

# **HSBC Bank Middle East Limited – UAE Operations**

Financial Statements

For the year ended 31 December 2014

## Annual Report and Accounts 2014

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### Presentation of Information

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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 Auditors' Report**

The Chief Executive Officer  
HSBC Bank Middle East Limited – UAE Operations

### **Report on the Financial Statements**

We have audited the accompanying financial statements of HSBC Bank Middle East Limited – UAE Operations ("the Bank") which comprise the statement of financial position as at 31 December 2014, the statements of income, comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

#### *Management's Responsibility for the Financial Statements*

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

#### *Auditors' Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the entity's preparation and fair presentation of the financial statements 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 entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

### **Opinion**

In our opinion, the financial statements present fairly, in all material respects, the financial position of the Bank as at 31 December 2014, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

### **Report on Other Legal and Regulatory Requirements**

We further confirm that we have obtained all information and explanations necessary for our audit and that the financial statements comply, in all material respects, with the applicable requirements of Union Law no. 10 of 1980.

KPMG Lower Gulf Limited  
Muhammad Tariq  
Registration No: 793

**17 MAR 2015**

## Financial Statements

### Income statement for the year ended 31 December 2014

	Notes	2014 AED000	2013 AED000
Interest income .....	6	3,005,274	3,033,677
Interest expense .....	6	(487,806)	(652,514)
Net interest income .....		2,517,468	2,381,163
Fee income .....	7	1,525,208	1,344,616
Fee expense .....	7	(144,385)	(164,073)
Net fee income .....		1,380,823	1,180,543
Trading income excluding net interest income .....		821,366	875,756
Net interest expense on trading activities .....		(61,999)	(42,271)
Net trading income .....		759,367	833,485
Net expense from financial instruments designated at fair value .....	5	(7,802)	(8,596)
Gain/(Loss) from financial investments .....		1,623	(721)
Other operating income .....	8	459,115	472,395
<b>Net operating income before loan impairment charges and other credit risk provisions .....</b>		<b>5,110,594</b>	<b>4,858,269</b>
Loan impairment charges and other credit risk provisions .....	9	(67,709)	(41,421)
<b>Net operating income .....</b>		<b>5,042,885</b>	<b>4,816,848</b>
Employee compensation and benefits .....	10	(1,546,957)	(1,354,285)
General and administrative expenses .....		(894,176)	(1,041,836)
Depreciation and impairment of property, plant and equipment .....	22	(30,156)	(42,849)
Amortisation and impairment of intangible assets .....	21	(19,717)	(23,000)
<b>Total operating expenses .....</b>		<b>(2,491,006)</b>	<b>(2,461,970)</b>
<b>Profit before tax .....</b>		<b>2,551,879</b>	<b>2,354,878</b>
Tax expense .....	12	(372,827)	(365,393)
<b>Profit for the year .....</b>		<b>2,179,052</b>	<b>1,989,485</b>

The accompanying notes on pages 9 to 72 form an integral part of these financial statements.

**Financial Statements (continued)****Statement of comprehensive income for the year ended 31 December 2014**

	<b>2014</b>	2013
	<b>AED000</b>	AED000
Profit for the year.....	<b>2,179,052</b>	1,989,485

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

Available-for-sale investments.....	<b>(7,373)</b>	(4,912)
– fair value losses .....	<b>(9,029)</b>	(5,048)
– fair value gains transferred to income statement on disposal .....	<b>(1,634)</b>	-
– income taxes .....	<b>3,290</b>	136

Cash flow hedges.....	<b>(47,414)</b>	(12,723)
– fair value losses .....	<b>(56,734)</b>	(15,326)
– fair value losses/(gains) transferred to income statement.....	-	-
– income taxes .....	<b>9,320</b>	2,603

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

Re-measurement of defined benefit asset/liability.....	<b>(55,899)</b>	(35,976)
– before income taxes.....	<b>(55,899)</b>	(35,976)
– income taxes .....	-	-

Total comprehensive income for the year .....	<b>2,068,366</b>	1,935,874
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*The accompanying notes on pages 9 to 72 form an integral part of these financial statements.*

## Financial Statements (continued)

## Statement of financial position at 31 December 2014

	Notes	2014 AED000	2013 AED000
<b>Assets</b>			
Cash and balances at central banks .....	14	9,115,607	11,075,873
Trading assets .....	18	1,044,080	1,060,509
Derivatives .....	19	4,024,776	3,934,398
Loans and advances to banks .....	15	16,895,412	11,065,106
Loans and advances to customers .....	16	66,440,954	58,240,952
Reverse repurchase agreements – non-trading .....	38	62,866	-
Financial investments .....	20	21,472,926	22,679,140
Other assets .....	23	1,816,548	2,043,287
Intangible assets .....	21	67,743	78,652
Property, plant and equipment .....	22	101,806	94,451
Deferred tax assets .....	24	656,375	665,144
<b>Total assets .....</b>		<b>121,699,093</b>	<b>110,937,512</b>
<b>Liabilities and equity</b>			
<b>Liabilities</b>			
Deposits by banks .....		9,459,869	6,385,805
Customer accounts .....	25	72,742,810	67,770,959
Trading liabilities .....	26	5,743,470	4,535,972
Financial liabilities designated at fair value .....	27	3,159,900	1,849,089
Derivatives .....	19	4,135,530	3,960,216
Debt securities in issue .....	28	6,405,515	5,970,176
Subordinated liabilities .....	35	2,759,085	2,759,002
Other liabilities .....	29	4,199,997	5,585,240
Current tax liabilities .....		417,897	393,581
Accruals and deferred income .....		294,051	253,695
Provisions for liabilities & charges .....	30	424,319	394,675
<b>Total liabilities .....</b>		<b>109,742,443</b>	<b>99,858,411</b>
<b>Head office funds</b>			
Allocated capital .....		4,495,255	4,495,255
Legal reserves .....		1,647,462	1,429,556
Other reserves .....		(273,182)	(171,677)
Retained earnings .....		6,087,115	5,325,967
<b>Total head office funds .....</b>		<b>11,956,650</b>	<b>11,079,101</b>
<b>Total head office funds and liabilities .....</b>		<b>121,699,093</b>	<b>110,937,512</b>

The accompanying notes on pages 9 to 72 form an integral part of these financial statements.

  
Abdulfattah Sharaf

Chief Executive Officer - UAE

17 MAR 2015

## Financial Statements (continued)

### Statement of cash flows for the year ended 31 December 2014

	Note	2014 AED000	2013 AED000
<b>Cash flows from operating activities</b>			
Profit before tax .....		2,551,879	2,354,878
Adjustments for:			
– Provision for retirement benefits & other liabilities .....		95,566	132,822
– Allowance for impairment losses.....		67,709	41,421
– Depreciation and amortisation .....		49,873	65,849
– Share based payment expense including options.....		58,414	57,633
– Fair value movement on own debt.....		7,802	8,596
– (Gain)/loss on investment in equity shares .....		(1,623)	721
– Loss/(gain) on disposal of property and equipment .....		38	(1,248)
Net cash generated before changes in operating assets / liabilities .....		2,829,658	2,660,672
– Change in loans and advances to banks .....		(718,335)	9,275,815
– Change in loans and advances to customers .....		(8,267,711)	(1,797,202)
– Change in other assets .....		89,280	1,870,458
– Change in deposits by banks.....		2,968,930	(2,333,434)
– Change in customer accounts.....		4,971,851	(7,618)
– Change in other liabilities .....		(1,176,858)	(1,085,021)
– Retirement benefits and other charges paid .....		(71,342)	(47,716)
– Tax paid.....		(327,037)	(308,226)
Net cash generated from operating activities .....		298,435	8,227,728
<b>Cash flows from investing activities</b>			
– Sale of financial assets and liabilities classified as fair value through profit and loss (net) .....		2,526,936	990,033
– Sale of available-for-sale investments (net) .....		1,200,464	929,960
– Purchase of property and equipment and intangible assets .....		(46,686)	(22,374)
Net cash generated from investing activities .....		3,680,714	1,897,619
<b>Cash flows from financing activities</b>			
– Debt securities issued / (repaid) (net) .....		435,422	(2,295,965)
– Dividend paid to head office.....		(1,200,000)	(1,010,075)
Net cash used in financing activities .....		(764,578)	(3,306,040)
<b>Net increase in cash and cash equivalents .....</b>		<b>3,214,571</b>	<b>6,819,308</b>
Cash and cash equivalents as at 1 January .....		20,463,393	13,644,085
Cash and cash equivalents as at 31 December .....	36	23,677,964	20,463,393

The accompanying notes on pages 9 to 72 form an integral part of these financial statements.

## Financial Statements (continued)

### Statement of changes in equity for the year ended 31 December 2014

	2014							
	Other reserves							
	Allocated capital AED000	Legal Reserve AED000	Available- for-sale fair value reserve AED000	Cash flow hedging reserve AED000	Actuarial gains/(losses) reserve AED000	Other reserve AED000	Unremitted profits AED000	Total head office funds AED000
At 1 January 2014 .....	4,495,255	1,429,556	9,922	25,040	(148,923)	(57,716)	5,325,967	11,079,101
Profit for the year .....	-	-	-	-	-	-	2,179,052	2,179,052
Other comprehensive income (net of tax) .....								
Available-for-sale investments .....	-	-	(7,373)	-	-	-	-	(7,373)
Cash flow hedges .....	-	-	-	(47,414)	-	-	-	(47,414)
Actuarial losses on defined benefit plans .....	-	-	-	-	(55,899)	-	-	(55,899)
Total comprehensive income for the year.....	-	-	(7,373)	(47,414)	(55,899)	-	2,179,052	2,068,366
Transfer of profits to Head Office .....	-	-	-	-	-	-	(1,200,000)	(1,200,000)
Other movements .....	-	217,905	-	-	-	9,181	(217,905)	9,181
At 31 December 2014 .....	4,495,255	1,647,462	2,549	(22,374)	(204,822)	(48,535)	6,087,115	11,956,650

The accompanying notes on pages 9 to 72 form an integral part of these financial statements.



## Financial Statements (continued)

### Statement of changes in equity for the year ended 31 December 2013

	2013							
					Other reserves			
	Allocated capital AED000	Legal Reserve AED000	Available- for-sale fair value reserve AED000	Cash flow hedging reserve AED000	Actuarial gains/(losses) reserve AED000	Other reserve AED000	Unremitted profits AED000	Total head office funds AED000
At 1 January 2013 .....	4,495,255	1,230,608	14,834	37,763	(115,787)	(26,953)	4,548,346	10,184,066
Profit for the year .....	-	-	-	-	-	-	1,989,485	1,989,485
Other comprehensive income (net of tax) .....								
Available-for-sale investments .....	-	-	(4,912)	-	-	-	-	(4,912)
Cash flow hedges .....	-	-	-	(12,723)	-	-	-	(12,723)
Actuarial losses on defined benefit plans .....	-	-	-	-	(35,976)	-	-	(35,976)
Total comprehensive income for the year.....	-	-	(4,912)	(12,723)	(35,976)	-	1,989,485	1,935,874
Transfer of profit to Head Office.....	-	-	-	-	-	-	(1,010,075)	(1,010,075)
Other movements .....	-	198,948	-	-	2,840	(30,763)	(201,789)	(30,764)
At 31 December 2013.....	4,495,255	1,429,556	9,922	25,040	(148,923)	(57,716)	5,325,967	11,079,101

The accompanying notes on pages 9 to 72 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”) with its head office in Jersey, Channel Islands and incorporated in Jersey. HSBC Bank Middle East Limited’s ultimate holding company is HSBC Holdings plc (“the Group”), which is incorporated in the United Kingdom.

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

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

### 2 Basis of preparation

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

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

#### Standards adopted during the year ended 31 December 2014

There were no new standards applied during the year ended 31 December 2014, however there were amendments made to existing standards.

On 1 January 2014, the Bank adopted ‘Offsetting Financial Assets and Financial Liabilities (Amendments to IAS 32)’, which clarified the requirements for offsetting financial instruments and addressed inconsistencies in current practice when applying the offsetting criteria in IAS 32 ‘Financial Instruments: Presentation’. The amendments were applied retrospectively and did not have a material effect on the Bank’s financial statements.

During 2014, in addition to the above, the Bank adopted a number of interpretations and amendments to standards which had an insignificant effect on the financial statements of the Bank.

#### (b) Presentation of information

Capital disclosures under IAS 1 ‘Presentation of Financial Statements’ have been included in Note 37.

The functional currency of the Bank is United Arab Emirates Dirham (“AED”), which is also the presentation currency of the financial statements of the Bank.

#### (c) Use of estimates and assumptions

The preparation of financial information requires the use of estimates and assumptions about future conditions. The use of available information and the application of judgement are inherent in the formation of estimates; actual results in the future may differ from estimates upon which financial information is prepared.

## Notes to the Financial Statements (continued)

Management believes that the Bank's critical accounting policies where judgement is necessarily applied are those which relate to impairment of loans and advances, the valuation of financial instruments, impairment of available for sale assets, valuation of intangible assets recognised in business combinations, pensions and share based payments.

### (d) Future accounting developments

In addition to the projects to complete financial instrument accounting, discussed below, the IASB is continuing to work on projects on insurance and lease accounting which could represent significant changes to accounting requirements in the future.

### Standards and amendments issued by IASB but effective after 31 December 2014

During 2014, the EU endorsed the amendments issued by IASB through the Annual Improvements to IFRSs 2010-2012 Cycle and the 2011-2013 Cycle, as well as a narrow-scope amendment to IAS 19 Employee Benefits. The Bank has not early applied any of the amendments effective after 31 December 2014 and it expects they will have an immaterial impact, when applied, on the financial statements of the Bank.

In May 2014, the IASB issued IFRS 15 'Revenue from Contracts with Customers'. The standard is effective for annual periods beginning on or after 1 January 2017 with early application permitted. IFRS 15 provides a principles-based approach for revenue recognition, and introduces the concept of recognising revenue for obligations as they are satisfied. The standard should be applied retrospectively, with certain practical expedients available. The Bank is currently assessing the impact of this standard but it is not practicable to quantify the effect as at the date of the publication of these financial statements.

In July 2014, the IASB issued IFRS 9 'Financial Instruments', which is the comprehensive standard to replace IAS 39 'Financial Instruments: Recognition and Measurement', and includes requirements for classification and measurement of financial assets and liabilities, impairment of financial assets and hedge accounting.

### *Classification and measurement*

The classification and measurement of financial assets will depend on the entity's business model for their management and their contractual cash flow characteristics and result in financial assets being at amortised cost, fair value through other comprehensive income ('FVOCI') or fair value through profit or loss. In many instances, the classification and measurement outcomes will be similar to IAS 39, although differences will arise, for example, since IFRS 9 does not apply embedded derivative accounting to financial assets and equity securities will be measured at fair value through profit or loss or, in limited circumstances, at fair value through other comprehensive income. The combined effect of the application of the business model and the contractual cash flow characteristics tests may result in some differences in population of financial assets measured at amortised cost or fair value compared with IAS 39. The classification of financial liabilities is essentially unchanged, except that, for certain liabilities measured at fair value, gains or losses relating to changes in the entity's own credit risk are to be included in other comprehensive income.

### *Impairment*

The impairment requirements apply to financial assets measured at amortised cost and FVOCI, and lease receivables and certain loan commitments and financial guarantee contracts. At initial recognition, allowance (or provision in the case of commitments and guarantees) is required for expected credit losses ('ECL') resulting from default events that are possible within the next 12 months ('12 month ECL'). In the event of a significant increase in credit risk, allowance (or provision) is required for ECL resulting from all possible default events over the expected life of the financial instrument ('lifetime ECL').

The assessment of whether credit risk has increased significantly since initial recognition is performed for each reporting period by considering the probability of default occurring over the remaining life of the financial instrument, rather than by considering an increase in ECL.

## Notes to the Financial Statements (continued)

The assessment of credit risk, as well as the estimation of ECL, are required to be unbiased, probability-weighted and should incorporate all available information which is relevant to the assessment, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date. In addition, the estimation of ECL should take into account the time value of money. As a result, the recognition and measurement of impairment is intended to be more forward-looking than under IAS 39 and the resulting impairment charge will tend to be more volatile. It will also tend to result in an increase in the total level of impairment allowances, since all financial assets will be assessed for at least 11-month ECL and the population of financial assets to which lifetime ECL applies is likely to be larger than the population for which there is objective evidence of impairment in accordance with IAS 39.

### *Hedge accounting*

The general hedge accounting requirements aim to simplify hedge accounting, creating a stronger link between it and risk management strategy and permitting the former to be applied to a greater variety of hedging instruments and risks. The standard does not explicitly address macro hedge accounting strategies, which are being considered in a separate project. To remove the risk of any conflict between existing macro hedge accounting practice and the new general hedge accounting requirements, IFRS 9 includes an accounting policy choice to remain with IAS 39 hedge accounting.

### *Transition*

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

The mandatory application date for the standard as a whole is 1 January 2018, but it is possible to apply the revised presentation for certain liabilities measured at fair value from an earlier date. If this presentation was applied at 31 December 2014, the effect would be to increase or decrease profit before tax with the opposite effect on other comprehensive income based on the change in fair value attributable to changes in the Bank's credit risk for the year, with no effect on net assets.

The Bank is currently assessing the impact that the rest of IFRS 9 will have on the financial statements through a group-wide project which has been in place since 2012, but due to the complexity of the classification and measurement, impairment, and hedge accounting requirements and their inter-relationships, it is not possible at this stage to quantify the potential effect.

### (e) Changes to the presentation of the Financial Statements and Notes on the Financial Statements

From 1 January 2014, the Bank has chosen to present non-trading reverse repos and repos separately on the face of the balance sheet. These items are classified for accounting purposes as loans and receivables or financial liabilities measured at amortised cost. Previously, they were presented on an aggregate basis together with other loans or deposits measured at amortised cost under the following headings in the consolidated balance sheet: 'Loans and advances to banks', 'Loans and advances to customers', 'Deposits by banks' and 'Customer accounts'. The separate presentation aligns disclosure of reverse repos and repos with market practice and provides more meaningful information in relation to loans and advances.

## **3 Summary of significant accounting policies**

### (a) Interest income and expense

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

The effective interest rate is the rate that exactly discounts estimated future cash receipts or payments through the expected life of the financial instrument or, where appropriate, a shorter period, to the net carrying amount of the financial asset or financial liability.

## Notes to the Financial Statements (continued)

When calculating the effective interest rate, the Bank estimates cash flows considering all contractual terms of the financial instrument but not future credit losses. The calculation includes all amounts paid or received by the Bank that are an integral part of the effective interest rate of a financial instrument, including transaction costs and all other premiums or discounts.

Interest on impaired financial assets is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

### (b) Non- interest income

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 3(a)).

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

**Net income/expense from financial instruments designated at fair value** includes:

- all gains and losses from changes in the fair value of financial liabilities designated at fair value;
- all gains and losses from changes in the fair value of derivatives that are managed in conjunction with financial liabilities designated at fair value; and
- interest income, interest expense and dividend income in respect of:
  - financial liabilities designated at fair value; and
  - derivatives managed in conjunction with the above, except for interest arising from the Bank’s issued debt securities and derivatives managed in conjunction with those debt securities, which is recognised in ‘Interest expense’.

**Dividend income** is recognised when the right to receive payment is established. This is the ex-dividend date for listed equity securities, and usually the date when shareholders have approved the dividend for unlisted equity securities.

### (c) Valuation of financial instruments

All financial instruments are recognised initially at fair value. In the normal course of business, the fair value of a financial instrument on initial recognition is the transaction price (that is, the fair value of the consideration given or received). In certain circumstances, however, the fair value will be based on other observable current market transactions in the same instrument, without modification or repackaging, or on a valuation technique whose variables include only data from observable markets, such as interest rate yield curves, option volatilities and currency rates. When such evidence exists, the Bank recognises a trading gain or loss on inception of the financial instrument, being the difference between the transaction price and the fair value. When unobservable market data has a significant impact on the valuation of financial instruments, the entire initial difference in fair value indicated by the valuation model from the transaction price is not recognised immediately in the income statement but is recognised over the life of the transaction on an appropriate basis, or when the inputs become observable, or the transaction matures or is closed out, or when the Bank enters into an offsetting transaction.

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 are described in Note 31.

### (d) Reclassification of financial assets

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

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

## Notes to the Financial Statements (continued)

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

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

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

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

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

### (f) Impairment of loans and advances

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

#### **Individually assessed loans and advances**

The factors considered in determining that a loan is individually significant for the purposes of assessing impairment include:

- the size of the loan;
- the number of loans in the portfolio; and
- the importance of the individual loan relationship, and how this is managed.

Loans that meet the above criteria will be individually assessed for impairment, except when volumes of defaults and losses are sufficient to facilitate treatment under a collective assessment methodology.

Loans considered as individually significant are typically to corporate and commercial customers and are for larger amounts, which are managed on an individual relationship basis. Retail lending portfolios are generally assessed for impairment on a collective basis as the portfolios generally consist of large pools of homogeneous loans.

For all loans that are considered individually significant, the Bank assesses on a case-by-case basis at each balance sheet date whether there is any objective evidence that a loan is impaired. The criteria used by the Bank to determine that there is such objective evidence include:

- known cash flow difficulties experienced by the borrower;
- past due contractual payments of either principal or interest;
- breach of loan covenants or conditions;
- a concession granted to the borrower for economic or legal reasons relating to the borrower's financial difficulty that results in material forgiveness, or postponement of principal, interest or fees; and
- there has been deterioration in the financial condition or outlook of the borrower such that its ability to repay is considered doubtful.

## Notes to the Financial Statements (continued)

For those loans where objective evidence of impairment exists, impairment losses are determined by considering the following factors:

- the Bank's aggregate exposure to the customer;
- the viability of the customer's business model and its capability to trade successfully out of financial difficulties and generate sufficient cash flow to service its debt obligations;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the extent of other creditors' commitments ranking ahead of, or *pari passu* with, the Bank and the likelihood of other creditors continuing to support the company;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not denominated in local currency; and
- when available, the secondary market price of the debt.

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

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

### Collectively assessed loans and advances

Impairment is assessed on a collective basis in two circumstances:

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

### *Incurred but not yet identified impairment*

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

The collective impairment allowance is determined after taking into account:

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

## Notes to the Financial Statements (continued)

The period between a loss occurring and its identification is estimated by local management for each identified portfolio. The factors that may influence this estimation include economic and market conditions, customer behaviour, portfolio management information, credit management techniques and collection and recovery experiences in the market. As it is assessed empirically on a periodic basis the estimated period between a loss occurring and its identification may vary over time as these factors change.

### *Homogeneous groups of loans and advances*

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

Two alternative methods are used to calculate allowances on a collective basis:

- When appropriate empirical information is available, the Bank utilises roll-rate methodology. This methodology employs statistical analyses of historical data and experience of delinquency and default to estimate the amount of loans that will eventually be written off as a result of the events occurring before the balance sheet date which the Bank is not able to identify on an individual loan basis, and that can be reliably estimated. Under this methodology, loans are grouped into ranges according to the number of days past due and statistical analysis is used to estimate the likelihood that loans in each range will progress through the various stages of delinquency, and ultimately prove irrecoverable. In addition to the delinquency groupings, loans are segmented according to their credit characteristics as described above. Current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss. The estimated loss is the difference between the present value of expected future cash flows, discounted at the original effective interest rate of the portfolio, and the carrying amount of the portfolio.
- When the portfolio size is small or when information is insufficient or not reliable enough to adopt a roll-rate methodology, the Bank adopts a basic formulaic approach based on historical loss rate experience.

In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio, though sometimes it provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, when there have been changes in economic, regulatory or behavioural conditions which result in the most recent trends in the portfolio risk factors being not fully reflected in the statistical models. In these circumstances, the risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.

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

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

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

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

### **Reversals of impairment**

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



## Notes to the Financial Statements (continued)

### Reclassified loans and advances

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

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

### Assets acquired in exchange for loans

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

### Renegotiated loans

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

A loan that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement made on substantially different terms, or if the terms of an existing agreement are modified, such that the renegotiated loan is substantially a different financial instrument.

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

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

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

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

- eliminates or significantly reduces measurement or recognition inconsistencies that would otherwise arise from measuring financial assets or financial liabilities, or recognising gains and losses on them, on different bases. Under this criterion, the main classes of financial instruments designated by the Bank are long-term debt issues. The interest payable on certain fixed rate long-term debt securities issued has been matched with the interest on 'receive fixed/pay variable' interest rate swaps as part of a documented interest rate risk management strategy. An accounting mismatch would arise if the debt securities issued were accounted for at amortised cost, because the related derivatives are measured at fair value with changes in the fair value recognised in the income statement. By designating the long-term debt at fair value, the movement in the fair value of the long-term debt will also be recognised in the income statement.
- applies to groups of financial assets, financial liabilities or combinations thereof that are managed, and their performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy, and where information about the groups of financial instruments is reported to management on that basis; and
- relates to financial instruments containing one or more embedded derivatives that significantly modify the cash flows resulting from those financial instruments, including certain debt issues and debt securities held.

## Notes to the Financial Statements (continued)

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

### (i) Financial investments

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

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

Interest income is recognised on available-for-sale debt securities using the effective interest rate, calculated over the asset's expected life. Premiums and/or discounts arising on the purchase of dated investment securities are included in the calculation of their effective interest rates. Dividends are recognised in the income statement when the right to receive payment has been established.

At each balance sheet date an assessment is made of whether there is any objective evidence of impairment in the value of a financial asset. Impairment losses are recognised if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the financial asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset that can be reliably estimated.

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

Impairment losses for available-for-sale debt securities are recognised within 'Loan impairment charges and other credit risk provisions' in the income statement and impairment losses for available-for-sale equity securities are recognised within 'Gains less losses from financial investments' in the income statement. The impairment methodologies for available-for-sale financial assets are set out in more detail below:

- **Available-for-sale debt securities:** When assessing available-for-sale debt securities for 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 recovery of future cash flows. These events may include a significant financial difficulty of the issuer, a breach of contract such as a default, bankruptcy or other financial reorganisation, or the disappearance of an active market for the debt security because of financial difficulties relating to the issuer. These types of specific event and other factors such as information about the issuers' liquidity, business and financial risk exposures, levels of and trends in default for similar financial assets, national and local economic trends and conditions, and the fair value of collateral and guarantees may be considered individually, or in combination, to determine if there is objective evidence of impairment of a debt security.
- **Available-for-sale equity securities:** Objective evidence of impairment for available-for sale equity securities may include specific information about the issuer as detailed above, but may also include information about significant changes in technology, markets, economics or the law that provides evidence that the cost of the equity securities may not be recovered.

A significant or prolonged decline in the fair value of the asset below its cost is also objective evidence of impairment. In assessing whether it is significant, the decline in fair value is evaluated against the original cost of the asset at initial recognition. In assessing whether it is prolonged, the decline is evaluated against the period in which the fair value of the asset has been below its original cost at initial recognition.

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

## Notes to the Financial Statements (continued)

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

(ii) Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Bank positively intends, and is able, to hold until maturity. Held-to-maturity investments are initially recorded at fair value plus any directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest rate method, less any impairment losses.

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

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

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

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

(k) Derivatives and hedge accounting

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

Derivatives may be embedded in other financial instruments, for example, a convertible bond with an embedded conversion option. Embedded derivatives are treated as separate derivatives when their economic characteristics and risks are not clearly and closely related to those of the host contract; the terms of the embedded derivative would meet the definition of a stand-alone derivative if they were contained in a separate contract, and the combined contract is not held for trading nor designated at fair value. These embedded derivatives are measured at fair value with changes therein recognised in the income statement.

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

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

## Notes to the Financial Statements (continued)

### Hedge accounting

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

#### *Fair value hedge*

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

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

#### *Cash flow hedge*

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

The accumulated gains and losses recognised in other comprehensive income are reclassified to the income statement in the periods in which the hedged item will affect profit or loss. However, when the forecast transaction that is hedged results in the recognition of a non-financial asset or a non-financial liability, the gains and losses previously recognised in other comprehensive income are removed from equity and included in the initial measurement of the cost of the asset or liability.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in other comprehensive income at that time remains in equity until the forecast transaction is eventually recognised in the income statement. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was recognised in other comprehensive income is immediately reclassified to the income statement.

### Hedge effectiveness testing

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

The documentation of each hedging relationship sets out how the effectiveness of the hedge is assessed. The method adopted by an entity to assess hedge effectiveness will depend on its risk management strategy.

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

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

### Derivatives that do not qualify for hedge accounting

All gains and losses from changes in the fair values of derivatives that do not qualify for hedge accounting are recognised immediately in the income statement. These gains and losses are reported in 'Net trading income', except where derivatives are managed in conjunction with financial instruments designated at fair value (other than derivatives managed in conjunction with debt securities issued by the Bank), in which case gains and losses are reported in 'Net income from financial instruments designated at fair value'. The interest on derivatives managed in conjunction with debt securities issued by the Bank which are designated at fair value is recognised in 'Interest expense'. All other gains and losses on these derivatives are reported in 'Net income from financial instruments designated at fair value'.

Derivatives that do not qualify for hedge accounting include non-qualifying hedges entered into as part of documented interest rate management strategies for which hedge accounting was not, or could not, be applied. The size and direction of changes in fair value of non-qualifying hedges can be volatile from year to year, but do not alter the cash flows expected as part of the documented management strategies for both the non-qualifying hedge instruments and the assets and liabilities to which the documented interest rate strategies relate. Non-qualifying hedges therefore operate as economic hedges of the related assets and liabilities.

## Notes to the Financial Statements (continued)

### (l) Derecognition of financial assets and liabilities

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

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

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

### (m) Offsetting financial assets and financial liabilities

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

### (n) Intangible assets

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

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

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

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

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

### (o) Property, plant and equipment

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

Leasehold buildings are depreciated over the unexpired terms of the leases, or over their remaining useful lives.

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

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

### (p) Finance and operating leases

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

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

## Notes to the Financial Statements (continued)

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

### (q) Income tax

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

Current tax is the tax expected to be payable on the taxable profit for the year, calculated using tax rates enacted or substantively enacted by the balance sheet date, and any adjustment to tax payable in respect of previous years. Current tax assets and liabilities are offset when the Bank intends to settle on a net basis and the legal right to offset exists.

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

Deferred tax is calculated using the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled based on tax rates and laws enacted, or substantively enacted, by the balance sheet date. Deferred tax assets and liabilities are offset when they arise in the same tax reporting group and relate to income taxes levied by the same taxation authority, and when the Bank has a legal right to offset.

Deferred tax relating to actuarial gains and losses on post-employment benefits is recognised directly in other comprehensive income. Deferred tax relating to share-based payment transactions is recognised directly in equity to the extent that the amount of the estimated future tax deduction exceeds the amount of the related cumulative remuneration expense. Deferred tax relating to fair value re-measurement of available-for-sale investments and cash flow hedging instruments which are charged or credited directly to other comprehensive income, is also charged or credited to other comprehensive income and is subsequently recognised in the income statement when the deferred fair value gain or loss is recognised in the income statement.

### (r) Pension and other post-employment benefits

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

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

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

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

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

## Notes to the Financial Statements (continued)

### (s) Share-based payments

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

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

Fair value is determined by using appropriate valuation models, taking into account the terms and conditions of the award. Vesting conditions include service conditions and performance conditions; any other features of a share-based payment arrangement are non-vesting conditions. Market performance conditions and non-vesting conditions are taken into account when estimating the fair value of equity instruments at the date of grant, so that an award is treated as vesting irrespective of whether the market performance condition or non-vesting condition is satisfied, provided all other vesting conditions are satisfied.

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

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

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

### (t) Foreign currencies

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

### (u) Provisions

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

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

### (v) Financial guarantee contracts

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

The Bank may issue financial guarantees to other Bank entities. Where it has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the Bank may elect to account for guarantees as insurance contracts.

## Notes to the Financial Statements (continued)

This election is made on a contract by contract basis, but the election for each contract is irrevocable. Where these guarantees have been classified as insurance contracts, they are measured and recognised as insurance liabilities.

### (w) Debt securities issued and deposits by customers and banks

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

### (x) 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 for loans and advances to banks and customers.

### (y) Cash and cash equivalents

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

## 4 Use of assumptions, estimates and judgement

The results of the Bank are sensitive to the accounting policies, assumptions and estimates that underlie the preparation of its financial statements. The accounting policies used in the preparation of the financial statements are described in detail in Note 3.

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

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

### Impairment of loans and advances

The Bank's accounting policy for losses arising from the impairment of customer loans and advances is described in Note 3(f). Further information can be found in Note 37 'Risk Management'. Loan impairment allowances represent management's best estimate of losses incurred in the loan portfolios at the balance sheet date.

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

The methods used to calculate collective allowances on homogeneous groups of loans and advances that are not considered individually significant are disclosed in Note 3(f). They are subject to estimation uncertainty, in part because it is not practicable to identify losses on an individual loan basis because of the large number of individually insignificant loans in the portfolio.

The methods involve the use of statistically assessed historical information which is supplemented with significant management judgement to assess whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience. In normal circumstances, historical experience provides the most objective and relevant information from which to assess inherent loss within each portfolio, though sometimes it provides less relevant information about the inherent loss in a given portfolio at the balance sheet date, for example, where there have been changes in economic, regulatory or behavioural conditions such that the most recent trends in the portfolio risk factors are not fully reflected in the statistical models. In these circumstances, such risk factors are taken into account by adjusting the impairment allowances derived solely from historical loss experience.



## Notes to the Financial Statements (continued)

Risk factors include loan portfolio growth, product mix, unemployment rates, bankruptcy trends, geographic concentrations, loan product features, economic conditions such as national and local trends in housing markets, the level of interest rates, portfolio seasoning, account management policies and practices, changes in laws and regulations, and other factors that can affect customer payment patterns. The methodology and the assumptions used in calculating impairment losses are reviewed regularly in the light of differences between loss estimates and actual loss experience. For example, roll rates, loss rates and the expected timing of future recoveries are regularly benchmarked against actual outcomes to ensure they remain appropriate.

However, the exercise of judgement 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 our loan impairment allowances as a whole are sensitive.

### Valuation of financial instruments

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

Valuation techniques used to calculate fair values are discussed in Note 31. The main assumptions and estimates which management considers when applying a model with valuation techniques are:

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

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

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

### Impairment of available-for-sale financial assets

The Bank's accounting policy for impairment on available-for-sale financial assets is described in Note 3(f).

Management is required to exercise judgement in determining whether there is objective evidence that an impairment loss has occurred. Once impairment has been identified, the amount of impairment is measured in relation to the fair value of the asset. More information on assumptions and estimates requiring management judgement relating to the determination of fair values of financial instruments is provided above in 'Valuation of financial instruments'.

Deciding whether an available-for-sale debt security is impaired requires objective evidence of both the occurrence of a loss event and a related decrease in estimated future cash flows. The degree of judgement involved is less when cash flows are readily determinable, but increases when estimating future cash flows requires consideration of a number of variables, some of which may be unobservable in current market conditions.

There is no single factor to which the Bank's charge for impairment of available-for-sale debt securities is particularly sensitive, because of the range of different types of securities held, the range of geographical areas in which those securities are held, and the wide range of factors which can affect the occurrence of loss events and the cash flows of securities, including different types of collateral.

## Notes to the Financial Statements (continued)

It is possible that outcomes in the next financial year could be different from those modelled when seeking to identify impairment on available-for-sale debt securities. In this event, impairment may be identified in available-for-sale debt securities which had previously been determined not to be impaired, potentially resulting in the recognition of material impairment losses in the next financial year.

### Valuation of intangible assets recognised

The Bank's accounting policy for intangible assets is described in Note 3(n).

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

- **Core deposit intangible:** The core deposit intangible is valued using an income approach which calculates the present value of the difference between the cost of existing deposits and the cost of obtaining alternative funds over the useful life of the deposit base.
- **Customer relationships:** The customer relationship is valued using an income approach which considers the interest income on future loans of existing customers along with the non-interest income expected to be derived from them.
- **Preferential lease:** The preferential lease contract is valued using an income approach which considers the benefit to the lesser of obtaining a rental lease at lower than the market rate, over the term of the lease.

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

### Pensions

The assumptions used are disclosed in Note 10 'Employee compensation and benefits'.

### Share-based payments

The assumptions used are disclosed in Note 11 'Share-based payments'.

## 5 Net expense from financial instruments designated at fair value

Net expense from financial instruments designated at fair value includes:

- all gains and losses from changes in the fair value of financial assets and liabilities designated at fair value;
- all gains and losses from changes in the fair value of derivatives that are managed in conjunction with financial assets and liabilities designated at fair value; and
- interest income, interest expense and dividend income in respect of:
  - financial assets and liabilities designated at fair value; and
  - derivatives managed in conjunction with the above,
 except for interest arising from issued debt securities and derivatives managed in conjunction with those debt securities, which is recognised in 'Interest expense'.

Net expense on long-term debt issued and related derivatives

	2014 AED000	2013 AED000
- changes in own credit spread on long-term debt .....	(22,527)	(13,761)
- other changes in fair value .....	14,725	5,165
<b>Net expense from instruments designated at fair value</b>	<b>(7,802)</b>	<b>(8,596)</b>

## Notes to the Financial Statements (continued)

**6 Interest income and expense**

	2014 AED000	2013 AED000
<b>Interest income</b>		
- Loans and advances to banks .....	69,427	102,211
- Loans and advances to customers .....	2,794,823	2,769,542
- Investments .....	96,063	135,547
- Others .....	44,961	26,377
<b>Total interest income</b>	<b>3,005,274</b>	<b>3,033,677</b>
	2014 AED000	2013 AED000
<b>Interest expense</b>		
- Deposits by banks .....	(215,797)	(269,054)
- Customer accounts .....	(101,306)	(176,622)
- Debt issued .....	(170,703)	(206,701)
- Others .....	-	(137)
<b>Total interest expense</b>	<b>(487,806)</b>	<b>(652,514)</b>
<b>Net interest income</b>	<b>2,517,468</b>	<b>2,381,163</b>

**7 Fee income and expense**

	2014 AED000	2013 AED000
<b>Fee income</b>		
Personal banking fees .....	360,957	352,329
Corporate banking fees .....	537,847	551,513
Investment banking fees .....	626,404	440,774
<b>Total</b>	<b>1,525,208</b>	<b>1,344,616</b>
<b>Fee expense</b>		
Personal banking fees .....	(55,157)	(46,694)
Corporate banking fees .....	(25,802)	(38,618)
Investment banking fees .....	(63,426)	(78,761)
<b>Total</b>	<b>(144,385)</b>	<b>(164,073)</b>
<b>Net fee income</b>	<b>1,380,823</b>	<b>1,180,543</b>

**8 Other operating income**

	2014 AED000	2013 AED000
Recovery of operational/support cost (refer note 42).....	393,473	414,127
(Loss)/gain on disposal of property plant and equipment .....	(38)	1,248
Others .....	65,680	57,020
<b>Total</b>	<b>459,115</b>	<b>472,395</b>

**9 Loan impairment charges and other credit risk provisions**

	2014 AED000	2013 AED000
<b>Loan impairment charge and other credit risk provisions</b>		
Net impairment charge on loans and advances to customers .....	(90,162)	(48,532)
Net impairment in respect of other credit risk provisions .....	22,453	7,111
<b>Total</b>	<b>(67,709)</b>	<b>(41,421)</b>

## Notes to the Financial Statements (continued)

**10 Employee compensation and benefits**

	2014 AED000	2013 AED000
Wages and salaries .....	1,021,167	858,221
Social security costs .....	10,140	8,805
Post-employment benefits .....	64,400	53,720
Others .....	451,250	433,539
<b>Total</b>	<b>1,546,957</b>	<b>1,354,285</b>

## Post-employment benefit plans

	2014 AED000	2013 AED000
<i>Income statement charge in respect of defined benefit plans</i>		
Defined benefit pension plans .....	55,527	44,936
	<b>55,527</b>	<b>44,936</b>

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

	2014 AED000	2013 AED000
Defined benefit pension plans .....	390,861	298,582

**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.

<b>Present value of defined benefit obligations</b>	2014 AED000	2013 AED000
At 1 January .....	298,582	242,120
Current service cost .....	48,225	39,222
Other movements .....	1,993	2,037
Interest cost .....	7,302	5,714
Actuarial losses .....	55,899	34,763
Benefits paid .....	(21,140)	(25,274)
Net liability .....	<b>390,861</b>	<b>298,582</b>

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

	2014 AED000	2013 AED000
Current service cost .....	48,225	39,222
Interest cost .....	7,302	5,714
<b>Total expense</b>	<b>55,527</b>	<b>44,936</b>

## Notes to the Financial Statements (continued)

### Post-employment defined benefit plans' principal actuarial assumptions

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

#### Principal actuarial assumptions

	Discount rate %	Rate of pay increase %	Combined rate of resignation and employment termination %
<b>At 31 December 2014</b>			
United Arab Emirates .....	<b>2.19</b>	<b>5.0</b>	<b>12.0</b>
<b>At 31 December 2013</b>			
United Arab Emirates .....	2.65	5.0	12.0

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

## 11 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 10).

### Deferred share awards

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

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

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

	Charge recognised in 2014 in respect of performance year:		Charge expected to be recognised in 2015 or later in respect of performance year:	
	2014 <sup>1</sup> AED000	Pre-2014 AED000	2014 <sup>1</sup> AED000	Pre-2014 AED000
HSBC deferred share awards .....	9,155	28,665	14,408	21,672

  

	Charge recognised in 2013 in respect of performance year:		Charge expected to be recognised in 2014 or later in respect of performance year:	
	2013 <sup>1</sup> AED000	Pre-2013 AED000	2013 <sup>1</sup> AED000	Pre-2013 AED000
HSBC deferred share awards .....	15,247	36,525	33,272	24,321

<sup>1</sup> Regulatory and best practice guidance has clarified the required structure and terms of deferred bonus arrangements awarded to employees, who now have a better understanding of the likely nature of the awards to be granted. As a result, the vesting period for deferred share awards expected to be granted in 2015 in respect of the 2014 performance year was determined to have started on 1 January 2014 and a charge was recognised from that date. Previously, the charge was recognised from the grant date.

## Notes to the Financial Statements (continued)

**12 Tax expense**

	<b>2014</b>	2013
	<b>AED000</b>	AED000
<b>Current tax</b>		
Tax – on current year profit .....	<b>408,992</b>	371,167
Tax – adjustments in respect of prior years.....	<b>(55,435)</b>	42,434
Deferred tax.....	<b>19,176</b>	13,232
Other.....	<b>94</b>	200
Prior year deferred tax .....	-	(61,640)
Tax expense.....	<b>372,827</b>	365,393

*Analysis of tax expense*

	<b>2014</b>	2013
	<b>AED000</b>	AED000
Accounting profit.....	<b>2,551,879</b>	2,354,878
Taxation at UAE corporate tax rate of 20% (2013: 20%) .....	<b>510,376</b>	470,976
Exempt income in respect of Jebel Ali and Ras Al Khaimah branches.....	<b>(91,983)</b>	(98,917)
Expenses not deductible for tax purposes .....	<b>9,775</b>	12,340
Adjustment in respect of prior period liabilities.....	<b>(55,435)</b>	(19,206)
Other.....	<b>94</b>	200
Overall tax expense .....	<b>372,827</b>	365,393

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

## Notes to the Financial Statements (continued)

**13 Analysis of financial assets and liabilities by measurement basis**

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

At 31 December 2014						
	Held for trading AED000	Designated at fair value AED000	Available-for-sale securities AED000	Financial assets and liabilities at amortised cost AED000	Derivatives designated as hedging instruments AED000	Total AED000
<b>Financial assets</b>						
Cash and balances at central banks .....	-	-	-	9,115,607	-	9,115,607
Trading assets .....	1,044,080	-	-	-	-	1,044,080
Derivatives .....	3,995,743	-	-	-	29,033	4,024,776
Loans and advances to banks .....	-	-	-	16,895,412	-	16,895,412
Loans and advances to customers .....	-	-	-	66,440,954	-	66,440,954
Reverse repurchase agreements – non-trading .....	-	-	-	62,866	-	62,866
Financial investments .....	-	-	21,472,926	-	-	21,472,926
Other assets .....	-	-	-	1,816,548	-	1,816,548
<b>Total financial assets .....</b>	<b>5,039,823</b>	<b>-</b>	<b>21,472,926</b>	<b>94,331,387</b>	<b>29,033</b>	<b>120,873,169</b>
Total non-financial assets .....						825,924
<b>Total assets .....</b>						<b>121,699,093</b>
<b>Financial liabilities</b>						
Deposits by banks .....	-	-	-	9,459,869	-	9,459,869
Customer accounts .....	-	-	-	72,742,810	-	72,742,810
Trading liabilities .....	5,743,470	-	-	-	-	5,743,470
Financial liabilities designated at fair value .....	-	3,159,900	-	-	-	3,159,900
Derivatives .....	4,023,731	-	-	-	111,799	4,135,530
Subordinated liabilities .....	-	-	-	2,759,085	-	2,759,085
Debt securities in issue .....	-	-	-	6,405,515	-	6,405,515
Other liabilities .....	-	-	-	4,199,997	-	4,199,997
<b>Total financial liabilities .....</b>	<b>9,767,201</b>	<b>3,159,900</b>	<b>-</b>	<b>95,567,276</b>	<b>111,799</b>	<b>108,606,176</b>
Total non-financial liabilities .....						1,136,267
<b>Total liabilities .....</b>						<b>109,742,443</b>

## Notes on the Financial Statements (continued)

At 31 December 2013						
	Held for trading AED000	Designated at fair value AED000	Available-for-sale securities AED000	Financial assets and liabilities at amortised cost AED000	Derivatives designated as cash flow hedging instruments AED000	Total AED000
<b>Financial assets</b>						
Cash and balances at central banks .....	-	-	-	11,075,873	-	11,075,873
Trading assets .....	1,060,509	-	-	-	-	1,060,509
Derivatives .....	3,898,279	-	-	-	36,119	3,934,398
Loans and advances to banks .....	-	-	-	11,065,106	-	11,065,106
Loans and advances to customers .....	-	-	-	58,240,952	-	58,240,952
Financial investments .....	-	-	22,679,140	-	-	22,679,140
Other assets .....	-	-	-	2,043,287	-	2,043,287
<b>Total financial assets .....</b>	<b>4,958,788</b>	<b>-</b>	<b>22,679,140</b>	<b>82,425,218</b>	<b>36,119</b>	<b>110,099,265</b>
Total non-financial assets .....						838,247
<b>Total assets .....</b>						<b>110,937,512</b>
<b>Financial liabilities</b>						
Deposits by banks .....	-	-	-	6,385,805	-	6,385,805
Customer accounts .....	-	-	-	67,770,959	-	67,770,959
Trading liabilities .....	4,535,972	-	-	-	-	4,535,972
Financial liabilities designated at fair value .....	-	1,849,089	-	-	-	1,849,089
Derivatives .....	3,960,215	-	-	-	-	3,960,215
Debt securities in issue .....	-	-	-	5,970,176	-	5,970,176
Other liabilities .....	-	-	-	5,585,240	-	5,585,240
<b>Total financial liabilities .....</b>	<b>8,496,187</b>	<b>1,849,089</b>	<b>-</b>	<b>85,712,180</b>	<b>-</b>	<b>96,057,456</b>
Total non-financial liabilities .....						3,800,955
<b>Total liabilities .....</b>						<b>99,858,411</b>

## 14 Cash and balances at central bank

	2014 AED000	2013 AED000
Cash in hand .....	825,361	775,855
Balances with central bank .....	236,243	2,757,366
Statutory reserves .....	8,054,003	7,542,652
	<b>9,115,607</b>	<b>11,075,873</b>

## 15 Loans and advances to banks

	2014 AED000	2013 AED000
Loans and advances to banks .....	16,895,412	11,065,106
	<b>16,895,412</b>	<b>11,065,106</b>



## Notes on the Financial Statements (continued)

### 16 Loans and advances to customers

	2014 AED000	2013 AED000
Overdrafts .....	5,991,470	5,990,375
Credit cards .....	2,255,914	2,240,715
Term lending .....	48,213,028	41,329,768
Bills discounted .....	4,739,040	3,565,994
Others .....	8,573,825	8,556,939
	<b>69,773,277</b>	<b>61,683,791</b>
Less: Allowance for impairment losses (note 17)	<b>3,332,323</b>	<b>3,442,839</b>
	<b>66,440,954</b>	<b>58,240,952</b>

### 17 Allowance for impairment losses

	2014 AED000	2013 AED000
Balance as at 1 January .....	3,442,839	3,731,421
Charge for the year .....	633,484	935,346
Released during the year .....	(451,064)	(624,422)
Write off during the year .....	(326,553)	(609,108)
Other movements .....	33,617	9,602
Balance as at 31 December .....	<b>3,332,323</b>	<b>3,442,839</b>

### 18 Trading assets

	2014 AED000	2013 AED000
Trading assets:		
– not subject to re-pledge or resale by counterparties .....	<b>1,044,080</b>	1,060,509
	<b>1,044,080</b>	<b>1,060,509</b>
Treasury and other eligible bills .....	47,285	-
Debt securities .....	724,236	681,447
Loans and advances .....	<b>272,559</b>	<b>379,062</b>
	<b>1,044,080</b>	<b>1,060,509</b>

## Notes on the Financial Statements (continued)

### 19 Derivatives

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

	Assets			Liabilities		
	Trading AED000	Hedging AED000	Total AED000	Trading AED000	Hedging AED000	Total AED000
<b>At 31 December 2014</b>						
Foreign exchange.....	1,533,925	1,369	1,535,294	1,581,249	106,204	1,687,453
Interest rate .....	1,836,050	27,664	1,863,714	1,786,638	5,595	1,792,233
Equity .....	14,844	-	14,844	14,844	-	14,844
Credit .....	425,925	-	425,925	456,001	-	456,001
Commodity and other .....	184,999	-	184,999	184,999	-	184,999
<b>Total .....</b>	<b>3,995,743</b>	<b>29,033</b>	<b>4,024,776</b>	<b>4,023,731</b>	<b>111,799</b>	<b>4,135,530</b>

	Assets			Liabilities		
	Trading AED000	Hedging AED000	Total AED000	Trading AED000	Hedging AED000	Total AED000
<b>At 31 December 2013</b>						
Foreign exchange.....	1,194,256	-	1,194,256	1,246,238	-	1,246,238
Interest rate .....	2,058,403	36,119	2,094,522	2,077,351	-	2,077,351
Equity .....	12,726	-	12,726	12,726	-	12,726
Credit .....	616,560	-	616,560	607,581	-	607,581
Commodity and other .....	16,334	-	16,334	16,319	-	16,319
<b>Total .....</b>	<b>3,898,279</b>	<b>36,119</b>	<b>3,934,398</b>	<b>3,960,215</b>	<b>-</b>	<b>3,960,216</b>

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

Derivatives are carried at fair value and shown in the balance sheet as separate totals of assets and liabilities. A description of how the fair value of derivatives is derived is set out in Note 31. Derivative assets and liabilities on different transactions are only set off (netted) if the transactions are with the same counterparty, a legal right of set off exists and the cash flows are intended to be settled on a net basis.

#### Use of derivatives:

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

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, with matching deals being used to achieve this where necessary. When entering into derivative transactions, the Bank employs the same credit risk management procedures to assess and approve potential credit exposures that are used for traditional lending.

#### Trading derivatives:

Most of the 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 in derivatives are entered into principally for the purpose of generating profits from short-term fluctuations in price or margin. Positions may be traded actively or be held over a period of time to benefit from expected changes in exchange rates, interest rates, equity prices or other market parameters. Trading includes market-making, positioning and arbitrage activities. Market-making entails quoting bid and offer prices to other market participants for the purpose of generating revenues based on spread and volume; positioning means managing market risk positions in the expectation of benefiting from favourable movements in prices, rates or indices; arbitrage involves identifying and profiting from price differentials between markets and products.

## Notes on the Financial Statements (continued)

As mentioned above, other derivatives classified as held-for-trading include non-qualifying hedging derivatives, ineffective hedging derivatives and the components of hedging derivatives that are excluded from assessing hedge effectiveness. Non-qualifying hedging derivatives are entered into for risk management purposes but do not meet the criteria for hedge accounting. These include derivatives managed in conjunction with financial instruments designated at fair value.

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

The notional or contractual amounts of these instruments indicate the nominal value of transactions outstanding at the balance sheet date; they do not represent amounts at risk.

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

	2014 AED000	2013 AED000
Foreign exchange.....	240,424,272	159,122,215
Interest rate .....	169,449,594	163,722,203
Equity .....	871,550	839,302
Credit .....	31,982,982	29,673,947
Commodity and other .....	475,934	209,577
	<b>443,204,332</b>	<b>353,567,244</b>

### **Credit derivatives:**

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

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

### **Derivatives valued using models with unobservable inputs**

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

### *Unamortised balance of derivatives valued using models with unobservable inputs*

	2014 AED000	2013 AED000
Unamortised balance at 1 January .....	–	–
Deferral on new transactions.....	–	4,172
Recognised in the income statement during the period:		
– amortisation.....	–	–
– subsequent to unobservable inputs becoming observable .....	–	(1,271)
– maturity or termination, or offsetting derivatives.....	–	–
Risk hedged .....	–	(2,901)
Unamortised balance at 31 December <sup>1</sup> .....	–	–

<sup>1</sup> This amount is yet to be recognised in the income statement.

## Notes on the Financial Statements (continued)

### Hedging instruments:

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

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

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

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

	2014	2014	2013	2013
	Fair value hedge	Cash flow hedge	Fair value hedge	Cash flow hedge
	AED000	AED000	AED000	AED000
Foreign exchange.....	-	4,331,912	-	-
Interest rate .....	633,741	4,148,456	-	1,836,250
	<b>633,741</b>	<b>8,480,368</b>	<b>-</b>	<b>1,836,250</b>

### *Fair value hedges*

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

#### *Fair value of derivatives designated as fair value hedges*

	At 31 December 2014		At 31 December 2013	
	Assets	Liabilities	Assets	Liabilities
	AED000	AED000	AED000	AED000
Interest rate .....	2,560	5,022	-	-
	<b>2,560</b>	<b>5,022</b>	<b>-</b>	<b>-</b>

### *Losses arising from fair value hedges*

	2014	2013
	AED000	AED000
Losses on the hedged items attributable to the hedged risk.....	<b>(481)</b>	<b>-</b>

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

## Notes on the Financial Statements (continued)

### Cash flow hedges

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

### Fair value of derivatives designated as cash flow hedges

	At 31 December 2014		At 31 December 2013	
	Assets AED000	Liabilities AED000	Assets AED000	Liabilities AED000
Foreign Exchange.....	1,369	106,204	-	-
Interest rate .....	25,104	573	36,119	-

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

	3 months or less AED000	More than 3 months but less than 1 year AED000	5 years or less but more than 1 year AED000	More than 5 years AED000
<b>At 31 December 2014</b>				
Assets .....	8,478,300	8,478,300	6,642,050	108,706
Liabilities.....	-	-	-	-
Net cash inflow exposure .....	8,478,300	8,478,300	6,642,050	108,706
<b>At 31 December 2013</b>				
Assets .....	1,836,250	1,836,250	1,836,250	-
Liabilities.....	-	-	-	-
Net cash inflow exposure .....	1,836,250	1,836,250	1,836,250	-

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

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

During the years ended 31 December 2014 and 31 December 2013, no gains or losses were recognised due to hedge ineffectiveness.

## Notes on the Financial Statements (continued)

## 20 Financial investments

	2014 AED000	2013 AED000
Financial investments:		
– not subject to repledge or resale by counterparties .....	21,472,926	22,679,140
	2014 AED000	2013 AED000
Treasury and other eligible bills .....		
– available-for-sale .....	1,101,712	-
Debt securities .....		
– available-for-sale .....	20,370,419	22,678,283
Equity securities .....		
– available-for-sale .....	795	857
Total financial investments .....	21,472,926	22,679,140

## Notes on the Financial Statements (continued)

## 21 Intangible assets

*Movement of intangible assets*

	Internally generated software AED000	Purchased software AED000	Customer relationship AED000	Core deposits AED000	Preferential lease payment AED000	Total AED000
<b>Cost</b>						
At 1 January 2014 .....	122,496	38,466	13,100	41,798	5,315	221,175
Additions <sup>1</sup> .....	8,446	363	-	-	-	8,809
Acquisition of business .....	-	-	-	-	-	-
Disposals .....	(36,522)	(8,830)	-	-	-	(45,352)
Exchange differences .....	-	-	-	-	-	-
Other changes .....	-	-	-	-	-	-
<b>At 31 December 2014 .....</b>	<b>94,420</b>	<b>29,999</b>	<b>13,100</b>	<b>41,798</b>	<b>5,315</b>	<b>184,632</b>
<b>Accumulated amortisation</b>						
At 1 January 2014 .....	95,907	36,693	2,183	6,966	774	142,523
Charge for the year <sup>2</sup> .....	10,143	1,067	1,872	5,971	664	19,717
Impairment .....	-	-	-	-	-	-
Disposals .....	(36,522)	(8,830)	-	-	-	(45,352)
Other changes .....	1	-	-	-	-	1
<b>At 31 December 2014 .....</b>	<b>69,527</b>	<b>28,930</b>	<b>4,055</b>	<b>12,936</b>	<b>1,438</b>	<b>116,889</b>
<b>Net carrying amount at 31 December 2014<sup>3</sup> .....</b>	<b>24,891</b>	<b>1,069</b>	<b>9,045</b>	<b>28,861</b>	<b>3,877</b>	<b>67,743</b>
<b>Cost</b>						
At 1 January 2013 .....	123,369	35,838	13,100	41,798	5,315	219,420
Additions <sup>1</sup> .....	8,443	1,504	-	-	-	9,947
Acquisition of business .....	-	-	-	-	-	-
Disposals .....	(8,475)	-	-	-	-	(8,475)
Exchange differences .....	-	-	-	-	-	-
Other changes .....	(841)	1,124	-	-	-	283
<b>At 31 December 2013 .....</b>	<b>122,496</b>	<b>38,466</b>	<b>13,100</b>	<b>41,798</b>	<b>5,315</b>	<b>221,175</b>
<b>Accumulated amortisation</b>						
At 1 January 2013 .....	93,923	33,644	312	995	110	128,984
Charge for the year <sup>2</sup> .....	11,286	2,587	1,871	5,971	664	22,379
Impairment .....	621	-	-	-	-	621
Disposals .....	(8,461)	-	-	-	-	(8,461)
Other changes .....	(1,462)	462	-	-	-	(1,000)
<b>At 31 December 2013 .....</b>	<b>95,907</b>	<b>36,693</b>	<b>2,183</b>	<b>6,966</b>	<b>774</b>	<b>142,523</b>
<b>Net carrying amount at 31 December 2013<sup>3</sup> .....</b>	<b>26,589</b>	<b>1,773</b>	<b>10,917</b>	<b>34,832</b>	<b>4,541</b>	<b>78,652</b>

1 At 31 December 2014, the Bank did not have any contractual commitments to acquire intangible assets (2013: nil).

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

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

## Notes on the Financial Statements (continued)

### 22 Property, plant and equipment

#### *Movement of property & equipment*

	Short leasehold land and buildings AED000	Equipment, fixtures and fittings AED000	Total AED000
<b>Cost or fair value</b>			
At 1 January 2014 .....	215,804	282,215	498,019
Additions at cost.....	15,618	22,259	37,877
Disposals .....	(48,425)	(112,145)	(160,570)
Other changes .....	-	(7)	(7)
At 31 December 2014 .....	<u>182,997</u>	<u>192,322</u>	<u>375,319</u>
<b>Accumulated depreciation</b>			
At 1 January 2014 .....	150,035	253,533	403,568
Depreciation charge for the year .....	14,919	15,237	30,156
Disposals .....	(48,268)	(111,940)	(160,208)
Impairment losses recognised .....	-	-	-
Other changes.....	-	(3)	(3)
At 31 December 2014 .....	<u>116,686</u>	<u>156,827</u>	<u>273,513</u>
<b>Net carrying amount at 31 December 2014 .....</b>	<b><u>66,311</u></b>	<b><u>35,495</u></b>	<b><u>101,806</u></b>
<b>Cost or fair value</b>			
At 1 January 2013 .....	219,041	280,740	499,781
Additions at cost.....	2,027	10,400	12,427
Disposals .....	(5,264)	(7,475)	(12,739)
Other changes .....	-	(1,450)	(1,450)
At 31 December 2013 .....	<u>215,804</u>	<u>282,215</u>	<u>498,019</u>
<b>Accumulated depreciation</b>			
At 1 January 2013 .....	134,423	237,800	372,223
Depreciation charge for the year .....	19,509	23,340	42,849
Disposals .....	(3,897)	(5,516)	(9,413)
Impairment losses recognised .....	-	-	-
Other changes.....	-	(2,091)	(2,091)
At 31 December 2013 .....	<u>150,035</u>	<u>253,533</u>	<u>403,568</u>
<b>Net carrying amount at 31 December 2013 .....</b>	<b><u>65,769</u></b>	<b><u>28,682</u></b>	<b><u>94,451</u></b>

### 23 Other assets

	2014 AED000	2013 AED000
Interest receivable .....	168,514	173,826
Prepaid expenses.....	58,430	75,304
Endorsements and acceptances.....	1,448,331	1,535,227
Items in course of collection from other banks.....	20	-
Other accounts .....	<u>141,253</u>	<u>258,930</u>
	<b><u>1,816,548</u></b>	<b><u>2,043,287</u></b>



## Notes on the Financial Statements (continued)

**24 Deferred tax assets**

	2014 AED000	2013 AED000
Deferred tax is applicable to the following		
<i>Recognised in income statement</i> .....		
Other liabilities .....	31,129	53,268
Allowance for impairment losses .....	625,246	620,951
<i>Recognised in statement of comprehensive income</i> .....		
Available-for-sale investment reserve .....	-	(2,699)
Cash flow hedge reserve .....	-	(6,376)
	<u>656,375</u>	<u>665,144</u>

**25 Customer accounts**

	2014 AED000	2013 AED000
Current accounts .....	40,733,569	38,633,652
Savings accounts .....	7,751,489	7,441,108
Call deposits .....	7,314,030	6,935,932
Term deposits .....	14,138,595	14,355,790
Money market term deposits .....	2,712,177	346,567
Others .....	92,950	57,910
	<u>72,742,810</u>	<u>67,770,959</u>

**26 Trading liabilities**

	2014 AED000	2013 AED000
Customer accounts .....	7,013	1,989
Other debt securities in issue .....	5,389,242	4,282,147
Other trading liabilities .....	347,215	251,836
	<u>5,743,470</u>	<u>4,535,972</u>

**27 Financial liabilities designated at fair value**

	2014 AED000	2013 AED000
Debt securities in issue .....	<u>3,159,900</u>	<u>1,849,089</u>

At 31 December 2014, the accumulated amount of change in fair value attributable to changes in credit risk was a loss of AED 29.88 million (2013: AED 7.35 million gain).

**28 Debt securities in issue**

	2014		2013	
	Carrying amount AED000	Fair value AED000	Carrying amount AED000	Fair value AED000
Medium term notes .....	14,954,657	14,950,799	12,101,412	12,081,224
Of which debt securities in issue reported as				
- trading liabilities .....	(5,389,242)	(5,389,242)	(4,282,147)	(4,282,147)
- financial liabilities designated at fair value .....	(3,159,900)	(3,159,900)	(1,849,089)	(1,849,089)
	<u>6,405,515</u>	<u>6,401,657</u>	5,970,176	5,949,988

## Notes on the Financial Statements (continued)

### 29 Other liabilities

	2014 AED000	2013 AED000
Items in course of transmission to other banks .....	401,866	1,374,726
Marginal deposits .....	1,377,250	1,108,122
Banker's drafts .....	154,936	-
Endorsements and acceptances .....	1,448,331	1,535,227
Other liabilities .....	817,614	1,567,165
	<b>4,199,997</b>	<b>5,585,240</b>

### 30 Provisions for liabilities and charges

	2014 AED000	2013 AED000
At 1 January .....	394,675	279,559
Charge for the year .....	95,566	132,822
Provisions utilised .....	(71,342)	(47,716)
Exchange differences and other movements .....	5,420	30,010
At 31 December .....	<b>424,319</b>	<b>394,675</b>

AED 33,458 thousand (2013: AED 96,093 thousand) relates to costs arising from contingent liabilities and contractual commitments; and AED 390,861 thousand (2013: AED 298,582 thousand) relates to provisions for pension & post retirement obligations.

### 31 Fair value of financial instruments

The classification of financial instruments is determined in accordance with the accounting policies set out in Note 2(c). The use of assumptions and estimation in valuing financial instruments is described below.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. The following table sets out the financial instruments carried at fair value.

*Financial instruments carried at fair value and bases of valuation*

	Valuation techniques:			
	Quoted market price Level 1 AED000	Using observable inputs Level 2 AED000	With significant non-observable inputs Level 3 AED000	Total AED000
At 31 December 2014				
Assets				
Trading assets .....	-	1,044,080	-	1,044,080
Derivatives .....	-	4,015,565	9,211	4,024,776
Financial investments: available-for-sale .....	-	21,472,131	795	21,472,926
Liabilities				
Trading liabilities .....	-	5,743,470	-	5,743,470
Financial liabilities designated at fair value ....	3,159,900	-	-	3,159,900
Derivatives .....	-	4,093,662	41,868	4,135,530
At 31 December 2013				
Assets				
Trading assets .....	-	1,060,509	-	1,060,509
Derivatives .....	-	3,929,279	5,119	3,934,398
Financial investments: available-for-sale .....	-	22,678,283	857	22,679,140
Liabilities				
Trading liabilities .....	-	4,535,972	-	4,535,972
Financial liabilities designated at fair value ....	1,849,089	-	-	1,849,089
Derivatives .....	-	3,950,374	9,842	3,960,216

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

## Notes on the Financial Statements (continued)

### 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. Finance establishes the accounting policies and procedures governing valuation, and is responsible for ensuring that they comply with all relevant accounting standards.

For all financial instruments where fair values are determined by reference to externally quoted prices or observable pricing inputs to models, independent price determination or validation is utilised. In inactive markets, direct observation of a traded price may not be possible. In these circumstances, the Bank will source alternative market information to validate the financial instrument's fair value, with greater weight given to information that is considered to be more relevant and reliable. The factors that are considered in this regard are, *inter alia*:

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

For fair values determined using a valuation model, the control framework may include, as applicable, independent development or validation of (i) the logic within valuation models; (ii) the inputs to those models; (iii) any adjustments required outside the valuation models; and, (iv) where possible, model outputs. Valuation models are subject to a process of due diligence and calibration before becoming operational and are calibrated against external market data on an ongoing basis.

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

### Determination of fair value

Fair values are determined according to the following hierarchy:

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

The best evidence of fair value is a quoted price in an actively traded market. The fair values of financial instruments that are quoted in active markets are based on bid prices for assets held and offer prices for liabilities issued. Where a financial instrument has a quoted price in an active market and it is part of a portfolio, the fair value of the portfolio is calculated as the product of the number of units and quoted price and no block discounts are made. In the event that the market for a financial instrument is not active, a valuation technique is used.

The judgement as to whether a market is active may include, but is not restricted to, the consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads. The bid/offer spread represents the difference in prices at which a market participant would be willing to buy compared with the price at which they would be willing to sell. In inactive markets, obtaining assurance that the transaction price provides evidence of fair value or determining the adjustments to transaction prices that are necessary to measure the fair value of the instrument requires additional work during the valuation process.

## Notes on the Financial Statements (continued)

Valuation techniques incorporate assumptions about factors that other market participants would use in their valuations, including interest rate yield curves, exchange rates, volatilities, and prepayment and default rates.

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 derivation 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 carrying amount and/or inception profit ('day 1 gain or loss') 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 level at which an arm's length transaction would be likely to occur. It generally does not mean that there is no market data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used).

In certain circumstances, primarily where debt is hedged with interest rate derivatives, the Bank records its own debt in issue at fair value, based on quoted prices in an active market for the specific instrument concerned, if available. 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 included within trading liabilities and are measured at fair value. The credit spread applied to these instruments is derived from the spreads at which the Bank issues structured notes. These market spreads are significantly smaller than credit spreads observed for plain vanilla debt or in the credit default swap markets.

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 adjustments

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

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

### Risk-related adjustments

#### *Bid-offer*

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

#### *Uncertainty*

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

## Notes on the Financial Statements (continued)

### *Credit 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 (see below).

### *Debit valuation adjustment*

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

## **Model-related adjustments**

### *Model limitation*

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

### *Inception profit (Day 1 P&L reserves)*

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

## **Credit valuation adjustment/debit valuation adjustment methodology**

The Bank calculates a separate credit valuation adjustment ('CVA') and debit valuation adjustment ('DVA') for each HSBC legal entity, and within each entity for each counter-party 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.

## **Valuation of uncollateralised derivatives**

Historically, the Bank has valued uncollateralised derivatives by discounting expected future cash flows at a benchmark interest rate, typically Libor or its equivalent. In line with evolving industry practice, in the second half of 2014, the Bank revised its estimation methodology for valuing the uncollateralised derivative portfolios by introducing a funding fair value adjustment ('FFVA'). The FFVA adjustment reflects the estimated present value of the future market funding cost or benefit associated with funding uncollateralised derivative exposure. The impact of FFVA adoption in 2014 is a reduction in net trading income of AED 9.36 million. This is an area in which a full industry consensus has not yet emerged and the Bank will continue to monitor industry evolution and refine the calculation methodology as necessary.

## Notes on the Financial Statements (continued)

### Fair value valuation bases

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

	Assets		Liabilities
	Available-for-sale AED000	Derivatives AED000	Derivatives AED000
<b>At 31 December 2014</b>			
Other derivatives.....	–	9,211	41,868
Other portfolios.....	795	–	–
	<b>795</b>	<b>9,211</b>	<b>41,868</b>
<b>At 31 December 2013</b>			
Other derivatives.....	–	5,119	9,842
Other portfolios.....	857	–	–
	<b>857</b>	<b>5,119</b>	<b>9,842</b>

### 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 modeling approaches used are standard across the industry. For more complex derivative products, there may be some differences in market practice. Inputs to valuation models are determined from observable market data wherever possible, including prices available from exchanges, dealers, brokers or providers of consensus pricing. Certain inputs may not be observable in the market directly, but can be determined from observable prices via model calibration procedures or estimated from historical data or other sources. Examples of inputs that may be unobservable include volatility surfaces, in whole or in part, for less commonly traded option products, and correlations between market factors such as foreign exchange rates, interest rates and equity.

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

### Other portfolios

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

### Movement in Level 3 financial instruments

	Assets		Liabilities
	Available-for-sale AED000	Derivatives AED000	Derivatives AED000
<b>At 1 January 2014</b> .....	857	5,119	9,842
Total gains/(losses) recognised in profit or loss .....	(62)	4,092	32,026
Total gains/(losses) recognised in other comprehensive income .....	–	–	–
Purchases .....	–	–	–
Sales .....	–	–	–
Transfers out .....	–	–	–
Transfers in .....	–	–	–
<b>At 31 December 2014</b> .....	<b>795</b>	<b>9,211</b>	<b>41,868</b>
Total unrealised gains/(losses) recognised in profit or loss relating to assets and liabilities held on 31 December 2014.....	–	4,092	30,178

## Notes on the Financial Statements (continued)

At 1 January 2013 .....	1,491	13,250	1,471
Total gains/(losses) recognised in profit or loss .....	(634)	(8,006)	8,371
Total gains/(losses) recognised in other comprehensive income .....	-	-	-
Purchases .....	-	-	-
Sales .....	-	-	-
Transfers out .....	-	(1,396)	-
Transfers in .....	-	1,271	-
At 31 December 2013 .....	857	5,119	9,842
Total unrealised gains/(losses) recognised in profit or loss relating to assets and liabilities held on 31 December 2013 .....	-	5,119	(7,738)

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

## 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 2014					
Fair value					
Valuation techniques					
	Carrying amount AED000	Quoted market price Level 1 AED000	Using observable inputs Level 2 AED000	With significant unobservable inputs Level 3 AED000	Total AED000
<b>Assets and liabilities not held for sale</b>					
<b>Assets</b>					
Loans and advances to banks .....	16,895,412	-	16,916,719	-	16,916,719
Loans and advances to customers .....	66,440,954	-	-	65,624,345	65,624,345
Reverse repurchase agreements – non-trading .....	62,866	-	62,866	-	62,866
<b>Liabilities</b>					
Deposits by banks .....	9,459,869	-	9,486,492	-	9,486,492
Customer accounts .....	72,742,810	-	73,145,570	-	73,145,570
Debt securities in issue .....	6,405,515	-	6,405,515	-	6,405,515
<b>At 31 December 2013</b>					
Fair value					
Valuation techniques					
	Carrying amount AED000	Quoted market price Level 1 AED000	Using observable inputs Level 2 AED000	With significant unobservable inputs Level 3 AED000	Total AED000
<b>Assets and liabilities not held for sale</b>					
<b>Assets</b>					
Loans and advances to banks .....	11,065,106	-	11,097,068	-	11,097,068
Loans and advances to customers .....	58,240,952	-	-	57,882,772	57,882,772
<b>Liabilities</b>					
Deposits by banks .....	6,385,805	-	6,422,000	-	6,422,000
Customer accounts .....	67,770,959	-	68,050,008	-	68,050,008
Debt securities in issue .....	5,970,176	-	5,970,176	-	5,970,176

## Notes on the Financial Statements (continued)

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

### Assets

Cash and balances at central banks  
 Items in the course of collection from other banks  
 Endorsements and acceptances  
 Short-term receivables within ‘Other assets’  
 Accrued income

### Liabilities

Items in the course of transmission to other banks  
 Endorsements and acceptances  
 Short-term payables within ‘Other liabilities’  
 Accruals

### Valuation:

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

### *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 group believes are consistent with those which would be used by market participants in valuing such loans; and trading inputs from other market participants which includes observed primary and secondary trades.

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

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

### *Deposits by banks and customer accounts*

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

### *Debt securities in issue and subordinated liabilities*

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

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



## Notes on the Financial Statements (continued)

### 32 Maturity analysis of assets and liabilities

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

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

#### Maturity analysis of assets and liabilities

	At 31 December 2014			At 31 December 2013		
	Due within one year AED000	Due after more than one year AED000	Total AED000	Due within one year AED000	Due after more than one year AED000	Total AED000
<b>Assets</b>						
Loans and advances to banks .....	15,848,749	1,046,663	16,895,412	9,586,925	1,478,181	11,065,106
Loans and advances to customers .....	39,137,176	27,303,778	66,440,954	33,296,556	24,944,396	58,240,952
Reverse repurchase agreements –non- trading .....	62,866	-	62,866	-	-	-
Financial investments .....	20,048,412	1,424,514	21,472,926	22,373,890	305,250	22,679,140
Other financial assets .....	1,710,965	105,583	1,816,548	1,795,242	248,045	2,043,287
	<b>76,808,168</b>	<b>29,880,538</b>	<b>106,688,706</b>	<b>67,052,613</b>	<b>26,975,872</b>	<b>94,028,485</b>
<b>Liabilities</b>						
Deposits by banks .....	9,459,572	297	9,459,869	6,385,805	-	6,385,805
Customer accounts .....	72,686,236	56,574	72,742,810	67,631,564	139,395	67,770,959
Financial liabilities designated at fair value ..	-	3,159,900	3,159,900	-	1,849,089	1,849,089
Debt securities in issue .....	5,585,195	820,320	6,405,515	372,474	5,597,702	5,970,176
Other financial liabilities .....	2,993,239	1,206,758	4,199,997	4,119,081	1,466,158	5,585,240
	<b>90,724,242</b>	<b>5,243,849</b>	<b>95,968,091</b>	<b>78,508,924</b>	<b>9,052,344</b>	<b>87,561,269</b>

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

	On demand AED000	Due within 3 months AED000	Due between 3 and 12 months AED000	Due between 1 and 5 years AED000	Due after 5 years AED000
<b>At 31 December 2014</b>					
Deposits by banks .....	1,894,465	7,034,922	530,185	297	-
Customer accounts .....	64,043,253	3,081,863	5,561,120	56,574	-
Trading liabilities .....	5,743,470	-	-	-	-
Financial liabilities designated at fair value .....	-	-	-	3,159,900	-
Derivatives .....	4,135,530	-	-	-	-
Debt securities in issue .....	-	2,622,548	2,962,647	612,262	208,058
Subordinated loan from head office .....	-	-	-	-	2,759,085
Other financial liabilities .....	392	1,214,862	228,895	4,182	-
	<b>75,817,110</b>	<b>13,954,195</b>	<b>9,282,847</b>	<b>3,833,215</b>	<b>2,967,143</b>
Guarantees and off balance sheet commitments .....	<b>3,592,574</b>	<b>19,344,477</b>	<b>27,373,879</b>	<b>19,910,883</b>	<b>2,343,758</b>
	<b>79,409,684</b>	<b>33,298,672</b>	<b>36,656,726</b>	<b>23,744,098</b>	<b>5,310,901</b>
<b>At 31 December 2013</b>					
Deposits by banks .....	1,710,298	4,588,232	86,806	469	-
Customer accounts .....	58,095,001	6,157,440	3,377,693	140,825	-
Trading liabilities .....	4,535,972	-	-	-	-
Financial liabilities designated at fair value .....	-	-	-	1,849,089	-
Derivatives .....	3,960,216	-	-	-	-
Debt securities in issue .....	-	170,687	201,788	5,597,701	-
Subordinated loan from head office .....	-	-	-	-	2,759,002
Other financial liabilities .....	11,764	1,228,892	279,551	14,821	-
	<b>68,313,251</b>	<b>12,145,251</b>	<b>3,945,838</b>	<b>7,602,905</b>	<b>2,759,002</b>
Guarantees and off balance sheet commitments .....	<b>5,122,250</b>	<b>17,064,252</b>	<b>19,188,280</b>	<b>20,544,140</b>	<b>1,094,041</b>
	<b>73,435,501</b>	<b>29,209,503</b>	<b>23,134,118</b>	<b>28,147,045</b>	<b>3,853,043</b>

## Notes on the Financial Statements (continued)

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 37 ‘Risk management’.

### 33 Offsetting of financial assets and financial liabilities

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

	Gross amounts of recognised financial assets AED000	Gross amounts offset in the balance sheet AED000	Amounts presented in the balance sheet AED000	Financial instruments AED000	Cash collateral received AED000	Net amount AED000
Amounts not set off in the balance sheet						
<b>At 31 December 2014</b>						
Derivatives.....	4,024,776	–	4,024,776	–	–	4,024,776
Reverse repurchase, securities borrowing and similar agreements .....	62,866	–	62,866	–	–	62,866
Classified as:						
- loans and advances to banks at amortised cost.....						
Loans and advances to customers excluding reverse repos at amortised cost .....	3,954,788	–	3,954,788	–	(724,068)	3,230,720
	<b>8,042,430</b>	<b>–</b>	<b>8,042,430</b>	<b>–</b>	<b>(724,068)</b>	<b>7,318,362</b>
<b>At 31 December 2013</b>						
Derivatives.....	3,934,398	–	3,934,398	–	–	3,934,398
Reverse repurchase, securities borrowing and similar agreements .....	–	–	–	–	–	–
Classified as:						
- loans and advances to banks at amortised cost.....						
Loans and advances to customers excluding reverse repos at amortised cost .....	3,445,715	–	3,445,715	–	(846,077)	2,599,638
	<b>7,380,113</b>	<b>–</b>	<b>7,380,113</b>	<b>–</b>	<b>(846,077)</b>	<b>6,534,036</b>

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

	Gross amounts of recognised financial liabilities AED000	Gross amounts offset in the balance sheet AED000	Amounts presented in the balance sheet AED000	Financial instruments AED000	Cash collateral pledged AED000	Net amount AED000
Amounts not set off in the balance sheet						
<b>At 31 December 2014</b>						
Derivatives.....	4,135,530	–	4,135,530	–	–	4,135,530
<b>At 31 December 2013</b>						
Derivatives.....	3,960,216	–	3,960,216	–	–	3,960,216

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

## Notes on the Financial Statements (continued)

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

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

### 34 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 Nil (2013: AED Nil). The fair value of any such collateral that have been sold or repledged is AED Nil (2013: AED Nil). The Bank is obliged to return these assets.

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

### 35 Subordinated liabilities

On 23 December 2009, a sub-ordinated loan of AED 2,754 million was provided by the Bank's head office. The loan carries an interest rate of Libor plus 630bps payable annually and 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 2014. UAE Central Bank has approved the loan to be considered as Tier 2 capital for regulatory purposes.

### 36 Cash and cash equivalents

	2014 AED000	2013 AED000
Cash and balances with the central bank.....	9,115,607	11,075,873
Loans and advances to banks maturing within 3 months .....	14,562,357	9,387,520
	<b>23,677,964</b>	<b>20,463,393</b>

### 37 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 (the Bank) and global business level. The risk management framework fosters the continuous monitoring of the risk environment and an integrated evaluation of risks and their interactions. Integral to the Bank's risk management framework are the enterprise tools of Risk Appetite, Top and Emerging ('T&E') Risks, Risk Map and Stress Testing.

## Notes on the Financial Statements (continued)

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

In their oversight and stewardship of risk management at Bank level, RMC are supported by a dedicated Risk function headed by the Chief Risk Officer ('CRO'), who is a member of RMC and reports to the Chief Executive Officer ('CEO') and to the MENA CRO.

### Risk culture

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

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

### Risk appetite

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

Quantitative and qualitative metrics are organized under fifteen categories, namely; returns, costs, capital, risk-weighted assets, liquidity and funding, loan impairments, exposure to the HSBC Group, credit and portfolio concentrations, market risk, operational risk, internal audit, financial crime compliance, reputational risk, sustainability risk and technology infrastructure. Measurements against the metrics serve to:

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

### Credit risk

Credit risk management:

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

## Notes on the Financial Statements (continued)

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

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

Within the Bank, the Credit Risk function is headed by the CRO who reports to the CEO and to the MENA 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 RMC, the Audit and Risk Committee and the HBME Board of Directors.
- Acting on behalf of the Bank as the primary interface, for credit-related issues, with external parties including the rating agencies, corporate analysts, trade associations etc.

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

### Credit quality

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

The Bank's risk rating system facilitates the Internal Ratings Based ('IRB') approach for portfolio management purposes. The system adopted by the Bank to support calculation under Basel II of the minimum credit regulatory capital requirement for banks, sovereigns and certain larger corporates.

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.

## Notes on the Financial Statements (continued)

### Impairment Assessment

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

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

### Write-off of loans and advances

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

Unsecured personal facilities, including credit cards, are generally written off at between 150 and 210 days past due, the standard period being the end of the month in which the account becomes 180 days contractually delinquent. Write-off periods may be extended, generally to no more than 360 days past due but in very exceptional circumstances exceeding that figure, where local regulation or legislation constrain earlier writeoff, or where the realisation of collateral for secured real estate lending extends to this time.

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

### Cross-border exposures

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

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

### Credit exposure

#### *Maximum exposure to credit risk*

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

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

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

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 2014			At 31 December 2013		
	Maximum exposure	Offset	Exposure to credit risk (net)	Maximum exposure	Offset	Exposure to credit risk (net)
	AED000	AED000	AED000	AED000	AED000	AED000
Cash and balances at central banks .....	9,115,607	-	9,115,607	11,075,873	-	11,075,873
Trading assets .....	1,044,080	-	1,044,080	1,060,509	-	1,060,509
– treasury and other eligible bills .....	47,285	-	47,285	-	-	-
– debt securities .....	724,236	-	724,236	681,447	-	681,447
– loans and advances to banks .....	266,893	-	266,893	319,717	-	319,717
– loans and advances to customers .....	5,666	-	5,666	59,345	-	59,345
Derivatives .....	4,024,776	-	4,024,776	3,934,399	-	3,934,399
Loans and advances held at amortised cost .....	83,336,366	(724,068)	82,612,298	69,306,058	(846,077)	68,459,981
– loans and advances to banks .....	16,895,412	-	16,895,412	11,065,106	-	11,065,106
– loans and advances to customers .....	66,440,954	(724,068)	65,716,886	58,240,952	(846,077)	57,394,875
Reverse repurchase agreements – non-trading .....	62,866	-	62,866	-	-	-
Financial investments .....	21,472,926	-	21,472,926	22,679,140	-	22,679,140
– Other investments .....	795	-	795	857	-	857
– debt securities .....	21,472,131	-	21,472,131	22,678,283	-	22,678,283
Other assets .....	1,816,548	-	1,816,548	2,043,287	-	2,043,287
– endorsements and acceptances .....	1,448,331	-	1,448,331	1,535,227	-	1,535,227
– accrued income and other .....	368,217	-	368,217	508,060	-	508,060
Financial guarantees and similar contracts .....	24,292,503	-	24,292,503	21,657,882	-	21,657,882
Loan commitments and other credit-related commitments .....	48,273,068	-	48,273,068	41,355,081	-	41,355,081
	<b>193,438,740</b>	<b>(724,068)</b>	<b>192,714,672</b>	<b>173,112,229</b>	<b>(846,077)</b>	<b>172,266,152</b>

## Collateral and other credit enhancements held

*Loans and advances held at amortised cost*

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

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

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

## Notes on the Financial Statements (continued)

### Personal lending – Residential mortgages by level of collateral:

	2014 AED000	2013 AED000
Uncollateralised .....	10,132	176,643
Fully collateralised .....	7,966,326	7,177,455
Less than 25% loan to value ('LTV') .....	517,725	394,945
25% to 50% LTV .....	4,057,800	1,898,024
51% to 75% LTV .....	2,665,961	3,602,987
76% to 90% LTV .....	571,978	1,154,964
91% to 100% LTV .....	152,862	126,535
Partially collateralised		
- greater than 100% LTV .....	335,951	302,498
- collateral value .....	245,977	271,705
Total residential mortgages .....	8,312,409	7,656,596

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

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

### Personal lending – Other personal lending:

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

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

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

#### Commercial real estate:

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

	2014 AED000	2013 AED000
Rated CRR/EL 1 to 7 .....	1,062,851	613,656
Uncollateralised .....	983,072	91,356
Fully collateralised .....	79,779	77,961
Partially collateralised .....	-	444,339
- collateral value .....	-	40,830
Rated CRR/EL 8 to 10 .....	714,032	1,067,549
Uncollateralised .....	24,628	26,314
Fully collateralised .....	25,133	377,012
Partially collateralised .....	664,271	664,223
- collateral value .....	325,467	325,467

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



## Notes on the Financial Statements (continued)

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

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

	2014 AED000	2013 AED000
Rated CRR/EL 8 to 10 .....	4,205,833	4,140,656
Uncollateralised .....	1,603,164	1,533,480
Fully collateralised .....	594,712	182,623
Partially collateralised .....	2,007,957	2,424,553
- collateral value .....	337,314	303,266

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

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

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

### *Loans and advances to banks*

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

### *Other credit risk exposures*

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

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

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

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

## Notes on the Financial Statements (continued)

### *Concentration of exposure:*

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

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

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

- the majority of the Bank's exposure to credit risk is concentrated in the UAE. Within the UAE, the Bank's credit risk is diversified over a wide range of industrial and economic groupings; and
- the Bank's position as part of a major international banking group means, that it has a significant concentration of exposure to banking counterparties. The majority of credit risk to the banking industry at 31 December 2014 and 31 December 2013 was concentrated in the Europe and Asia.

### *Loans and advances*

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

### **Gross loans and advances to customers by industry sector**

	<b>Gross loans and advances to customers</b>	
	<b>2014</b>	<b>2013</b>
	<b>AED000</b>	<b>AED000</b>
<b>Personal</b>		
Residential mortgages .....	<b>8,312,409</b>	7,646,594
Other personal .....	<b>5,104,003</b>	5,338,794
	<b>13,416,412</b>	12,985,388
<b>Corporate and commercial</b>		
Commercial, industrial and international trade .....	<b>25,293,273</b>	23,115,272
Commercial real estate .....	<b>1,776,883</b>	1,667,174
Other property-related .....	<b>3,898,725</b>	3,221,358
Government .....	<b>4,983,938</b>	4,288,607
Other commercial .....	<b>7,442,558</b>	6,472,154
	<b>43,395,377</b>	38,764,565
<b>Financial</b>		
Non-bank financial institutions .....	<b>12,961,488</b>	9,933,837
	<b>12,961,488</b>	9,933,837
Total gross loans and advances to customers .....	<b>69,773,277</b>	61,683,790
Impaired loans	<b>4,917,565</b>	5,103,532
- as a percentage of gross loans and advances to customers	<b>7.05%</b>	8.27%

## Notes on the Financial Statements (continued)

### Credit quality of financial instruments

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

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

#### Credit quality classification

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

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

### Quality classification definitions

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

'Good': exposures require closer monitoring and demonstrate a good capacity to meet financial commitments, with low default risk. Retail accounts typically show only short periods of delinquency, with any losses expected to be minimal following the adoption of recovery processes.

'Satisfactory': exposures require closer monitoring and demonstrate an average to fair capacity to meet financial commitments, with moderate default risk. Retail accounts typically show only short periods of delinquency, with any losses expected to be minor following the adoption of recovery processes.

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

'Impaired': exposures have been assessed as impaired. Wholesale exposures where the Bank considers that either the customer is unlikely to pay its credit obligations in full, without recourse by the Bank to the actions such as realising security if held, or the customer is past due more than 90 days on any material credit obligation. Retail loans and advances greater than 90 days past due unless they have been individually assessed as not impaired. Renegotiated loans that have met the requirements to be disclosed as impaired and have not yet met the criteria to be returned to the unimpaired portfolio.

### Risk rating scales

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

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

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

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

## 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*

31 December 2014								
	Neither past due nor impaired				Past due not impaired AED000	Impaired AED000	Impairment allowances AED000	Total AED000
	Strong AED000	Good AED000	Satisfactory AED000	Sub-Standard AED000				
Cash and balances at central banks .....	9,115,607	-	-	-	-	-	-	9,115,607
Trading assets .....	439,052	48,693	490,684	65,651	-	-	-	1,044,080
– treasury and other eligible bills .....	-	-	47,285	-	-	-	-	47,285
– debt securities ..	439,052	48,693	170,841	65,651	-	-	-	724,237
– loans and advances to banks .....	-	-	266,892	-	-	-	-	266,892
– loans and advances to customers .....	-	-	5,666	-	-	-	-	5,666
Derivatives .....	454,830	845,908	2,500,394	223,644	-	-	-	4,024,776
Loans and advances held at amortised cost .....	39,295,060	24,047,081	15,115,689	2,132,532	1,160,762	4,917,565	(3,332,323)	83,336,366
– loans and advances to banks .....	12,254,594	2,263,639	2,373,496	3,683	-	-	-	16,895,412
– loans and advances to customers .....	27,040,466	21,783,442	12,742,193	2,128,849	1,160,762	4,917,565	(3,332,323)	66,440,954
Reverse repurchase agreements - non-trading .....	62,866	-	-	-	-	-	-	62,866
Financial investments .....	885,253	-	20,586,878	-	-	-	-	21,472,131
– treasury and other eligible bills .....	-	-	1,101,712	-	-	-	-	1,101,712
– debt securities ..	885,253	-	19,485,166	-	-	-	-	20,370,419
Other assets .....	72,259	670,393	1,012,395	32,908	9,107	19,486	-	1,816,548
– endorsements and acceptances .....	68,782	669,805	650,683	32,908	6,667	19,486	-	1,448,331
– accrued income and other .....	3,477	588	361,712	-	2,440	-	-	368,217
Total .....	50,324,927	25,612,075	39,706,040	2,454,734	1,169,869	4,937,051	(3,332,323)	120,872,374

## Notes on the Financial Statements (continued)

31 December 2013								
	Neither past due nor impaired				Past due not impaired AED000	Impaired AED000	Impairment allowances AED000	Total AED000
	Strong AED000	Good AED000	Satisfactory AED000	Sub-Standard AED000				
Cash and balances at central banks .....	11,075,873	-	-	-	-	-	-	11,075,873
Trading assets .....	436,127	58,855	555,682	9,845	-	-	-	1,060,509
– treasury and other eligible bills .....	-	-	-	-	-	-	-	-
– debt securities ..	381,895	58,855	230,852	9,845	-	-	-	681,447
– loans and advances to banks .....	-	-	319,717	-	-	-	-	319,717
– loans and advances to customers .....	54,232	-	5,113	-	-	-	-	59,345
Derivatives .....	304,192	308,440	2,940,995	380,771	-	-	-	3,934,398
Loans and advances held at amortised cost .....	31,704,782	19,083,486	12,483,386	3,186,526	1,187,185	5,103,532	(3,442,839)	69,306,058
– loans and advances to banks .....	10,429,893	635,213	-	-	-	-	-	11,065,106
– loans and advances to customers .....	21,274,889	18,448,273	12,483,386	3,186,526	1,187,185	5,103,532	(3,442,839)	58,240,952
Financial investments .....	853,753	-	21,824,530	-	-	-	-	22,678,283
– treasury and other eligible bills .....	-	-	-	-	-	-	-	-
– debt securities ..	853,753	-	21,824,530	-	-	-	-	22,678,283
Other assets .....	35,153	698,620	1,217,215	67,292	25,008	-	-	2,043,288
– endorsements and acceptances .....	33,538	698,596	723,838	67,292	11,964	-	-	1,535,228
– accrued income and other .....	1,615	24	493,377	-	13,044	-	-	508,060
Total .....	44,409,880	20,149,401	39,021,808	3,644,434	1,212,193	5,103,532	(3,442,839)	110,098,409

## 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.

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 AED000	30-59 days AED000	60-89 days AED000	90-179 days AED000	Over 180 days AED000	Total AED000
At 31 December 2014 .....	654,307	213,596	226,435	42,861	23,563	1,160,762
At 31 December 2013 .....	851,552	150,434	153,416	17,363	14,420	1,187,185

### **Renegotiated loans and forbearance**

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

HSBC Group's policies and practices are based on criteria which enable local management to judge whether repayment is likely to continue. These typically provide a customer with terms and conditions that are more favourable than those provided initially. Loan forbearance is only granted in situations where the customer has showed a willingness to repay the borrowing and is expected to be able to meet the revised obligations.

The contractual terms of a loan may be modified for a number of reasons which include changing market conditions, customer retention and other factors not related to the current or potential credit deterioration of a customer. When the contractual payment terms of a loan have been modified because the lender has significant concerns about the borrower's ability to meet contractual payments when due, these loans are classified as 'renegotiated loans'. For the purposes of this disclosure the term 'forbearance' is synonymous with the renegotiation of loans for these purposes.

For retail lending, when considering whether there is 'significant concern' regarding a customer's ability to meet contractual loan repayments when due, the Bank assesses the customer's delinquency status, account behaviour, repayment history, current financial situation and continued ability to repay. Where the customer is not meeting contractual repayments or it is evident that they will be unable to do so without the renegotiation, there will be a significant concern regarding their ability to meet contractual payments, and the loan will be disclosed as impaired, unless the concession granted is insignificant as discussed further below.

For loan restructurings in wholesale lending, indicators of significant concerns regarding a borrower's ability to pay include:

- The debtor is currently in default on any of its debt.
- The debtor has declared or is in the process of declaring bankruptcy or entering into a similar process.
- There is significant doubt as to whether the debtor will continue to be a going concern.
- Currently, the debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange as a result of trading or financial difficulties.
- Based on estimates and projections that only encompass the current business capabilities, the Bank forecasts that the debtor's entity-specific cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity. Thus actual payment default may not yet have occurred.
- Absent the modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a non-distressed debtor.

## Notes on the Financial Statements (continued)

Where the modification of contractual payment terms of a loan represents a concession for economic or legal reasons relating to the borrower's financial difficulty, and is a concession that we would not otherwise consider, then the renegotiated loan is disclosed as impaired in accordance with our impaired loan disclosure convention, unless the concession is insignificant and there are no other indicators of impairment.

### 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. For loans that are assessed for impairment on a collective 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.

For retail lending the minimum period of payment performance required depends on the nature of loans in the portfolio, but is typically not less than six months. This period of payment performance is in addition to the receipt of a minimum of two payments within a 60 day period from a customer to initially qualify for the renegotiation. The qualifying payments are required in order to demonstrate that the renegotiated terms are sustainable for the borrower. For corporate and commercial loans, which are individually assessed for impairment and where non-monthly payments are more commonly agreed, the history of payment performance will depend on the underlying structure of payments agreed as part of the restructure.

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 2014				At 31 December 2013			
	Neither past due nor impaired AED000	Past due but not impaired AED000	Impaired AED000	Total AED000	Neither past due nor impaired AED000	Past due but not impaired AED000	Impaired AED000	Total AED000
Retail .....	108,905	8,873	161,131	278,909	236,994	22,047	175,605	434,646
Residential mortgages...	70,482	3,087	138,105	211,674	149,952	11,224	148,877	310,053
Other personal .....	38,423	5,786	23,026	67,235	87,042	10,823	26,728	124,593
Commercial real estate .....	642,950	-	1,346,182	1,989,132	987,983	94,166	1,297,432	2,379,581
Corporate and commercial...	165,658	58,058	1,249,902	1,473,618	435,994	296,237	931,386	1,663,617
Financial .....	917,359	-	65,656	983,015	971,243	-	-	971,243
Total renegotiated loans and advances to customers...	1,834,872	66,931	2,822,871	4,724,674	2,632,214	412,450	2,404,423	5,449,087
Total impairment allowance on renegotiated loans .....				1,410,042				1,467,885

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

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

### Impaired loans

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

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



## Notes on the Financial Statements (continued)

### Movement in impairment allowances on loans and advances to customers

	Customers		Total AED000
	Individually assessed AED000	Collectively assessed AED000	
At 1 January 2014 .....	2,684,084	758,755	3,442,839
Amounts written off .....	(81,881)	(244,672)	(326,553)
Recoveries of loans and advances written off in previous years .....	289	91,969	92,258
Charge to income statement .....	114,029	(23,867)	90,162
Exchange and other movements .....	52,084	(18,467)	33,617
<b>At 31 December 2014</b>	<b>2,768,605</b>	<b>563,718</b>	<b>3,332,323</b>
At 1 January 2013 .....	2,931,819	799,603	3,731,422
Amounts written off .....	(324,529)	(285,315)	(609,844)
Recoveries of loans and advances written off in previous years .....	160,591	101,801	262,392
Charge to income statement .....	(94,134)	142,666	48,532
Exchange and other movements .....	10,337	-	10,337
At 31 December 2013 .....	2,684,084	758,755	3,442,839

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

	At 31 December	
	2014 %	2013 %
<i>Customers</i>		
Individually assessed impairment allowances .....	3.97	4.35
Collectively assessed impairment allowances .....	0.81	1.23
	<b>4.78</b>	<b>5.58</b>

### Liquidity and funding

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. This risk arises from mismatches in the timing of cash flows. Funding risk (a form of liquidity risk) arises when the liquidity needed to fund illiquid asset positions cannot be obtained on the expected terms and when required.

The objective of the Bank's liquidity and funding risk management framework is to allow the bank to withstand very severe liquidity stresses. It is designed to be adaptable to changing business models, markets and regulations.

The Bank employs a number of measures to monitor liquidity risk.

#### Policies and procedures

The management of liquidity and funding is primarily undertaken locally in the Bank's operating entities in compliance with practices and limits set by the HSBC Group's Risk Management Meeting ('RMM'). These limits vary according to the depth and liquidity of the market in which the entities operate. It is HSBC's general policy that each banking entity should be self-sufficient in funding its own activities.

As part of HSBC's Asset, Liability and Capital Management ('ALCM') structure, the Bank has established Asset and Liability Management Committees ('ALCO') at Bank level. The terms of reference of all ALCOs include the monitoring and control of liquidity and funding.

### Primary sources of funding

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

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

## Notes on the Financial Statements (continued)

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 32.

### Core deposits

A key assumption of the Bank's internal framework is the categorisation of customer deposits into core and non-core. This characterisation takes into account the inherent liquidity risk categorisation of the entity originating the deposit, the nature of the customer and the size and pricing of the deposit.

### Advances to core funding ratio

Core customer deposits are an important source of funds to finance lending to customers, and discourages reliance on short-term professional funding. This is achieved by placing limits on banking entities (including branches) which restrict their ability to increase loans and advances to customers without corresponding growth in core customer deposits or long term debt funding; this measure is referred to as the 'advances to core funding' ratio.

Advances to core funding ratio limits for major markets in which the Bank operates are set by the Asset and Liability Management Committee ('ALCO'). The ratio describes current loans and advances to customers as a percentage of the total of core customer deposit and term funding with a remaining term to maturity in excess of one year. Loans and advances to customers which are part of reverse repurchase arrangements, and where the Bank receives securities which are deemed to be liquid, are excluded from the advances to core funding ratio.

	Advances to core funding ratio during:	
	2014	2013
	%	%
Year-end .....	<b>103.36%</b>	97.77%
Maximum .....	<b>106.87%</b>	98.81%
Minimum .....	<b>97.77%</b>	85.55%
Average .....	<b>104.02%</b>	91.49%

### Market risk management

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

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

### 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.

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;

## Notes on the Financial Statements (continued)

- the use of a 99% confidence level, by definition, does not take into account losses that might occur beyond this level of confidence;
- VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures; and
- VAR is unlikely to reflect loss potential on exposures that only arise under significant market moves.

### Trading and non-trading portfolios

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

Risk type	Portfolio	
	Trading	Non-trading
Foreign exchange and commodity .....	VAR	VAR <sup>1</sup>
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

	2014 AED000	2013 AED000
At 31 December .....	12,184	6,994
Average .....	8,729	7,619
Minimum .....	4,253	5,211
Maximum .....	13,543	12,953

### 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 2014 was AED 3.21 million (2013: AED 2.39 million). This is analysed below by risk type:

#### VAR by risk type for the trading intent activities

	Foreign exchange AED000	Interest rate AED000	Credit AED000	Total <sup>1</sup> AED000
At 31 December 2014 .....	368	2,264	2,340	3,206
At 31 December 2013 .....	672	1,626	1,612	2,385
<b>Average</b>				
2014 .....	643	2,927	2,200	3,653
2013 .....	672	3,951	3,409	5,511
<b>Minimum</b>				
2014 .....	226	705	548	921
2013 .....	392	1,295	1,568	2,381
<b>Maximum</b>				
2014 .....	1,864	7,086	6,226	9,082
2013 .....	1,217	11,289	9,009	11,205

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

## Notes on the Financial Statements (continued)

### Gap risk

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

Given the characteristics of these transactions, they will make little or no contribution to VAR or to traditional market risk sensitivity measures. The Bank captures the risks for such transactions within the stress testing scenarios and monitor gap risk on an ongoing basis. The Bank incurred no material gap losses arising from movements in the underlying market price on such transactions in the 12 months ended 31 December 2014.

### Non-trading portfolios

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

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

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

### Sensitivity of net interest income

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

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

Projected net interest income sensitivity figures represent the effect of the pro forma movements in net interest income based on the projected yield curve scenarios and the Bank's current interest rate risk profile. This effect, however, does not incorporate actions which would probably be taken by Global Markets or in the business units to mitigate the effect of interest rate risk. In reality, Global Markets seeks proactively to change the interest rate risk profile to minimise losses and optimise net revenues.

The projections also assume that interest rates of all maturities move by the same amount (although rates are not assumed to become negative in the falling rates scenario) and, therefore, do not reflect the potential impact on net interest income of some rates changing while others remain unchanged. In addition, the projections take account of the effect on net interest income of anticipated differences in changes between interbank interest rates and interest rates linked to other bases (such as Central Bank rates or product rates over which the entity has discretion in terms of the timing and extent of rate changes). The projections make other simplifying assumptions, including that all positions run to maturity.

Projecting the movement in net interest income from prospective changes in interest rates is a complex interaction of structural and managed exposures. The Bank's exposure to the effect of movements in interest rates on our net interest income arises in two main areas: core deposit franchises and Balance Sheet Management.

- core deposit franchises are exposed to changes in the cost of deposits raised and spreads on wholesale funds. The net interest income benefit of core deposits increases as interest rates rise and decreases as interest rates fall. This risk is asymmetrical in a very low interest rate environment, however, as there is limited room to lower deposit pricing in the event of interest rate reductions; and
- residual interest rate risk is managed within Balance Sheet Management, under our policy of transferring interest rate risk to Balance Sheet Management to be managed within defined limits and with flexibility as to the instruments used.

## Notes on the Financial Statements (continued)

The sensitivity analysis reflects the fact that our deposit taking businesses generally benefit from rising rates which are partially offset by increased funding costs in Balance Sheet Management given our simplifying assumption of unchanged Balance Sheet Management positioning. The benefit to deposit taking businesses of rising rates is also offset by the increased funding cost of trading assets, which is recorded in ‘Net interest income’ and therefore captured in the sensitivity analysis, whereas the income from such assets is recorded in ‘Net trading income’.

### 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. Pension scheme obligations fluctuate with changes in long-term interest rates, inflation, salary levels and the longevity of scheme members. Pension scheme assets include equities and debt securities, the cash flows of which change as equity prices and interest rates vary. There is a risk that market movements in equity prices and interest rates could result in asset values which, taken together with regular on going contributions, are insufficient over time to cover the level of projected obligations and these, in turn, could increase with a rise in inflation and members living longer. Management, together with the trustees who act on behalf of the pension scheme beneficiaries, assess these risks using reports prepared by independent external actuaries and takes action and, where appropriate, adjust investment strategies and contribution levels accordingly.

### Operational risk management

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk. Operational risk is relevant to every aspect of the Bank’s business and covers a wide spectrum of issues. Losses arising through fraud, unauthorised activities, errors, omission, inefficiency, systems failure or from external events all fall within the operational risk definition.

A formal governance structure provides oversight over the management of operational risk. An Operational Risk and Internal Control Committee, which reports to the Risk Management Committee, meets monthly to discuss key risk issues and review the effectiveness of the operational risk management framework.

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

A centralised database is used to record the results of the operational risk management process. Operational risk and control assessments, and incidents, are input and maintained by the business units. To ensure that operational risk losses are consistently reported and monitored at Group level, all Group companies are required to report all losses debited to the Profit and Loss Account. Losses under US\$10,000 may be aggregated and recorded as Bulk losses or Multiple Incident Loss Amounts (MILAs). MILA losses share a common loss event type and are similar in nature. Losses US\$10,000 and above need to be recorded as “Individual” incidents.

### 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% (2013: 12%). The Bank’s regulatory capital is analysed into two tiers:

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

## Notes on the Financial Statements (continued)

### Capital structure as at 31 December

	2014 Basel II AED000	2013 Basel II AED000
<b>Composition of regulatory capital</b>		
Tier 1 capital .....	9,709,854	9,010,965
Tier 2 capital .....	3,609,517	3,356,914
Total regulatory capital .....	13,319,371	12,367,879
<b>Risk weighted assets</b>		
Credit and counterparty risk .....	76,786,410	67,164,342
Market risk .....	5,120,830	2,326,053
Operational risk .....	8,841,493	5,819,381
	90,748,733	75,309,776
<b>Capital ratios</b>	%	%
Capital adequacy ratio .....	14.68	16.42

### 38 Non-trading reverse repurchase and repurchase agreements

The extent to which non-trading reverse repos represent amounts with banks is set out below.

	2014 AED000	2013 AED000
Banks <sup>1</sup> .....	62,866	-
At 31 December .....	62,866	-

<sup>1</sup> Reverse repos included above are the end party. All intercompany reverse repos and repos are presented in the 'Loans and advances to banks' and 'Deposits by banks'.

### 39 Contingent liabilities, contractual commitments and guarantees

	2014 AED000	2013 AED000
<b>Guarantees and other contingent liabilities</b>		
Guarantees .....	24,292,503	21,657,882
	24,292,503	21,657,882
<b>Commitments</b>		
Documentary credits and short-term trade-related transactions .....	802,228	1,930,945
Undrawn formal standby facilities, credit lines and other commitments to lend .....	47,470,840	39,424,136
	48,273,068	41,355,081

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.

## Notes on the Financial Statements (continued)

### 40 Lease commitments

#### Operating lease commitments

At 31 December 2014, 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	
	2014	2013
	AED000	AED000
Future minimum lease payments under non-cancellable operating leases expiring:		
– no later than one year .....	66,872	62,829
– later than one year and no later than five years .....	163,269	175,454
– later than five years .....	31,530	43,928
	<b>261,671</b>	<b>282,211</b>

#### 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	
	2014 <sup>1</sup>	2013
	AED000	AED000
Lease receivables:		
- no later than one year .....	163,508	191,659
- later than one year and no later than five years	89,405	427,670
- later than five years .....	-	276,614
	<b>252,913</b>	<b>895,943</b>

<sup>1</sup> Certain categories of finance leases have been recategorised within loans and advances.

### 41 Legal proceedings and regulatory matters

The Bank is party to legal proceedings, investigations and regulatory matters in a number of jurisdictions arising out of its normal business operations.

The review undertaken at the direction of the Jersey Financial Services Commission (the "Commission") into HBME's adherence to Jersey anti-money laundering requirements and international sanctions legislation has concluded. The Commission is currently reviewing the report.

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

#### Anti-money laundering and sanctions-related

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 the indirect parent of that company, HSBC North America Holdings Inc. ('HNAH'), entered into a consent cease-and-desist order with the Federal Reserve Board (the 'Orders'). These Orders required improvements to establish an effective compliance risk management programme across HSBC's US businesses, including risk management related to US Bank Secrecy Act ('BSA') and anti-money laundering ('AML') compliance. Steps continue to be taken to address the requirements of the Orders.

In December 2012, HSBC Holdings, HNAH and HSBC Bank USA entered into agreements with US and UK government agencies regarding past inadequate compliance with the BSA, AML and sanctions laws. Among those agreements, HSBC Holdings and HSBC Bank USA entered into a five-year deferred prosecution agreement with the DoJ, the US Attorney's Office for the Eastern District of New York, and the US Attorney's Office for the Northern District of West Virginia (the 'US DPA'); HSBC Holdings entered into a two-year deferred prosecution agreement with the New York County District Attorney (the 'DANY DPA'); and HSBC Holdings consented to a cease-and-desist order and HSBC Holdings and HNAH consented to a civil money penalty order with the FRB. In addition,

## Notes on the Financial Statements (continued)

HSBC Bank USA entered into a civil money penalty order with FinCEN and a separate civil money penalty order with the OCC. HSBC Holdings also entered into an agreement with the Office of Foreign Assets Control ('OFAC') regarding historical transactions involving parties subject to OFAC sanctions and an undertaking with the UK Financial Conduct Authority ('FCA') to comply with certain forward-looking AML and sanctions-related obligations.

Under these agreements, HSBC Holdings and HSBC Bank USA made payments totalling US\$1.9bn to US authorities and are continuing to comply with ongoing obligations. In July 2013, the US District Court for the Eastern District of New York approved the US DPA and retained authority to oversee implementation of that agreement. Under the agreements with the DoJ, FCA, and the FRB, an independent monitor (who is, for FCA purposes, a 'skilled person' under Section 166 of the Financial Services and Markets Act) is evaluating and regularly assessing the effectiveness of HSBC's AML and sanctions compliance function and HSBC's progress in implementing its remedial obligations under the agreements.

HSBC Holdings has fulfilled all of the requirements imposed by the DANY DPA which expired by its terms at the end of the two-year period of that agreement in December 2014. If HSBC Holdings and HSBC Bank USA fulfil all of the requirements imposed by the US DPA, the DoJ charges against those entities will be dismissed at the end of the five-year period of that agreement. The DoJ may prosecute HSBC Holdings or HSBC Bank USA in relation to any matters that are the subject of the US DPA if HSBC Holdings or HSBC Bank USA breaches the terms of the US DPA.

HSBC Bank USA also entered into a separate consent order with the OCC requiring it to correct the circumstances and conditions as noted in the OCC's then most recent report of examination, and imposing certain restrictions on HSBC Bank USA directly or indirectly acquiring control of, or holding an interest in, any new financial subsidiary, or commencing a new activity in its existing financial subsidiary, unless it receives prior approval from the OCC. HSBC Bank USA also entered into a separate consent order with the OCC requiring it to adopt an enterprise-wide compliance programme.

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, 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 killed or injured in Iraq between April 2004 and November 2011. The complaint was filed against HSBC Holdings, HSBC Bank plc, HSBC Bank USA and HSBC Bank Middle East, as well as other non-HSBC banks and the Islamic Republic of Iran (together, the 'Defendants'). The plaintiffs allege that defendants conspired to violate the US Anti-Terrorism Act of 2001, by altering or falsifying payment messages involving Iran, Iranian parties and Iranian banks for transactions processed through the US. Defendants' motion to dismiss is due to be filed in March 2015. This matter is at an early stage. Based on the facts currently known, it is not practicable at this time for HSBC to predict the resolution of this matter, including the timing or any possible impact on HSBC.

## 42 Related party transactions

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

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

HSBC Holdings plc  
8 Canada Square  
London  
E14 5HQ

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



## Notes on the Financial Statements (continued)

### Transactions with related parties

	2014	2013
	Balance at the year end <sup>1</sup> AED000	Balance at the year end <sup>1</sup> AED000
<b>Assets</b>		
Loans and advances to customers .....	1,383,967	1,365,000
Loans and advances to banks .....	6,377,257	7,992,658
<b>Liabilities</b>		
Deposits by banks .....	6,884,343	4,398,898
Customer accounts .....	123,138	20,209
Subordinated loan from head office .....	2,754,375	2,754,375
Irrevocable commitments and contingencies .....	1,919,955	2,198,573

	For the year ended 31 December 2014 AED000	For the year ended 31 December 2013 AED000
<b>Income Statement</b>		
Interest income .....	45,841	56,444
Interest expense .....	212,647	263,546
Fee income .....	246,872	130,565
Fee expense .....	67,798	95,069
Other operating income .....	393,473	414,127
General and administrative expenses .....	300,430	311,613

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

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

### 43 Events after the balance sheet date

These accounts were approved by management on 17 March 2015 and authorised for issue.

### 44 Comparative figures

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