307)**	**332,307**	**-**	**-**	**(332,307)**	**332,307**
Foreign exchange and others…………………..	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
Others ……………..........	**-**	**-**	**-**	**-**	**-**	**(3,932)**	**-**	**-**	**-**	**(3,932)**
At 31 Dec 2018	**17,234,228**	**(102,834)**	**710,871**	**(147,470)**	**876,015**	**(519,770)**	**-**	**-**	**18,821,114**	**(770,074)**
ECL release/(charge) for the period……………….	**-**	**8,293**	**-**	**(148,895)**	**-**	**(129,946)**	**-**	**-**	**-**	**(270,548)**
Recoveries……………....	**-**	**-**	**-**	**-**	**-**	**70,371**	**-**	**-**	**-**	**70,371**
Total ECL Charge for the period	**-**	**8,293**	**-**	**(148,895)**	**-**	**(59,575)**	**-**	**-**	**-**	**(200,177)**

Notes on the Financial Statements (continued)

Credit quality of financial instruments

Credit Review and Risk Identification teams regularly review exposures and processes in order to provide an independent, rigorous assessment of the credit risk management framework across the HSBC Group, reinforce secondary risk management controls and share best practice. Internal audit, as a tertiary control function, focuses on risks with a global perspective and on the design and effectiveness of primary and secondary controls, carrying out oversight audits via the sampling of global/regional control frameworks, themed audits of key or emerging risks and project audits to assess major change initiatives.

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

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

Credit quality classification

	Wholesale	Retail lending	Debt securities/other
Quality classification	**Internal credit rating**	**Internal credit rating**	**External credit rating**
Strong	CRR[1] 1 to CRR 2	Band 1[2] and 2	A- and above
Good	CRR 3	Band 3	BBB+ to BBB-
Satisfactory	CRR 4 to CRR 5	Band 4 and 5	BB+ to B and unrated
Sub – standard	CRR 6 to CRR 8	Band 6	B- to C
Impaired	CRR 9 to CRR 10	Band 7	Default

[1] *Customer risk rating ('CRR')*
[2] *12-month point-in-time ('PIT') probability weighted probability of default ('PD')*

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 Band 1 to Band 6 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') within 12 months from the date of the financial statements. All distinct customers use the 10 or 23-grade scale, depending on the degree of sophistication of the Basel approach adopted for the exposure.

Previously, retail lending credit quality was disclosed under IAS 39, which was based on expected-loss percentages. Now, retail lending credit quality is disclosed on an IFRS 9 basis, which is based on a 12-month point-in-time ('PIT') probability weighted probability of default ('PD').

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

Notes on the Financial Statements (continued)

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

Distribution of financial instruments by credit quality

	Gross carrying/notional amount						
	Strong AED'000	**Good AED'000**	**Satisfactory AED'000**	**Sub-Standard AED'000**	**Credit impaired AED'000**	**Allowance for ECL AED'000**	**Net AED'000**
In-scope for IFRS 9							
Cash and balances at central bank	9,020,749	-	-	-	-	(12)	9,020,737
Loans and advances to banks	8,310,322	2,240,662	696,989			(3,775)	11,244,198
Loans and advances to customers	17,270,752	19,817,101	20,292,735	2,286,330	4,424,207	(3,417,808)	60,673,317
Reverse repurchase agreements - non-trading...	829,843	998,102	945,705	-	-	(29)	2,773,621
Financial investments........	8,566,482		6,018,376	-	-	(405)	14,584,453
Other assets.......................	97,882	361,209	1,434,856	28,794		(1,027)	1,921,714
– endorsements and acceptances	41,851	361,209	799,274	28,794	-	(1,027)	1,230,101
– others	56,031	-	635,582	-	-	-	691,613
Out-of-scope for IFRS 9							
Trading assets	233,163	73,971	582,801	14,271	-	-	904,206
Derivatives........................	2,685,689	323,520	232,771	18,369	-	-	3,260,349
Total gross carrying amount on balance sheet	47,014,882	23,814,565	30,204,233	2,347,764	4,424,207	(3,423,056)	104,382,595
Loan and other credit related commitments.........	9,102,195	5,045,856	2,419,965	110,410	1,953	(9,590)	16,670,789
Financial guarantee and similar contracts................	6,929,657	8,897,315	11,118,161	1,168,988	282,687	(38,222)	28,358,586
Total nominal amount off balance sheet	16,031,852	13,943,171	13,538,126	1,279,398	284,640	(47,812)	45,029,375
At 31 Dec 2018	63,046,734	37,757,736	43,742,359	3,627,162	4,708,847	(3,470,868)	149,411,970

Notes on the Financial Statements (continued)

	Neither past due nor impaired							
	Strong AED'000	Good AED'000	Satisfactory AED'000	Sub-Standard AED'000	Past due not impaired AED'000	Impaired AED'000	Impairment allowances AED'000	Total AED'000
Cash and balances at central bank	7,098,868	-	-	-	-	-	-	7,098,868
Trading assets	450,670	192,751	954,997	20,102	-	-	-	1,618,520
Derivatives	346,117	209,497	2,711,637	10,752	-	-	-	3,278,003
Loans and advances held at amortised cost	27,925,363	16,974,401	19,146,607	1,967,683	1,930,601	4,514,192	(3,610,589)	68,848,258
– loans and advances to banks	2,811,121	2,978,266	8,234,574	-	-	-	-	14,023,961
– loans and advances to customers	25,114,242	13,996,135	10,912,033	1,967,683	1,930,601	4,514,192	(3,610,589)	54,824,297
Reverse repurchase agreements - non-trading..........................	3,339,108	137,536	1,619,086	-	-	-	-	5,095,730
Financial investments	6,531,377	-	9,897,539	-	-	-	-	16,428,916
Other assets	58,152	422,455	953,973	12,846	9,053	16,339	-	1,472,818
– endorsements and acceptances	52,745	421,989	616,080	12,846	9,053	16,339	-	1,129,052
– Others	5,407	466	337,893	-	-	-	-	343,766
31 Dec 2017	45,749,655	17,936,640	35,283,839	2,011,383	1,939,654	4,530,531	(3,610,589)	103,841,113

Distribution of financial instruments to which the impairment requirements in IFRS 9 are applied, by credit quality and stage allocation
(Audited)

	Strong AED'000	Good AED'000	Satisfactory AED'000	Sub-standard AED'000	Credit Impaired AED'000	Total AED'000	Allowance for ECL AED'000	Net AED'000
Gross carrying amount on balance sheet								
Stage 1	**44,090,994**	**23,152,544**	**25,659,450**	**1,353,420**	**-**	**94,256,408**	**(218,925)**	**94,037,483**
Stage 2	**5,036**	**264,530**	**3,729,212**	**961,704**	**-**	**4,960,482**	**(255,506)**	**4,704,976**
Stage 3	**-**	**-**	**-**	**-**	**4,289,111**	**4,289,111**	**(2,813,529)**	**1,475,582**
POCI	**-**	**-**	**-**	**-**	**135,096**	**135,096**	**(135,096)**	**-**
	44,096,030	**23,417,074**	**29,388,662**	**2,315,124**	**4,424,207**	**103,641,097**	**(3,423,056)**	**100,218,041**
Nominal amount off balance sheet								
Stage 1	**16,016,354**	**12,091,001**	**11,837,823**	**698,494**	**-**	**40,643,672**	**(25,756)**	**40,617,916**
Stage 2	**15,498**	**1,852,170**	**1,700,303**	**580,904**	**-**	**4,148,875**	**(22,056)**	**4,126,819**
Stage 3	**-**	**-**	**-**	**-**	**284,640**	**284,640**	**-**	**284,640**
POCI	**-**	**-**	**-**	**-**	**-**	**-**	**-**	**-**
	16,031,852	**13,943,171**	**13,538,126**	**1,279,398**	**284,640**	**45,077,187**	**(47,812)**	**46,029,374**
At 31 Dec 2018	**60,127,882**	**37,360,245**	**42,926,788**	**3,594,522**	**4,708,847**	**148,718,284**	**(3,470,868)**	**146,247,416**

Notes on the Financial Statements (continued)

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.

Further 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.

	Up to 29 days AED'000	**30-59 days AED'000**	**60-89 days AED'000**	**90-179 days AED'000**	**Over 180 days AED'000**	**Total AED'000**
Loans and advances to customers held at amortised cost						
– personal	**122,728**	**58,325**	**45,033**	**-**	**-**	**226,086**
– corporate and commercial	**728,137**	**84,060**	**118,236**	**-**	**-**	**930,433**
– non-bank financial institutions	**42**	**-**	**-**	**-**	**-**	**42**
At 31 December 2018	**850,907**	**142,385**	**163,269**	**-**	**-**	**1,156,561**
Loans and advances to customers held at amortised cost						
– personal	174,876	88,861	59,679	-	-	323,416
– corporate and commercial	1,457,027	24,374	46,509	34,781	44,492	1,607,183
– non-bank financial institutions	-	-	-	-	-	-
At 31 December 2017	1,631,903	113,235	106,188	34,781	44,492	1,930,599

Impaired loans

Impaired and stage 3 loans and advances are those that meet any of the following criteria:

- Wholesale loans and advances classified as Customer Risk Rating ('CRR') 9 or CRR 10. These grades are assigned when the bank considers that either the customer is unlikely to pay their credit obligations in full without recourse to security, or when the customer is more than 90 days past due on any material credit obligation to the Bank;
- Retail loans and advances classified as Band 9 or 10.These grades are typically assigned to retail loans and advances more than 90 days past due unless individually they have been assessed as not impaired; and
- 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

	Total AED'000
At 1 January 2017	3,969,240
Amounts written off	(835,729)
Charge to income statement	450,361
Exchange and other movements	26,717
At 31 December 2017	3,610,589

Renegotiated loans and forbearance

Where a loan is modified due to significant concerns about the borrower's ability to meet contractual payments when due, a range of forbearance strategies is employed in order to improve the management of customer relationships, maximise collection opportunities and, if possible, avoid default, foreclosure or repossession.

Notes on the Financial Statements (continued)

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.

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.

Notes on the Financial Statements (continued)

Renegotiated loans and advances to customers

	At 31 December 2018				At 31 December 2017			
	Stage1 AED'000	**Stage2 AED'000**	**Stage3 AED'000**	**Total AED'000**	Neither past due nor impaired AED'000	Past due but not impaired AED'000	Impaired AED'000	Total AED'000
Retail	**-**	**-**	**512,983**	**512,983**	131,365	17,277	364,698	513,340
– Residential mortgages	**-**	**-**	**459,635**	**459,635**	115,215	15,302	313,119	443,636
– Other personal	**-**	**-**	**53,348**	**53,348**	16,150	1,975	51,579	69,704
Corporate and commercial	**1,281,062**	**381,224**	**2,324,128**	**3,986,414**	1,059,677	59,127	2,200,656	3,319,460
Financial	**54,310**	**-**	**-**	**54,310**	60,094	-	-	60,094
Total renegotiated loans and advances to customers	**1,335,372**	**381,224**	**2,837,111**	**4,553,707**	1,251,136	76,404	2,565,354	3,892,894
Total impairment allowance on renegotiated loans				**(1,870,795)**				(1,650,717)

For retail lending, unsecured renegotiated loans are generally segmented from other parts of the loan portfolio. Renegotiated expected credit loss assessments reflect the higher rates of losses typically encountered with renegotiated loans. For wholesale lending, renegotiated loans are typically assessed individually. Credit risk ratings are intrinsic to the impairment assessments. The individual impairment assessment takes into account the higher risk of the future non-payment inherent in renegotiated loans.

For details of our impairment policies on loans and advances and financial investments, see Note 3 on the Financial Statements.

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 are 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

	2018 AED'000
Stage 1	
Not collateralised	-
Fully collateralised	**6,137,300**
– Less than 50% loan to value ('LTV')	**1,062,188**
– 51% to 60% LTV	**704,331**
– 61% to 70% LTV	**1,134,613**
– 71% to 80% LTV	**1,956,489**
– 81% to 90% LTV	**1,087,897**
– 91% to 100% LTV	**191,782**
Partially collaterised	
Greater than 100% LTV (A)	**381,167**
– 101% to 110% LTV	**218,382**
– 111% to 120% LTV	**44,934**
– Greater than 120% LTV	**117,851**
Collateral value on A	**307,203**
Total	**6,518,467**
Stage 2	
Not collateralised	-
Fully collateralised	**119,385**
– Less than 50% loan to value ('LTV')	**18,348**
– 51% to 60% LTV	**6,415**
– 61% to 70% LTV	**14,569**
– 71% to 80% LTV	**42,111**
– 81% to 90% LTV	**28,988**
– 91% to 100% LTV	**8,954**
Partially collaterised	
Greater than 100% LTV (B)	**13,576**
– 101% to 110% LTV	**7,291**
– 111% to 120% LTV	**1,306**
– Greater than 120% LTV	**4,979**
Collateral value on B	**11,219**
Total	**132,961**
Stage 3	
Not collateralised	-
Fully collateralised	**209,580**
– Less than 50% loan to value ('LTV')	**44,314**
– 51% to 60% LTV	**21,489**
– 61% to 70% LTV	**36,339**
– 71% to 80% LTV	**47,853**
– 81% to 90% LTV	**51,161**
– 91% to 100% LTV	**8,424**
Partially collaterised	
Greater than 100% LTV (C)	**396,919**
– 101% to 110% LTV	**27,561**
– 111% to 120% LTV	**41,413**
– Greater than 120% LTV	**327,945**
Collateral value on C	**248,511**
Total	**606,499**
Total residential mortgages	**7,257,927**

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.

Notes on the Financial Statements (continued)

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.

Other personal lending

The other personal lending consists primarily of motor vehicle, credit cards and second lien portfolios. Motor vehicle lending is generally collateralised by the motor vehicle financed. 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.

Collateral on loans and advances

Commercial real estate loans and advances

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.

Wholesale lending: commercial real estate loans and advances including loan commitments by level of collateral

	2018 AED'000
Stage 1	
Not collateralised	**5,922,552**
Fully collateralised	**226,257**
– Less than 50% loan to value ('LTV')	**73,053**
– 51% to 75% LTV	**46,848**
– 76% to 90% LTV	**-**
– 91% to 100% LTV	**106,356**
`	
Partially collaterised	**1,069,372**
Collateral value on A	**919,385**
Total	**7,218,181**
Stage 2	
Not collateralised	**185,786**
Fully collateralised	
– Less than 50% loan to value ('LTV')	**70,714**
– 51% to 75% LTV	**70,714**
– 76% to 90% LTV	**-**
– 91% to 100% LTV	**-**
Total	**256,500**
Stage 3	
Not collateralised	**112,765**
Fully collateralised	**25,345**
– Less than 50% loan to value ('LTV')	**25,345**
– 51% to 75% LTV	**-**
– 76% to 90% LTV	**-**
– 91% to 100% LTV	**-**
Partially collaterised (C)	**628,428**
Collateral value on C	**599,410**
Total	**766,538**
Total	**8,241,219**

Notes on the Financial Statements (continued)

The collateral included in the table above consists of fixed first charges on real estate and charges over cash for commercial real estate. These facilities are disclosed as not collateralised if they are unsecured or benefit from credit risk mitigation from guarantees, which are not quantified for the purposes of this disclosure.

The value of commercial real estate collateral is determined through a combination of professional and internal valuations and physical inspection. Due to the complexity of valuing collateral for commercial real estate, local valuation policies determine the frequency of review based on local market conditions. Revaluations are sought with greater frequency when, 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, or 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, that is sub-standard, or approaching impaired). Where such concerns exist the revaluation method selected will depend upon the loan-to-value relationship, the direction in which the local commercial real estate market has moved since the last valuation and, most importantly, the specific characteristics of the underlying commercial real estate which is of concern.

Other corporate, commercial and financial (non-bank) is analysed separately below reflecting the difference in collateral held on the portfolios. For financing activities in corporate and commercial lending that are not predominantly commercial real estate-oriented, collateral value is not strongly correlated to principal repayment performance. Collateral values are generally refreshed when an obligor’s general credit performance deteriorates and we have to assess the likely performance of secondary sources of repayment should it prove necessary to rely on them.

Notes on the Financial Statements (continued)

Wholesale lending: other corporate, commercial and financial (non-bank) loans and advances including loan commitments by level of collateral and by stage

	2018 AED'000
Stage 1	
Not collateralised	**61,705,105**
Fully collateralised	**771,574**
– Less than 50% loan to value ('LTV')	**137,829**
– 51% to 75% LTV	**87,903**
– 76% to 90% LTV	**162,074**
– 91% to 100% LTV	**383,768**
Partially collateralised (A)	**4,503,888**
Collateral value on A	**996,461**
Total	**66,980,567**
Stage 2	
Not collateralised	**7,377,691**
Fully collateralised	**45,182**
Less than 50% loan to value ('LTV')	**2,190**
51% to 75% LTV	**13,320**
76% to 90% LTV	**19,047**
91% to 100% LTV	**10,625**
Partially collateralised	**616,334**
Collateral value on B	**251,105**
Total	**8,039,207**
Stage 3	
Not collateralised	**1,835,285**
Fully collateralised	**334,117**
Less than 50% loan to value ('LTV')	**10,395**
51% to 75% LTV	**78,254**
76% to 90% LTV	**245,468**
91% to 100% LTV	**-**
	-
Partially collateralised	**493,241**
Collateral value on C	**188,930**
Total	**2,662,643**
POCI	
Not collateralised	**135,095**
Total	**135,095**
Total	**77,817,512**

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;

Securities issued by governments, banks and other financial institutions may benefit from additional credit enhancement, notably through government guarantees that reference these assets.

Trading assets include loans and advances held with trading intent, the majority of which consist of reverse repos and stock borrowing which, by their nature, are collateralised.

Notes on the Financial Statements (continued)

The Bank's maximum exposure to credit risk includes financial guarantees and similar arrangements that the Bank issues or enters into, and loan commitments that the Bank 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.

Derivatives

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

Concentration of exposure

Concentrations of credit risk arise when a number of counterparties or exposures 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.

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 as per governing regulations including that of the Central Bank, 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 2018 and 31 December 2017 was concentrated in the Middle East and Europe.

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. The Bank uses 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.

Notes on the Financial Statements (continued)

Loans and advances

Gross loans and advances to customers by industry sector

	Gross loans and advances to customers	
	2018	2017
	AED'000	AED'000
Personal		
Residential mortgages	**7,255,521**	6,905,157
Other personal	**5,426,449**	6,178,373
	12,681,970	13,083,530
Corporate and commercial		
Commercial, industrial and international trade	**26,385,383**	26,068,303
Commercial real estate	**1,821,263**	1,677,259
Other property-related	**6,790,446**	4,667,033
Government	**6,027,037**	4,497,151
Other commercial	**9,626,015**	7,642,099
	50,650,144	44,551,845
Financial		
Non-bank financial institutions	**759,013**	799,511
	759,013	799,511
Total gross loans and advances to customers	**64,091,127**	58,434,886
Impaired loans	**4,424,207**	4,514,192
- as a percentage of gross loans and advances to customers	**6.90%**	7.73%
Impairment Allowances	**(3,417,808)**	(3,610,589)
- as a percentage of gross loans and advances to customers	**5.33%**	6.18%

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.

Structure and organisation of the liquidity risk management function

The Bank's management of liquidity and funding is in compliance with the HSBC Group's LFRF, and with practices and limits set by the HSBC Group Management Board ('GMB') through the Risk Management Meeting ('RMM') and approved by the HSBC Holdings Board for 'RMM operating entities'.

The elements of the LFRF are underpinned by a robust governance framework, the two major elements of which are:

- Group, regional and entity level asset and liability management committees ('ALCOs'); and
- Annual individual liquidity adequacy assessment process ('ILAAP') for the UAE branch, which is used to validate local risk tolerance and set risk appetite.

The primary responsibility for managing liquidity and funding within the Bank's framework and risk appetite resides with the UAE ALCO and UAE RMM, and overseen by HBME ALCO, HSBC Group ALCO and the HSBC Group Risk Management Meeting.

Liquidity coverage ratio ('LCR')

The LCR aims to ensure that a bank has sufficient unencumbered high-quality liquid assets ('HQLA') to meet its liquidity needs in a 30 calendar day liquidity stress scenario.

Unaudited	Liquidity coverage ratio during:	
	2018	2017
	%	%
Year-end	**182.2**	197.5

Notes on the Financial Statements (continued)

Net Stable Funding Ratio

The Bank calculates NSFR in line with Basel Committee on Banking Supervision's publication number 295 (BCBS295). This calculation requires various interpretations of the text, and therefore the bank's NSFR may not be directly comparable with the ratios of other institutions.

Unaudited	Net Stable Funding Ratio during:	
	2018	2017
	%	%
Year-end	**131.6**	142.9

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 2018, the Bank was within the risk tolerance levels set for depositor concentration and term funding maturity concentration.

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 the total liabilities of AED 93,220m at 31 December 2018, funding from customers amounted to AED 61,049m, of which AED 60,868m 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 28.

Assets available to meet these liabilities, and to cover outstanding commitments to lend (AED 148,925m), included cash, central bank balances, items in the course of collection and treasury and other bills (AED 3,670m); loans to banks (AED 11,244m, including AED 7,559m repayable within one year); and loans to customers (AED 60,673m, including AED 30,110m 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.

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 and financial investments designated as fair value through other comprehensive income.

Notes on the Financial Statements (continued)

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.

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.

Notes on the Financial Statements (continued)

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:

	Portfolio	
	Trading	**Non-trading**
Risk type		
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

	2018	2017
	AED'000	AED'000
At 31 December	**8,355**	37,042
Average	**25,068**	20,798
Minimum	**8,351**	10,614
Maximum	**38,367**	37,872

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.

Market-making and position-taking is undertaken within Global Markets. The VAR for such trading intent activity at 31 December 2018 was AED 6.1m (2017: AED 35.1m). This is analysed below by risk type:

Notes on the Financial Statements (continued)

VAR by risk type for the trading intent activities

	Foreign exchange AED'000	Interest rate AED'000	Credit AED'000	Total[1] AED'000
At 31 December 2018	**3,816**	**4,187**	**2,248**	**6,101**
At 31 December 2017	37,701	10,406	1,358	35,058
Average				
2018	**14,747**	**10,229**	**1,792**	**17,252**
2017	12,414	10,289	2,819	16,356
Minimum				
2018	**3,453**	**2,075**	**922**	4,823
2017	752	5,212	456	5,081
Maximum				
2018	**37,490**	**15,401**	**4,599**	**24,067**
2017	37,701	15,553	3,825	35,058

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

Non Trading portfolios

Non-trading VaR of the Bank includes contributions from all global businesses. There is no commodity risk in the non-trading portfolios.

Non-trading VaR includes the interest rate risk in the banking book transferred to and managed by Balance Sheet Management ('BSM') and the non-trading financial instruments held by BSM. The management of interest rate risk in the banking book and the role of BSM are described further in net interest income sensitivity section below. The daily levels of total non-tradingVaR over the last year are set out in the table below.

	Foreign exchange AED'000	Interest rate AED'000	Credit AED'000	Total[1] AED'000
At 31 December 2018	**NA**	**8,551**	**1,796**	**7,816**
At 31 December 2017	NA	12,804	3,379	13,054
Average				
2018	**NA**	**15,783**	**3,387**	**17,101**
2017	NA	8,896	2,468	8,947
Minimum				
2018	**NA**	**8,515**	**1,278**	**7,508**
2017	NA	6,387	1,164	5,675
Maximum				
2018	**NA**	**21,909**	**8,011**	**25,957**
2017	NA	13,304	4,485	13,054

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

Gap risk

Certain products are structured in such a way that they give rise to enhanced gap risk, being the risk that loss is incurred upon occurrence of a gap event. A gap event is a significant and sudden change in market price with no accompanying trading opportunity. Such movements may occur, for example, when, in reaction to an adverse event or unexpected news announcement, some parts of the market move far beyond their normal volatility range and become temporarily illiquid.

Given the characteristics, 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 losses arising from gap risk movements in the underlying market price on such transactions in the 12 months ended 31 December 2018.

Notes on the Financial Statements (continued)

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, and the re-pricing behaviour of managed rate products.

The control of market risk in the non-trading portfolios is based on transferring the risks to the books managed by Global Markets or 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.

Net interest income sensitivity

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. The latter are consolidated to illustrate the combined pro forma effect on the Bank’s consolidated portfolio valuations and net interest income.

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 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. Responsibility for minimising operational risk lies with all the Bank’s employees. They are required to manage the operational risks of the business for which they are responsible. The objective of the Bank's operational risk management is to manage and control operational risk in a cost-effective manner within targeted levels of operational risk consistent with the Bank’s risk appetite, as defined by the Group Management Board.

Notes on the Financial Statements (continued)

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.

Responsibility for minimising operational risk lies with all the Bank's employees. They are required to manage the operational risks of the business for which they are responsible.
The objective of the Bank's operational risk management is to manage and control operational risk in a cost-effective manner within targeted levels of operational risk consistent with the Bank's risk appetite, as defined by the Group Management Board.

Operational risk management framework

Overview

The objective of our operational risk management is to manage and control operational risk in a cost-effective manner within targeted levels of operational risk consistent with our risk appetite, as defined by the Board of Directors.

Key developments in 2018

During 2018, we continued to strengthen our approach to managing operational risk, as set out in the Bank's operational risk management framework ('ORMF'). The approach sets out the governance, appetite and provides an end-to-end view of non-financial risks, enhancing focus on the risks that matter the most and associated controls. It incorporates a risk management system to enable active risk management.

Activity to strengthen our risk culture and better embed the approach, particularly the three lines of defence model, continued to be a key focus in 2018. It sets our roles and responsibilities for managing operational risk on a daily basis.

Governance and structure

The ORMF defines minimum standards and processes, and the governance structure for the management of operational risk and internal control in our countries, businesses and 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.
We have a dedicated Operational Risk sub-function within our Risk function. It is responsible for providing oversight of the ORMF, monitoring the level of operational losses and the internal control environment supported by their second line of defence functions. It supports the Chief Risk Officer and the Risk Committee, which meets at least quarterly to discuss key risk issues and review implementation of the ORMF. The sub-function is also responsible for preparation of operational risk reporting, including reports for consideration by the RMM and Risk Committee. A formal governance structure provides oversight of the sub-function's management.

Key risk management processes

Business managers are responsible for maintaining an acceptable level of internal control commensurate with the scale and nature of operations, and for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls. The ORMF helps managers to fulfil these responsibilities by defining a standard risk assessment methodology and providing a tool for the systematic reporting of operational loss data.
A Group-wide risk management system is used to record the results of the operational risk management process. Operational risk and control self-assessments, along with issue and action plans, are entered and maintained by business units. Business and functional management monitor the progress of documented action plans to address shortcomings. To help ensure that operational risk losses are consistently reported and monitored, businesses and functions are required to report individual losses when the net loss is expected to exceed $10,000. Losses are entered into the Group-wide risk management system and reported to governance on a monthly basis.

Continuity of business operations

Every department within the organisation undertakes business continuity management, which incorporates the development of a plan including a business impact analysis assessing risk when business disruption occurs.
The Bank maintains dedicated work area recovery sites. Regular testing of these facilities is carried out with representation from each business and support function, to ensure business continuity plans remain accurate, relevant and fit for purpose. Where possible, it is ensured that critical business systems are not co-located with business system users, thereby reducing concentration risk.

Notes on the Financial Statements (continued)

Legal risk

The Bank implements processes and procedures to manage legal risk that conform to HSBC Group standards.

Legal risk falls within the definition of operational risk and includes:

– contractual risk, which is the risk of a member of the Bank suffering financial loss, legal or regulatory action or reputational damage because its rights and/or obligations under a contract to which it is a party are technically defective;
– dispute adjudication risk, which is the risk of a member of the Bank suffering financial loss or reputational damage due to an adverse dispute environment or a failure to take appropriate steps to defend, prosecute and/or resolve actual or threatened legal claims brought against or by a group member, including for the avoidance of doubt, regulatory matters;
– legislative risk, which is the risk that a group member fails to or is unable to identify, analyse, track, assess or correctly interpret applicable legislation, case law or regulation, or new regulatory, legislative or doctrinal interpretations of existing laws or regulations, or decisions in the Courts or regulatory bodies;
– non-contractual rights risk, which is the risk that a group member's assets are not properly owned or protected or are infringed by others, or a group member infringes another party's rights; and
– non-contractual obligations risk, which is the risk arising due to infringement of third-party rights and/or breach of common law duties.

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

The Bank must notify the legal department immediately if any litigation, dispute or material regulatory action is either threatened or commenced against the Bank or an employee (acting in his capacity as an officer or employee of the Bank). The legal department must be immediately advised of any significant action by a regulatory authority, where the proceedings are criminal, or where the claim might materially affect HSBC Group's reputation.

The legal department will assess each claim that is threatened or commenced against the Bank or any employee (acting in his capacity as an officer or employee of the Bank) in order to determine the appropriate action, including appointment of external counsel, consideration of the merits of the claim, consideration of any provision, consideration of any document holds or interviews that may be required and consideration of any immediate reporting to senior management or the Bank's regulators as may be necessary.

The legal department must immediately advise the Bank's senior management, the HSBC Group of any threatened or actual litigation claims if such claim exceeds US$5m or of any significant action by a regulatory authority, where the proceedings are criminal or where a claim might materially affect HSBC Group's reputation. In addition, the legal department submits periodic returns to the Bank's risk management meeting and Board Risk Committee meeting, including updates on ongoing litigation and details of any judgements issued against the Bank. These returns are shared with the Bank's regulators on a periodic basis.

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

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 12.38% (2017: 11.75%).

The Bank's regulatory capital is analysed into two tiers:

– Tier 1 capital, which includes allocated capital and retained earnings; and
– Tier 2 capital, which includes collective impairment provision and subordinated facilities.

Notes on the Financial Statements (continued)

Capital structure as at 31 December

(Unaudited)	2018 Basel III AED'000	2017 Basel III AED'000
Composition of regulatory capital		
Common Equity Tier 1 (CET1) capital	**10,711,471**	10,776,451
Additional Tier 1 (AT1) capital	**-**	486
Total Tier 1 capital	**10,711,471**	10,776,937
Tier 2 Capital	**1,481,614**	2,015,924
Total Eligible Capital	**12,193,085**	12,792,861
Risk weighted assets		
Credit risk counterparty risk	**74,459,084**	73,094,999
Market risk	**6,642,544**	4,104,576
Operational risk	**9,136,175**	9,356,135
	90,237,803	86,555,710
Capital ratios	**%**	%
Capital adequacy ratio	**13.51**	14.78

34 Contingent liabilities, contractual commitments and guarantees

	2018 AED'000	2017 AED'000
Guarantees and other contingent liabilities		
Guarantees	**28,396,808**	27,950,946
Commitments		
Documentary credits and short-term trade-related transactions	**758,944**	620,810
Undrawn formal standby facilities, credit lines and other commitments to lend	**41,335,144**	43,498,040
	42,094,088	44,118,850

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.

Other commitments

In addition to the commitments disclosed above, at 31 December 2018 the Bank had capital commitments to purchase, within one year, land and building and other fixed assets for a value of AED Nil (2017: AED 817m).

35 Lease commitments

Operating lease commitments

At 31 December 2018, 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	
	2018 AED'000	2017 AED'000
Future minimum lease payments under non-cancellable operating leases expiring:		
– no later than one year	**35,858**	68,322
– later than one year and no later than five years	**75,907**	75,706
– later than five years	**7,130**	6,270
	118,895	150,298

In 2018, AED 70.2m was charged to 'General and administrative expenses' in respect of lease agreements related to minimum lease payments.

Notes on the Financial Statements (continued)

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	
	2018	2017
	AED'000	AED'000
Lease receivables:		
- no later than one year	**436,836**	489,543
- later than one year and no later than five years	**121,643**	35,210
- later than five years	**111,818**	246,169
	670,297	770,922

36 Interests in associates and Joint Arrangements

Joint arrangement of the Bank

	At 31 December 2018			
	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$621m fully paid**

Notes on the Financial Statements (continued)

37 Effect of reclassification upon adoption of IFRS 9

Reconciliation of balance sheet at 31 December 2017 and 1 Jan 2018

	IAS 39 measurement category	IFRS9 measurement category	IAS 39 carrying amount at 31 Dec 2017	Other changes in classification	IFRS9 reclassification to: Fair value through profit and loss	Fair value through other comprehensive income	Amortised cost	Carrying amount post reclassification	IFRS 9 re-measurement including expected credit losses	IFRS 9 carrying amount at 1 Jan 2018
Assets										
Cash and balances at Central banks	Amortised Cost	Amortised Cost	7,098,868	-	-	-	-	7,098,868	-	7,098,868
Trading assets[1]	FVPL	FVPL	1,618,520	(196,276)	-	-	-	1,422,244	-	1,422,244
Derivatives	FVPL	FVPL	3,278,003	-	-	-	-	3,278,003	-	3,278,003
Loans and advances to banks	Amortised Cost	Amortised Cost	14,023,961	-	-	-	-	14,023,961	(1,856)	14,022,105
Loans and advances to customers	Amortised Cost	Amortised Cost	54,824,297	-	-	-	-	54,824,297	(175,539)	54,648,758
Reverse repurchase agreements – non-trading	Amortised Cost	Amortised Cost	5,095,730	-	-	-	-	5,095,730	(111)	5,095,619
Financial investments[3,6]	FVOCI (Available for sale-equity instrumets)	FVOCI	16,428,916	-	-	-	-	16,428,916	-	16,428,916
Other assets[1]	Amortised Cost	Amortised Cost	1,536,964	196,276	-	-	-	1,733,240	(2,694)	1,730,856
Property, plant and equipment	NA	NA	110,725					110,725		110,725
Intangible assets	NA	NA	35,283					35,283		35,283
Deferred tax assets	NA	NA	702,701	-	-	-	-	702,701	37,243	739,944
Total assets			104,753,968	-	-	-	-	104,753,968	(142,957)	104,611,011
Liabilities										
Deposits by banks	Amortised Cost	Amortised Cost	8,498,802	-	-	-	-	8,498,802	-	8,498,802
Customer accounts	Amortised Cost	Amortised Cost	61,334,342	-	-	-	-	61,334,342	-	61,334,342
Trading liabilities[1.4]	FVPL	FVPL	4,811,443	(4,687,068)	-	-	-	124,375	-	124,375
Financial liabilities designated at fair value[4]	FVPL	FVPL	2,716,091	4,656,948	-	-	-	7,373,039	-	7,373,039
Derivatives	FVPL	FVPL	3,235,496	-	-	-	-	3,235,496	-	3,235,496
Debt securities in issue	Amortised Cost	Amortised Cost	3,825,214	-	-	-	-	3,825,214	-	3,825,214
Accruals, deferred income and other liabilities[1]	Amortised Cost	Amortised Cost	4,309,820	30,120	-	-	-	4,339,940	-	4,339,940
Provisions	NA	NA	790,417	-	-	-	-	790,417	54,156	844,573
Current Tax Liabilities	NA	NA	282,862	-	-	-	-	282,862	-	282,862
Subordinated Liabilities	Amortised Cost	Amortised Cost	2,756,823	-	-	-	-	2,756,823	-	2,756,823
Total liabilities			92,561,310	-	-	-	-	92,561,310	54,156	92,615,466

	IAS 39 carrying amount at 31 Dec 2017	IFRS 9 classification	Carrying amount post reclassification	IFRS 9 re-measurement including expected credit losses	IFRS 9 carrying amount at 1 Jan 2018
	AED'000	AED'000	AED'000	AED'000	AED'000
Head Office funds					
Allocated capital	4,495,255	-	4,495,255	-	4,495,255
Legal reserves	2,050,128	-	2,050,128	-	2,050,128
Other reserves [6]	(318,630)	-	(318,630)	496,841	178,211
Retained earnings	5,965,904	-	5,965,904	(694,387)	5,271,517
Total Head Office funds	12,192,657	-	12,192,657	(197,546)	11,995,111

Notes on the Financial Statements (continued)

Reconciliation of Impairment allowance under IAS 39 and provision under IAS 37 to expected credit losses under IFRS9

	IAS 39 measurement category	Reclassification to: Fair value through profit and loss AED'000	Reclassification to: Fair value through comprehensive income AED'000	Remeasurement: Amortised Cost AED'000	Remeasurement: Stage 3 AED'000	Remeasurement: Stage 1 & 2 AED'000	Total AED'000
Financial assets at amortised cost							
IAS 39 impairment allowance at 31 Dec 2017 ..							3,610,589
Cash and balances at Central banks	Amortised Cost (Loans & Receivables)	-	-	-	-	-	
Loans and advances to banks	Amortised Cost (Loans & Receivables)	-	-	-	-	1,967	1,967
Loans and advances to customers	Amortised Cost (Loans & Receivables)	-	-	-	205,290	(29,751)	175,539
Other assets	Amortised Cost (Loans & Receivables)	-	-	-	-	2,694	2,694
Expected credit loss allowance at 1 Jan 2018							3,790,789
Financial assets at fair value							
IAS 39 impairment allowance at 31 Dec 2017 ..							
Debt instruments at fair value	NA	NA	433	NA	NA	NA	433
Expected credit loss allowance at 1 Jan 2018							433
Loan commitments and financial guarantee contracts							
IAS 37 provisions at 31 Dec 2017							42,685
Provisions (loan commitments and financial guarantees)	NA	NA	NA	NA	(17,440)	71,596	54,156
Expected credit loss provision at 1 Jan 2018							96,841

Footnotes to Effect of reclassification upon adoption of IFRS 9

1 *Settlement accounts of AED 196m have been reclassified from 'Trading assets' to 'Other assets' as a result of the assessment of business model in accordance with IFRS 9. Settlement accounts previously presented as 'Trading liabilities' of AED 30m have been represented in 'Accruals, deferred income and other liabilities'. This change in presentation for financial liabilities is considered to provide more relevant information, given the change in presentation of financial assets. These changes in presentation of financial assets and liabilities have had no effect on measurement of these items and therefore on 'Retained earnings'.*

2 *IFRS 9 expected credit losses have decreased net assets by AED 197m principally comprising of AED 175m reduction in the carrying value of assets classified as 'Loans and advances to customers' and AED 54m increase in 'Provisions' relating to expected credit losses on loan commitments and financial guarantee contracts.*

3 *We have considered market practices for the presentation of AED 4,657m of financial liabilities which contain both deposit and derivative components. We have concluded that a change in accounting policy and presentation from 'Trading liabilities' would be appropriate, since it would better align with the presentation of similar financial instruments by peers and therefore provide more relevant information about the effect of these financial liabilities on our financial position and performance. As a result, rather than being classified as held for trading, we will designate these financial liabilities as at fair value through profit or loss since they are managed and their performance evaluated on a fair value basis. Consequently, changes in fair value of these instruments attributable to changes in own credit risk are recognised in other comprehensive income rather than profit or loss. For the year ended 31 December 2017, a restatement would have decreased 'Net income from financial instruments held for trading or managed on a fair value basis' by AED 57m, with an equivalent net increase in other comprehensive income.*

4 *While IFRS 9 ECL has no effect on the carrying value of FVOCI financial assets, which remain measured at fair value, the FVOCI reserve (formerly AFS reserve) relating to financial investments reclassified to 'Financial assets designated and otherwise mandatorily measured at fair value through profit or loss' in accordance with IFRS 9 has been transferred to retained earnings.*

5 *Measurement refers to that under IAS 39 and IFRS 9. Financial investments measured at fair value through other comprehensive income were measured as available-for-sale instruments under IAS 39.*

6 *In line with the requirements of the UAECB, an impairment reserve of AED 497m has been created. This impairment reserve has been created in relation to the difference between the IFRS 9 model ECLs for Stages 1 and 2 and the minimum general provision requirements of the UAECB as an appropriation of retained earnings and is not distributable. The IFRS 9 model ECLs for Stage 3 are above the minimum requirements of the UAECB and no impairment reserve is required.*

38 Intangibles assets and property, plant & equipment

Intangible assets

Included within intangible assets is internally generated software with a net carrying value of AED 98m (2017: AED 17m).

During the year, capitalisation of internally generated software was AED 94m (2017: AED 18m) and amortisation was AED 13m (2017: AED 11m).

Property, plant & equipment

Increase in property, plant and equipment is mainly from the acquisition of HSBC Tower AED 928m in 2018.

39 Legal proceedings and regulatory matters

The Bank is party to legal proceedings 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. The recognition of provisions is determined in accordance with the accounting policies set out in Note 3 of the Banks's Financial Statements for 2018. 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 2018. Where an individual provision is material, the fact that a provision has been made is stated and quantified, except to the extent doing so would be seriously prejudicial. 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.

Notes on the Financial Statements (continued)

Anti-money laundering and sanctions-related

(Matters relevant to the group as a subsidiary of HSBC operating in the Middle East)

In October 2010, HSBC Bank USA entered into a consent cease-and-desist 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. In 2012, an additional consent order was entered into with the OCC that required HSBC Bank USA to correct the circumstances noted in the OCC's report and imposed restrictions on HSBC Bank USA acquiring control of, or holding an interest in, any new financial subsidiary, or commencing a new activity in its existing financial subsidiary, without the OCC's approval. Between June and September 2018, the OCC and FRB terminated each of these Orders having determined that HSBC had satisfied their requirements.

In December 2012, among other agreements, HSBC Holdings entered into an agreement with the Office of Foreign Assets Control ('OFAC') regarding historical transactions involving parties subject to OFAC sanctions, consented to a cease-and-desist order with the FRB, entered into a 5 year deferred prosecution agreement with, among others, the US Department of Justice (the "US DPA") and agreed to an undertaking with the UK FCA to comply with certain forward-looking AML and sanctions-related obligations and to retain an independent compliance monitor to produce annual assessments of the Group's AML and sanctions compliance programme (the "Independent Consultant"). In February 2018, the Independent Consultant delivered his fourth annual follow-up review report and the fifth annual follow-up review report is expected to be delivered in February 2019. The Independent Consultant will continue working in his capacity as a skilled person and independent consultant for a period of time at the FCA's and FRB's discretion.

Through his country-level reviews, the Independent Consultant identified potential anti-money laundering and sanctions compliance issues that HSBC is reviewing further with the FRB and/or FCA. In December 2017, the US DPA expired and the charges deferred by the US DPA were dismissed. Additionally, HSBC is the subject of other ongoing investigations and reviews by the DoJ and HSBC Bank plc is the subject of an investigation by the FCA into its compliance with UK money laundering regulations and financial crime systems and controls requirements.
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 ("ATA Case 1"). 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. The plaintiffs allege that the 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 2017, following the filing by the Plaintiffs of a Second Amended Complaint in July 2017. In July 2017, the various motions before the Court were referred for review and for the issuance of a judicial report and recommendations, which was issued in July 2018, and which concluded that the New York District Court should deny the defendants' motion to dismiss. The defendants have challenged this conclusion. The future of ATA Case 1 remains under the consideration of the judge and the motion to dismiss filed by the HSBC defendants, including the group remains pending before the court.

In November 2017, a complaint was filed in the Southern District of New York on behalf of representatives of US soldiers killed or injured whilst serving in Iraq ("ATA Case 2"). The complaint was filed against HSBC Holdings plc, HSBC Bank plc, HSBC Bank Middle East Limited, HSBC Bank USA, N.A, HSBC North America Holdings Inc. and other non-HSBC Banks. 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 and also allege breaches of US Justice Against Sponsors of Terrorism Act ('JASTA'). The HSBC defendants in ATA Case 2, including the group have filed a Motion to Dismiss, which is currently pending before the Court.

In December 2018, three new cases and two cases relating to existing actions were filed in the New York District Court against the group and various HSBC companies, prompted by an expiry of the statute of limitations which applies to such ATA related claims (the "New ATA Cases"). These New ATA Cases are at a very early stage.

Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of ATA Case 1, ATA Case 2 or the New ATA Cases, including the timing or any possible impact on HSBC, which could be significant.

Notes on the Financial Statements (continued)

Foreign exchange rate investigations and litigation

Various regulators and competition and law enforcement authorities around the world, including in the EU, Switzerland, Brazil and South Africa, are conducting civil and criminal investigations and reviews into trading by HSBC and others on the foreign exchange markets. HSBC is cooperating with these investigations and reviews and settlements relevant to the group are detailed below.

In September 2017, HBSC Holdings and HNAH consented to a civil money penalty order with the FRB in connection with its investigation into HSBC's historic foreign exchange activities. Under the terms of the order, HSBC Holdings and HNAH agreed to pay a civil money penalty of US$175m to the FRB.

In January 2018, HSBC Holdings entered into a three-year deferred prosecution agreement with the Criminal Fraud Division of the DoJ, regarding fraudulent conduct in connection with two particular transactions in 2010 and 2011. This concluded the DoJ's investigation into HSBC's historical foreign exchange activities. Under the terms of the FX DPA, HSBC has a number of ongoing obligations, including continuing to cooperate with authorities and implementing enhancements to its internal controls and procedures in its Global Markets business, which will be the subject of annual reports to the DoJ. In addition, HSBC agreed to pay a financial penalty and restitution.

There are many factors that may affect the range of outcomes, and the resulting financial impact, of these matters, which could be significant.

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 and its subsidiaries, fellow branches, 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.

Transactions with related parties;

	2018	2017
	Balance at the year end[1]	Balance at the year end[1]
	AED'000	AED'000
Assets		
Loans and advances to customers	**1,055**	25,912
Loans and advances to banks	**7,162,628**	8,233,286
Reverse repurchase agreements – non-trading	**97,618**	66,857
Liabilities		
Deposits by banks	**5,912,312**	6,211,269
Customer accounts	**134,453**	349,451
Subordinated loan from Head Office	**2,754,375**	2,756,823
Guarantees and assets pledged by the bank as collateral security	**2,947,401**	2,635,394
Documentary credits and short-term trade-related transactions	**182,118**	171,689

	For the year ended 31 December 2018	For the year ended 31 December 2017
	AED'000	AED'000
Income Statement		
Interest income	**126,388**	105,875
Interest expense	**(272,160)**	(258,006)
Fee income	**209,973**	223,532
Fee expense	**(69,095)**	(78,392)
Other operating income	**374,707**	309,970
General and administrative expenses	**(436,458)**	(338,987)

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

Notes on the Financial Statements (continued)

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.

On 22 December 2017, the net assets from HSBC Middle East Finance Company Limited ("the Company"), a subsidiary of HBME, were transferred to the Bank for an initial purchase consideration of AED 63m, based on the carrying value as at 31 October 2017.

As the transfer was made with a member of the HBME group, which falls within the definition of a common control transaction, predecessor accounting had been applied and no gain on the transaction was booked as the consideration was equivalent to the carrying value of net assets.

The carrying value of net assets transferred as at 22 December 2017, AED 49m, comprised of loans and advances to customers (net of impairment allowances amounting to AED 15m) AED 989m, accrued interest receivable AED 3m, loans from related party (AED 943m) and accrued expenses (AED 0.6m).

The reduction in the carrying value of AED 15m was recognised as a payable to the Bank, which was subsequently settled on 28 January 2018.

41 Events after the balance sheet date

These accounts were approved by management on 12 March 2019 and authorised for issue.

HSBC Bank Middle East Limited – UAE Operations

Pillar III disclosures

For the year ended 31 December 2018

CONSOLIDATED CAPITAL STRUCTURE UNDER BASEL III

	AED'000
Tier 1 Capital	
Paid up share capital/common stock …………………………………………………………………	4,495,255
Reserves………………………………………………………………………………………………	6,236,558
Statutory reserve ………………………………………………………………………………	2,050,129
Special reserve ………………………………………………………………………………	-
General reserve ………………………………………………………………………………	4,186,429
Minority interests in the equity of subsidiaries ………………………………………………………	-
Innovative capital instruments………………………………………………………………………	-
Other capital instruments ..…………………………………………………………………………	-
Surplus capital from insurance companies ……………………………………………………………	-
	10,731,813
Less: Deductions for regulatory calculation …………………………………………………………	-
Less: Deductions from Tier 1 capital …………………………………………………………………	(20,342)
Tier 1 Capital	**10,711,471**
Tier 2 capital	**1,481,614**
Less: Other deductions from capitals …………………………………………………………………	-
Tier 3 capital ……………………………………………………………………………………………	-
Total eligible capital after deductions ……………………………………………………………	**12,193,084**

CONSOLIDATED CAPITAL STRUCTURE UNDER BASEL III

	AED'000
Capital Base	
Common Equity Tier 1 (CET1) Capital	
Share Capital	4,495,255
Share Premium	-
Eligible Reserves	1,768,184
Retained Earnings / (Accumulated Losses)	4,468,374
Eligible amount of minority interest	-
Capital shortfall if any	-
CET1 capital before the regulatory adjustments and threshold deduction	**10,731,813**
Less: Regulatory deductions	(20,342)
Less: Threshold deductions	-
Total CET1 capital after the regulatory adjustments and threshold deduction	**10,711,471**
Total CET1 capital after transitional arrangement for deductions (CET1)	**10,711,471**
Additional Tier 1 (AT1) Capital	
Eligible AT1 capital (After grandfathering)	-
Other AT1 Capital e.g. (Share premium, minority interest)	-
Total AT1 capital	**-**
Total AT1 capital after transitional arrangements (AT1)	**-**
Tier 2 (T2) Capital	
Tier 2 Instruments e.g. subordinated loan (After grandfathering and/or amortization)	550,875
Other Tier 2 capital (including General Provisions, etc.)	930,739
Total T2 Capital	**1,481,614**
Total T2 capital after transitional arrangements (T2)	**1,481,614**
Total Capital (CET1+AT1+T2)	**12,193,084**

HSBC Bank Middle East Limited - UAE Operations
Pillar III Disclosures
for the year ended 31 December 2018

INFORMATION ON SUBSIDIARIES AND SIGNIFICANT INVESTMENTS

Basis of Consolidation:

	Country of Incorporation	% Ownership	Description	Accounting Treatment	Surplus Capital	Capital Deficiencies	Total Interests
Subsidiaries…………………………	NA	NA	NA	NA	NA	NA	NA
Significant Investments…………….	NA	NA	NA	NA	NA	NA	NA

CAPITAL ADEQUACY

	Capital Charge AED'000	Capital Ratio %
Capital Requirements		
Credit Risk		
Standardised Approach………………………………………………………………...	7,818,204	
Foundation IRB………………………………………………………………………..	-	
Advanced IRB………………………………………………………………………….	-	
Market Risk		
Standardised Approach………………………………………………………………..	697,467	
Models Approach……………………………………………………………………...	-	
Operational Risk		
Basic Indicator Approach………………………………………………………………	-	
Standardised Approach/ASA…………………………………………………………...	959,298	
Advanced Measurement Approach………………………………………………………..	-	
Total Capital requirements	**9,474,969**	
Capital Ratio		
Total Capital Ratio for the Bank…………………………………………………………		**13.51%**
Tier 1 ratio for the Bank…………………………………………………………………		**11.87%**
Total for each significant bank subsidiary………………………………………………..		**NA**

CAPITAL ADEQUACY

Qualitative Disclosures

The Banks' policies around the management of Credit, Market and Operational risk are disclosed in the Financial Statements for the year ended 31 December 2018 as a part of Note 33.

Quantitative Disclosures

Capital Requirements	RWA AED'000	Capital Charge AED'000	Capital Ratio (%) %
Credit Risk - Standardized Approach……………………………………..	74,459,084	7,818,204	
Market Risk - Standardized Approach…………………………………….	6,642,544	697,467	
Operation Risk			
Basic Indicator Approach…………………………………………..	-	-	
Standardised Approach/ASA………………………………………	9,136,175	959,298	
Advanced Measurement Approach………………………………..	-	-	
Total Capital requirements………………………………………		**9,474,969**	
Capital Ratio			
Total Capital Ratio for the Bank……………………………………….			**13.51%**
Tier 1 ratio for the Bank……………………………………………….			**11.87%**
Total for each significant bank subsidiary…………………………….			**NA**

Qualitative Disclosures

Definition of past due and impaired (for accounting purposes)

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 below;
- retail exposures 90 days or more past due, unless individually they have been assessed as not impaired; or
- 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.

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') within 12 months from the date of the financial statements. All distinct customers use the 10 or 23-grade scale, depending on the degree of sophistication of the Basel approach adopted for the exposure.

Previously, retail lending credit quality was disclosed under IAS 39, which was based on expected-loss percentages. Now, retail lending credit quality is disclosed on an IFRS 9 basis, which is based on a 12-month point-in-time ('PIT') probability weighted probability of default ('PD').

For debt securities and certain other financial instruments, external ratings have been aligned to the five quality classifications. The ratings of Standard and Poor 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.

Further details around the Bank's accounting policies can be found in the audit Financial Statements for the year ended 31 December 2018.

Description of approaches followed for specific and general allowances and statistical methods

Impairment of amortised cost and FVOCI financial assets

Expected credit losses are recognised for loans and advances to banks and customers, non-trading reverse repurchase agreements, other financial assets held at amortised cost, debt instruments measured at fair value through other comprehensive income, and certain loan commitments and financial guarantee contracts. At initial recognition, allowance (or provision in the case of some loan commitments and financial guarantees) is required for ECL resulting from default events that are possible within the next 12 months (or less, where the remaining life is less than 12 months) ('12-month ECL'). In the event of a significant increase in credit risk, 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'. Purchased or originated credit-impaired financial assets (POCI) are treated differently as set out below.

Unimpaired and without significant increase in credit risk (stage 1)

ECL resulting from default events that are possible within the next 12 months ('12-month ECL') are recognised for financial instruments that remain in stage 1.

Significant increase in credit risk (stage 2)

An assessment of whether credit risk has increased significantly since initial recognition is performed at each reporting period by considering the change in the risk of default occurring over the remaining life of the financial instrument. The assessment explicitly or implicitly compares the risk of default occurring at the reporting date compared to that at initial recognition, taking into account reasonable and supportable information, including information about past events, current conditions and future economic conditions. The assessment is unbiased, probability-weighted, and to the extent relevant, uses forward-looking information consistent with that used in the measurement of ECL. The analysis of credit risk is multifactor. The determination of whether a specific factor is relevant and its weight compared with other factors depends on the type of product, the characteristics of the financial instrument and the borrower, and the geographical region. Therefore, it is not possible to provide a single set of criteria that will determine what is considered to be a significant increase in credit risk and these criteria will differ for different types of lending, particularly between retail and wholesale. However, unless identified at an earlier stage, all financial assets are deemed to have suffered a significant increase in credit risk when 30 days past due. In addition, wholesale loans that are individually assessed, typically corporate and commercial customers, and included on a watch or worry list are included in stage 2.

Credit-impaired (stage 3)

The Bank determines that a financial instrument is credit-impaired and in stage 3 by considering relevant objective evidence, primarily whether:

- contractual payments of either principal or interest are past due for more than 90 days;
- there are other indications that the borrower is unlikely to pay such as that a concession has been granted to the borrower for economic or legal reasons relating to the borrower’s financial condition; and
- the loan is otherwise considered to be in default.

If such unlikeliness to pay is not identified at an earlier stage, it is deemed to occur when an exposure is 90 days past due, even where regulatory rules permit default to be defined based on 180 days past due. Therefore the definitions of credit-impaired and default are aligned as far as possible so that stage 3 represents all loans which are considered defaulted or otherwise credit-impaired.

Interest income is recognised by applying the effective interest rate to the amortised cost amount, i.e. gross carrying amount less ECL allowance.

Purchased or originated credit-impaired (‘POCI’)

Financial assets that are purchased or originated at a deep discount that reflects the incurred credit losses are considered to be POCI. This population includes the recognition of a new financial instrument following a renegotiation where concessions have been granted for economic or contractual reasons relating to the borrower’s financial difficulty that otherwise would not have been considered. The amount of change-in-lifetime ECL is recognised in profit or loss until the POCI is derecognised, even if the lifetime ECL are less than the amount of ECL included in the estimated cash flows on initial recognition.

Write-off

Financial assets (and the related impairment allowances) 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.

Further details around the Bank's impairment policies can be found the in the audited Financial Statements for the year ended 31 December 2018.

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

	AED'000									
	Gross credit exposures					Exposures subject to deduction				
Loan Portfolio	**Rated**	**Unrated**	**Total**	**Post CRM**	**RWA post CRM**	**Rated**	**Unrated**	**Total**	**Post CRM**	**RWA post CRM**
Claims on sovereigns………………	22,367,553	4,278,410	26,645,964	26,645,964	363,752	22,367,554	4,278,410	26,645,964	26,645,964	363,752
Claims on public sector entities……	-	2,472,864	2,472,864	2,472,864	259,898	-	2,472,864	2,472,864	2,472,864	259,898
Claims on multilateral development bank…………………………………	2,080,501	-	2,080,501	2,080,501	-	2,080,501	-	2,080,501	2,080,501	-
Claims on securities firms………………………………..	-	-	-	-	-	-	-	-	-	-
Claims on banks……………………	22,983,242	5,310,021	28,293,263	26,306,410	7,929,686	22,983,242	5,310,021	28,293,263	26,306,410	7,929,686
Claims on corporate………………..	3,518,912	93,844,462	97,363,375	93,250,899	52,696,062	3,518,912	93,844,462	97,363,375	93,250,899	52,696,062
Regulatory and other retail exposure……………………………	-	11,309,876	11,309,876	11,291,724	3,873,597	-	11,309,876	11,309,876	11,291,724	3,873,597
Residential retail exposure…………	-	7,257,967	7,257,967	6,970,530	3,117,536	-	7,257,967	7,257,967	6,970,530	3,117,536
Commercial real estate……………..	-	-	-	-	-	-	-	-	-	-
Past due loans………………………	-	3,569,283	3,569,283	1,015,999	1,086,771	-	3,569,283	3,569,283	1,015,999	1,086,771
Other assets…………………………	608,739	9,609,061	10,217,800	8,783,601	5,131,730	608,739	9,609,061	10,217,800	8,783,601	5,131,730
Claims on securitised assets………..	-	-	-	-	-	-	-	-	-	-
Credit derivatives (Banks selling protection)…………………………	-	-	-	-	-	-	-	-	-	-
Total	**51,558,948**	**137,651,945**	**189,210,893**	**178,818,491**	**74,459,032**	**51,558,948**	**137,651,945**	**189,210,893**	**178,818,491**	**74,459,032**

Market risk as per the standardised approach

	AED'000
Interest rate risk	5,785,341
Equity position risk	-
Foreign exchange risk	857,202
Commodity risk	-
Total market risk capital charge	**6,642,544**

Interest rate risk in the banking book (IRRBB)

	AED'000	
Shift in yield curves	**Net interest income**	**Regulatory capital**
+200 basis point……………………………………………………	162,832	10,711,471
- 200 basis point……………………………………………………	(471,496)	10,711,471

Gross credit exposures by residual contractual maturity

	AED'000								
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……………………….	33,102,747	974,137	23,177,887	57,254,771	3,534,808	1,811,127	-	5,345,935	**62,600,706**
3 months to one year……………………..	6,539,740	1,390,616	142,797	8,073,153	5,438,019	1,726,019	-	7,164,037	**15,237,190**
One to five years…………………………	23,938,325	3,689,021	126,912	27,754,258	9,934,102	4,989,824	-	14,923,925	**42,678,183**
Over five years…………………………..	14,770,715	3,430,721	493,951	18,695,387	-	810,532	-	810,532	**19,505,919**
Total	**78,351,527**	**9,484,495**	**23,941,547**	**111,777,569**	**18,906,928**	**9,337,501**	**-**	**28,244,430**	**140,021,999**

Note:
* these are converted to on balance sheet equivalent amounts

Gross credit exposures by currency type

	AED'000								
Currency type	**Loans**	**Debt securities**	**Other assets**	**Total funded**	**Commitments***	**OTC derivatives***	**Other off-balance sheet exposures***	**Total non funded***	**Total**
Foreign Currency………………………	45,629,015	9,484,495	7,738,824	62,852,334	8,594,777	8,418,765	-	17,013,541	**79,865,875**
AED……………………………………	32,722,512	-	16,202,723	48,925,235	10,312,152	918,737	-	11,230,888	**60,156,123**
Total	**78,351,527**	**9,484,495**	**23,941,547**	**111,777,569**	**18,906,928**	**9,337,501**	**-**	**28,244,430**	**140,021,999**

Note:
* these are converted to on balance sheet equivalent amounts

Gross credit exposures by geographic region

AED'000

Geographic Region	Loans	Debt securities	Other assets	Total funded	Commitments*	OTC derivatives*	Other off-balance sheet exposures*	Total non funded*	Total
United Arab Emirates ("UAE")….......	49,894,820	571,603	23,149,625	73,616,048	15,017,609.58	1,428,970	-	16,446,580	**90,062,628**
GCC Excluding UAE………………....	13,275,149	663,903	563,881	14,502,933	744,357	689,125	-	1,433,482	**15,936,415**
Arab League (excluding GCC)……….	3,058,165	-	226,179	3,284,344	33,236	10,046	-	43,282	**3,327,626**
Asia………………………………..	1,745,591	2,177,408	-	3,922,999	258,227	35,588	-	293,815	**4,216,814**
Africa……………………………….	28,442	-	765	29,207	166	-	-	166	**29,373**
North America………………………..	958,537	3,293,539	-	4,252,076	235,597	18,555	-	254,152	**4,506,228**
South America………………………..	3,060,264	-	-	3,060,264	-	46,011	-	46,011	**3,106,275**
Caribbean…………………………..	-	-	-	-	-	-	-	-	**-**
Europe……………………………..	4,189,829	2,778,042	1,097	6,968,968	1,925,163	6,977,023	-	8,902,185	**15,871,153**
Australia…………………………….	28,067	-	-	28,067	48,236	39,227	-	87,463	**115,530**
Others……………………………….	2,112,663	-	-	2,112,663	644,338	92,956	-	737,294	**2,849,957**
Total	**78,351,527**	**9,484,495**	**23,941,547**	**111,777,569**	**18,906,928**	**9,337,501**	**-**	**28,244,430**	**140,021,999**

Note:
* these are converted to on balance sheet equivalent amounts

Impaired exposures by geographic region

	AED'000							
	Pastdue			Provisions		Adjustments		
Geographic Region	**Less than 90 days**	**90 days and above**	**Total**	**Specific**	**General**	**Write-offs**	**Writebacks**	**Total Impaired Assets**
United Arab Emirates ("UAE")……………………………………….	551,764	3,694,750	4,246,514	2,363,443	4,074	890,318	35,951	1,878,997
GCC Excluding UAE………………………………………………….	1,108	5,164	6,272	204	-	-	-	6,068
Arab League (excluding GCC)………………………………………..	-	-	-	-	-	-	-	-
Asia…………………………………………………………………	3,511	9,217	12,728	-	-	-	-	12,728
Africa……………………………………………………………….	9	-	9	-	-	-	-	9
North America………………………………………………………	485	8,483	8,968	-	-	-	-	8,968
South America………………………………………………………	2,129	18,363	20,492	18,363	-	-	-	2,129
Caribbean…………………………………………………………...	-	-	-	-	-	-	-	-
Europe………………………………………………………………	14,449	26,327	40,776	-	-	-	-	40,776
Australia…………………………………………………………….	11,197	-	11,197	-	-	-	-	11,197
Others……………………………………………………………….	1	-	1	-	-	-	-	1
Total	**584,653**	**3,762,304**	**4,346,957**	**2,382,010**	**4,074**	**890,318**	**35,951**	**1,960,873**

Note: Jurisdictions should not be included more than once under the geographic region

Gross credit exposures by industry segment

	AED'000								
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…………….	2,377	-	-	2,377	8,287	-	-	8,287	**10,664**
Crude Oil, Gas, Mining & Quarrying……………….	105,138	-	-	105,138	2,579,138	-	-	2,579,138	**2,684,276**
Manufacturing……………………………………….	10,279,453	-	-	10,279,453	1,822,194	41,169	-	1,863,363	**12,142,816**
Electricity& Water…………………………………..	7,849,175	-	-	7,849,175	-	237,200	-	237,200	**8,086,375**
Construction…………………………………………	3,223,976	-	-	3,223,976	3,607,247	18,581	-	3,625,828	**6,849,804**
Trade…………………………………………………	7,956,463	-	-	7,956,463	-	56,619	-	56,619	**8,013,082**
Transport, Storage & Communication………………	4,509,614	-	-	4,509,614	544,635	275,844	-	820,479	**5,330,093**
Financial Institutions……………………………...	15,813,094	2,875,100	239,195	18,927,389	1,457,275	8,551,984	-	10,009,259	**28,936,648**
Services……………………………………………...	8,082,181	-	-	8,082,181	1,421,418	76,064	-	1,497,482	**9,579,663**
Government………………………………………….	6,128,833	6,557,571	292,674	12,979,078	86,655	80,041	-	166,695	**13,145,773**
Retail/Consumer banking……………………………	1,863,630	-	-	1,863,630	3,287,499	-	-	3,287,499	**5,151,129**
All Others……………………………………………	12,537,593	51,824	23,409,678	35,999,095	4,092,581	-	-	4,092,581	**40,091,676**
Total	**78,351,527**	**9,484,495**	**23,941,547**	**111,777,569**	**18,906,928**	**9,337,501**	**-**	**28,244,430**	**140,021,999**

Note:
* these are converted to on balance sheet equivalent amounts

Impaired loans by industry segment

	AED'000							
	Pastdue			Provisions		Adjustments		
Industry Segment	**Less than 90 days**	**90 days and above**	**Total**	**Specific**	**General**	**Write-offs**	**Writebacks**	**Total Impaired Assets**
Agriculture, Fishing & related activities…………………..	-	-	-	-	-	-	-	-
Crude Oil, Gas, Mining & Quarrying……………………..	-	209	209	209	-	1,434	2,805	-
Manufacturing……………………………………………..	35,480	632,078	667,558	508,234	-	54,141	11,081	159,324
Electricity& Water……………………………………...	22	-	22	-	-	-	-	22
Construction……………………………………………….	7,013	1,512,557	1,519,570	871,494	-	146,365	7,267	648,076
Trade……………………………………………………	47,705	705,950	753,655	622,356	-	327,590	10,954	131,299
Transport, Storage & Communication…………………….	-	76,076	76,076	69,407	-	2	-	6,669
Financial Institutions…………………………………….	-	-	-	-	-	-	-	-
Services…………………………………………………	165,760	147,873	313,633	137,313	-	23,943	3,547	176,320
Government………………………………………………..	-	-	-	-	-	-	-	-
Retail/Consumer banking………………………………..	304,108	492,025	796,133	-	4,074	332,307	-	792,059
All Others……………………………………………….	24,565	195,536	220,101	172,997	-	4,536	298	47,104
Total	**584,653**	**3,762,304**	**4,346,957**	**2,382,010**	**4,074**	**890,318**	**35,951**	**1,960,873**

Reconciliation of changes in provisions for loans

	AED'000
Opening Balance of provisions for loans	3,642,197
Add: Charge for the year	
- Specific provisions	578,270
- General provisions	(634,608)
	3,585,859
Less: Write-off of loans	(72,389)
Less: Write-back of provisions for loans	(42,602)
Closing Balance of provisions for loans	**3,470,868**

Credit risk as per the standardised approach

	AED'000					
	On balance sheet	**Off balance sheet**	**Total**			
Asset classes	**Gross outstanding**	**Net exposure after Credit Converison Factors (CCF)**	**Gross exposure before CRM**	**CRM**	**After CRM**	**Risk weighted assets**
Claims on sovereigns………………………………………………………………...	26,214,392	122,408	26,336,800	-	26,336,800	363,752
Claims on non-central Government public sector entities (PSEs)…………………...	1,590,396	480,318	2,070,714	-	2,070,714	259,898
Claims on multilateral development banks…………………………………………..	2,080,501	-	2,080,501	-	2,080,501	-
Claims on banks……………………………………………………………………...	14,954,225	2,670,954	17,625,179	(1,986,853)	15,638,326	7,929,686
Claims on securities firms…………………………………………………………...	-	-	-	-	-	-
Claims on corporates………………………………………………………………...	40,612,086	15,626,521	56,238,607	(3,915,984)	52,322,623	52,696,062
Claims included in the regulatory retail portfolio……………………………………	5,175,718	5,525	5,181,243	(16,851)	5,164,392	3,873,597
Claims secured by residential property…………………………………………….....	7,255,561	1,203	7,256,764	-	7,256,764	3,117,536
Claims secured by commercial real estate…………………………………………...	-	-	-	-	-	-
Past due loans………………………………………………………………………..	3,569,283	-	3,569,283	-	3,569,283	1,086,771
Higher-risk categories………………………………………………………………..	-	-	-	-	-	-
Other assets…………………………………………………………………………..	10,217,800	-	10,217,800	-	10,217,800	5,131,730
Claims on securitised assets…………………………………………………………	-	-	-	-	-	-
Credit derivatives (banks selling protection)………………………………………...	-	-	-	-	-	-
Total claims	**111,669,962**	**18,906,928**	**130,576,890**	**(5,919,688)**	**124,657,202**	**74,459,032**

Credit risk mitigation: Disclosures for standardised approach

	AED'000	
	Exposures	**Risk weighted assets**
Gross Exposures prior to credit risk mitigation…………………………...………………………………………………………	184,738,179	78,599,897
Less: Exposures covered by on-balance sheet netting………………………………………………………………………………	-	-
Less: Exposures covered by eligible financial collateral…………………………………………………………………………	(2,474,331)	(1,415,009)
Less: Exposures covered by guarantees………………………………………………………………………………………………..	(3,445,357)	(2,725,856)
Less: Exposures covered by credit derivatives………………………………………………………………………………………	-	-
Net exposures after credit risk mitigation	**178,818,491**	**74,459,032**

EQUITY POSITION IN THE BANKING BOOK

a) Qualitative Disclosures

As at 31 December 2018, the bank's total equity investment portfolio in the banking book amounted to AED Nil, which represents quoted investments. For details of the accounting policies and valuation methodology, please refer to Note 3 of the financial statements under 'Significant Accounting Policies'. Details of fair value are reported in Note 18 of the financial statements under the heading of "Financial Investments".

b) Quantitative Disclosures

QUANTITATIVE DETAILS OF EQUITY POSITION:

	Current Year		Previous Year	
Type	**Publicly Traded**	**Privately Held**	**Publicly Traded**	**Privately Held**
Equities	-	-	-	-
Collective investment schemes	-	-	-	-
Any other investment	-	-	-	-
Total	-	-	-	-

REALISED, UNREALISED AND LATENT REVALUATION GAINS / (LOSSES) DURING THE YEAR:

Gains (Losses)	**AED'000**
Realised gains / (losses) from sales and liquidations	-
Unrealised gains / (losses) recognised in the balance sheet but not through profit and loss account	-
Latent revaluation gains / (losses) for investment recorded at cost but not recognised in balance sheet or profit and loss account	-
Total	**-**

ITEMS ABOVE INCLUDED IN TIER 1/TIER 2 CAPITAL:

Tier Capital	**AED'000**
Amount included in Tier I capital	-
Amount included in Tier II capital	-
Total	**-**

EQUITY POSITION IN THE BANKING BOOK

CAPITAL REQUIREMENTS BY EQUITY GROUPINGS

Grouping	AED'000
Strategic investments……………………………………………………………………………….	-
Available for sale……………………………………………………………………………………….	-
Held for trading…………………………………………………………………………………………..	-
Total capital requirement	**-**