HSBC Bank Middle East Limited - UAE Operations
Financial statements
As at and for the year ended 31 December 2010

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KPMG

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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 2010, the statements of comprehensive income (comprising a statement of comprehensive income and a separate statement of 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 Bank'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 Bank'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 2010, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

KPMG
Vijendra Nath Malhotra
Registration no. 48B

31 MAR 2011

HSBC Bank Middle East Limited - UAE Operations

Statement of income

For the year ended 31 December 2010

	Notes	2010 AED'000	2009 AED'000
Interest income	*4*	**3,582,455**	4,446,111
Interest expense	*4*	**(1,117,297)**	(1,357,130)
		-------------	------------
Net interest income		**2,465,158**	3,088,981
Fees and commission income	*5*	**1,412,380**	1,408,385
Fees and commission expense	*5*	**(151,504)**	(148,414)
Net trading income	*6*	**717,697**	838,574
Other operating income	*7*	**281,225**	459,367
		-------------	------------
Operating income		**4,724,956**	5,646,893
Administrative expenses	*8*	**(2,099,682)**	(2,035,537)
Depreciation and amortisation	*14, 15*	**(74,114)**	(67,768)
		-------------	------------
Operating profit before impairment losses		**2,551,160**	3,543,588
Loan impairment charges and other credit risk provisions			
- other credit risk provisions		**(2,249)**	(1,778)
- loans and advances to customers	*12.1*	**(1,534,345)**	(3,640,276)
- others		**(25,414)**	(10,006)
		(1,562,008)	(3,652,060)
Recoveries of bad debts written off		**136,394**	68,794
		----------	------------
Profit / (loss) before tax		**1,125,546**	(39,678)
Tax (expense) / benefit	*9*	**(182,163)**	3,664
		----------	------------
Profit / (loss) for the year		**943,383**	(36,014)
		======	=======

The notes on pages 7 to 75 are an integral part of these financial statements.

The independent auditors' report is set out on page 1.

HSBC Bank Middle East Limited - UAE Operations

Statement of comprehensive income

For the year ended 31 December 2010

	Notes	2010 AED'000	2009 AED'000
Net profit / (loss) for the year		**943,383**	(36,014)
Changes in fair value of available for sale investments		**(302)**	82,452
Changes in cash flow hedge reserve		**(45,576)**	35,633
(Loss) / gain on actuarial valuation of staff retirement benefits		**(23,278)**	29,934
Impairment loss on available for sale investments transferred to statement of income	*13.1*	**-**	14,406
Deferred tax recognised in other comprehensive income		**9,176**	(21,225)
		(59,980)	141,200
Total comprehensive income for the year		**883,403**	105,186

The notes on pages 7 to 75 are an integral part of these financial statements.

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HSBC Bank Middle East Limited - UAE Operations

Statement of financial position

As at 31 December

	Notes	2010 AED'000	2009 AED'000
ASSETS			
Cash and balances with the Central Bank	*10*	**5,670,767**	5,611,000
Loans and advances to banks	*11*	**10,631,345**	15,557,499
Loans and advances to customers	*12*	**50,889,326**	49,463,799
Financial investments	*13*	**24,487,162**	19,498,766
Property and equipment	*14*	**201,619**	226,109
Intangible assets	*15*	**47,642**	50,257
Deferred tax assets	*16*	**601,848**	596,039
Other assets	*17*	**6,382,715**	5,379,065
Total assets		**98,912,424**	96,382,534
LIABILITIES AND HEAD OFFICE FUNDS			
Liabilities			
Deposits by banks		**7,361,444**	5,818,152
Customer accounts	*18*	**60,227,871**	59,847,859
Debt securities in issue	*19*	**10,327,124**	11,829,482
Subordinated loan from head office	*20*	**2,754,375**	2,754,375
Other liabilities	*21*	**9,088,717**	7,875,748
Provisions for liabilities and charges	*22*	**187,053**	162,896
Total liabilities		**89,946,584**	88,288,512
Head office funds			
Allocated capital	*24*	**4,495,255**	4,495,255
Legal reserve	*24*	**938,275**	843,937
Other reserves		**(3,035)**	68,530
Unremitted profits		**3,535,345**	2,686,300
Total head office funds		**8,965,840**	8,094,022
Total liabilities and head office funds		**98,912,424**	96,382,534

The notes on pages 7 to 75 are an integral part of these financial statements.

The independent auditors' report is set out on page 1.

These financial statements are approved by:

Abdulfattah Sharaf
Chief Executive Officer - UAE

3 1 MAR 2011

HSBC Bank Middle East Limited - UAE Operations

Statement of cash flows

For the year ended 31 December

	Notes	2010 AED'000	2009 AED '000
Operating activities			
Net profit / (loss) before taxation		**1,125,546**	(39,678)
Adjustments for:			
Provisions for liabilities and charges	*22*	**21,700**	38,023
Allowance for impairment losses		**1,562,008**	3,650,282
Depreciation and amortisation		**74,114**	67,768
Loss/(gain) on disposal of property, equipment and investments		**14**	(6)
Net cash generated before changes in operating assets		**2,783,382**	3,716,389
Change in balances with Central Bank - statutory reserve		**81,865**	484,291
Change in loans and advances to banks		**67,936**	(35,476)
Change in loans and advances to customers		**(2,959,872)**	9,411,565
Change in other assets		**(1,010,464)**	1,640,570
Change in deposits by banks		**1,543,292**	(2,862,630)
Change in customer accounts		**380,012**	(7,828,160)
Change in other liabilities		**1,358,229**	(322,327)
Tax paid	*21.1*	**(324,055)**	(553,860)
Retirement benefits and other charges paid	*22*	**(23,070)**	(16,861)
Net cash generated from operating activities		**1,897,255**	3,633,501
Investing activities			
Purchase of investment securities classified as fair value through profit and loss (net)		**(766,867)**	(192,148)
Purchase of available for sale investments (net)		**(6,371,285)**	(1,058,698)
Purchase of property and equipment and intangible assets		**(80,234)**	(119,020)
Proceeds from sale of property and equipment		**14,529**	2,883
Net cash used in investing activities		**(7,203,857)**	(1,366,983)
Financing activities			
Debt securities (repaid) / issued		**(1,502,358)**	529,643
Subordinated loan from head office	*20*	**-**	2,754,375
Transfer of profits to head office		**-**	(4,590,821)
Net cash used in financing activities		**(1,502,358)**	(1,306,803)
(Decrease) / increase in cash and cash equivalents		**(6,808,960)**	959,715
Cash and cash equivalents at 1 January		**22,792,999**	21,833,284
Cash and cash equivalents at 31 December	*25*	**15,984,039**	22,792,999

The notes on pages 7 to 75 are an integral part of these financial statements.

The independent auditors' report is set out on page 1.

HSBC Bank Middle East Limited - UAE Operations

Statement of changes in head office funds

As at 31 December

	Allocated capital	Legal reserve	Other reserves: Available for sale reserve	Share based payment reserve	Cash flow hedge reserve	Actuarial gains/(losses) reserve	Unremitted profits	Total
	AED '000	AED'000	AED'000	AED'000	AED'000	AED'000	AED'000	AED'000
At 1 January 2009	4,495,255	843,937	(21,960)	21,098	(42,099)	(26,521)	7,313,135	12,582,845
Other comprehensive income								
Total comprehensive income for the year - net of income tax	-	-	77,487	2,085	28,506	29,934	(36,014)	101,998
Changes in head office funds								
Transfer of profits to head office	-		-	-	-	-	(4,590,821)	(4,590,821)
At 31 December 2009	4,495,255	843,937	55,527	23,183	(13,593)	3,413	2,686,300	8,094,022
At 1 January 2010	4,495,255	843,937	55,527	23,183	(13,593)	3,413	2,686,300	8,094,022
Other comprehensive income								
Total comprehensive income for the year - net of income tax	-	-	(241)	-	(36,461)	(23,278)	943,383	883,403
Changes in head office funds								
Transfer to legal reserve	-	94,338	-	-	-	-	(94,338)	-
Movement in share based payment reserve	-	-	-	(11,585)	-	-	-	(11,585)
At 31 December 2010	**4,495,255**	**938,275**	**55,286**	**11,598**	**(50,054)**	**(19,865)**	**3,535,345**	**8,965,840**

The notes on pages 7 to 75 are an integral part of these financial statements.

The independent auditors' report is set out on page 1.

1. Legal status and principal activities

The 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. HBME'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 eight branches as follows:

Abu Dhabi	Jebel Ali
Al Ain	Sharjah
Deira	Ras Al Khaimah
Dubai	Fujairah

These financial statements represent the combined assets, liabilities and results of the Bank.

The registered address of the Bank is 312/45, Al Suq Road, P.O. Box 66, Dubai, United Arab Emirates.

2. Basis of preparation

(a) Statement of compliance

These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") and interpretations adopted by the standing interpretation committee of the International Accounting Standards Board ("IASB").

(b) New standards and interpretations not yet adopted

A number of new standards, amendments to standards and interpretations that are issued but not effective for accounting period starting 1 January 2010, and have not been early adopted in preparing these financial statements:

- Amendments to IAS- 32: Financial Instruments: Presentation (effective 1 February 2010);
- IFRIC-19: Extinguishing Financial Liabilities with Equity Instruments (effective 1 July 2010);
- IAS-24 (Revised): Related Party Disclosures (effective 1 January 2011);
- Amendments to IFRIC 14 IAS-19: The limit on a Defined Benefit Assets, Minimum Funding Requirements and their Interaction (effective 1 January 2011); and

2. Basis of preparation *(continued)*

(b) New standards and interpretations not yet adopted *(continued)*

- IFRS 9: Financial Instruments (effective 1 January 2013).

Management is in process of assessing the impact of the new standards, amendments to standards and interpretations and amendments to published standards. Given the nature of the Bank's operations, IFRS 9 is expected to have a pervasive impact on the Bank's financial statements.

IFRS 9 is the first standard issued as part of a wider project to replace IAS39. Key features of IFRS 9 are:

- IFRS 9 retains but simplifies the mixed measurement model and establishes two primary measurement categories for financial assets: amortised cost and fair value;
- The basis of classification depends on the entity's business model and the contractual cash flow characteristics of the financial assets; and
- The guidance in IAS 39 on impairment of financial assets and hedge accounting continues to apply.

(c) Basis of measurement

The financial statements have been prepared on the historical cost basis except for the following:

- Derivative financial instruments, financial instruments at fair value through profit or loss and available for sale financial assets are measured at fair value; and

- The liability for defined benefit obligation is recognised as the present value of the defined benefit obligation.

(d) Functional and presentation currency

These financial statements are presented in United Arab Emirates Dirham ("AED"), which is the functional currency of the Bank, rounded to the nearest thousand.

(e) Use of estimates and judgements

The preparation of these financial statements in conformity with IFRS requires management to make judgments, estimates and assumptions that affect the application of accounting policies and reported amounts of assets and liabilities, income and expenses.

HSBC Bank Middle East Limited - UAE Operations

Notes to the financial statements *(continued)*

2. Basis of preparation *(continued)*

(e) Use of estimates and judgements *(continued)*

Actual results may differ from these estimates. The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

In particular, information about significant areas of estimation, uncertainty and judgement in applying accounting policies that have the most significant effect on the amounts recognised in the financial statements are described in note 3(s).

3. Significant accounting policies

The accounting policies set out below have been applied consistently to all periods presented in these financial statements.

(a) Interest income and expense

Interest income and expense for all interest bearing financial instruments except for those classified as held for trading or designated as fair value through profit or loss are recognised in 'Interest income' and 'Interest expense' in the statement of income using the effective interest rates of the financial assets or financial liabilities to which they relate.

Interest income and expense on financial instruments classified as held for trading or designated as fair value through profit or loss are considered to be incidental to the Bank's trading operations and are presented together with all other changes in the fair value of trading assets and liabilities in net trading income.

The effective interest rate is the rate that discounts estimated future cash receipts and payments earned or paid on a financial asset or a liability through its expected life or, where appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. The effective interest rate is established on initial recognition of the financial asset and liability and is not revised subsequently.

When calculating effective interest rates, the Bank estimates cash flows considering all contractual terms of the financial instruments, 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, including transaction costs and all other premiums or discounts.

3. Significant accounting policies *(continued)*

(a) Interest income and expense *(continued)*

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

(b) Fees and commission

Fees and commissions which form an integral part of the effective interest rate of financial instruments is recognised as an adjustment to the effective interest rate and is recorded in the net interest income.

Other fees and commission income earned from the provision of services are recognised as revenue, as and when the services are rendered. When a loan commitment is not expected to result in the draw-down of a loan, the related loan commitment fees are recognised on a straight line basis over the commitment period.

Other fees and commission expenses relate mainly to transaction and service fees, which are expensed as and when the services are received.

(c) Net trading income

Net trading income comprises gains less losses related to trading assets and liabilities, and includes all realised and unrealised fair value changes, interest, dividends, and foreign exchange differences.

(d) Taxation

Income tax comprises current tax and deferred tax. Income tax is recognised in the statement of income except to the extent that it relates to the items recognised in statement of comprehensive income, in which case related tax is also recognised in statement of comprehensive income.

Current tax is the expected tax payable on the taxable profit for the year, calculated using tax rates enacted or substantially enacted at the reporting date, in accordance with regulations issued by the Emirates of Abu Dhabi, Dubai, Sharjah and Fujairah, and the adjustment to tax payable, if any in respect of previous years.

3. Significant accounting policies *(continued)*

(d) Taxation *(continued)*

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

Deferred tax is measured at the tax rates expected to apply in the periods in which the assets will be realised or the liabilities settled. Deferred tax assets and liabilities are offset when they relate to income taxes levied by the same taxation authority, and when a legal right to offset exists.

(e) Financial instruments

A financial instrument is any contract that gives rise to both a financial asset for the Bank and a financial liability or equity instrument of another party or vice versa. All assets and liabilities in the statement of financial position are financial instruments, except property and equipment, capital work in progress, intangible assets, prepayments, advance receipts and head office funds.

Classification

Financial instruments are categorised as follows:

Financial instruments at fair value through profit or loss ("FVPL"): This category has two sub-categories: financial instruments held for trading and those designated to be fair valued through profit or loss at inception. A financial instruments is classified in this category if acquired principally for the purpose of selling in the short term or if so designated by management. Derivatives are also categorised as held for trading unless they are designated as hedges.

Loans and advances are non-derivative financial assets which includes current account balances with financial institutions and loans with fixed and determinable payments that are not quoted in an active market. They arise when the Bank provides money directly to the borrower with no intention of trading the receivable.

Held to maturity instruments are non-derivative financial instruments with fixed or determinable payments and fixed maturities that the Bank has the positive intent and ability to hold to maturity. Where the Bank sells other than an insignificant amount of held to maturity instruments, the entire category would be reclassified as available for sale.

3. Significant accounting policies *(continued)*

(e) Financial instruments *(continued)*

Classification *(continued)*

Available-for-sale assets are those non-derivative financial assets that are designated as available for sale or not classified as (a) loans and advances, (b) held-to-maturity investments or (c) FVPL.

Initial recognition

The Bank recognises financial assets and liabilities on its statement of financial position on the date it becomes a party to the contractual provisions of the instrument. From this date, any gains and losses arising from changes in fair value of the assets or liabilities designated as fair value through profit or loss or available for sale assets are recognised.

Loans and advances are recognised on the day the cash is advanced to the counterparty.

Derecognition

A financial asset is derecognised when the Bank loses control over the contractual rights that comprise that asset. This occurs when the rights are realised, expired or surrendered. A financial liability is derecognised when it is extinguished.

Assets classified as FVPL that are sold are derecognised, and corresponding receivables from the buyer for the payment are recognised as at the date the Bank commits to sell the assets. The Bank uses the specific identification method to determine the gain or loss on derecognition.

Loans and advances are derecognised on the day the cash is received by the Bank, or loans are either sold or written off.

Measurement

A financial asset or financial liability is initially measured at fair value plus (for an item not subsequently measured at fair value through profit or loss) transaction costs that are directly attributable to its acquisition or issue.

Subsequent to initial recognition all financial instruments to be fair valued through profit or loss and available for sale assets are measured at fair value, except any instrument that does not have a reliably measurable fair value. Such instruments are measured as set out in fair value measurement principles below.

3. Significant accounting policies *(continued)*

(e) Financial instruments *(continued)*

Measurement *(continued)*

All held to maturity financial instruments and loans and advances for which the fair value has not been hedged are measured at amortised cost less impairment losses. Amortised cost is calculated on the effective interest rate method. Premiums and discounts, including initial transaction costs, are included in the carrying amount of the related instrument and amortised based on the effective interest rate of the instrument.

Fair value measurement principles

Fair value is the amount for which an asset could be exchanged, or liabilities settled, between knowledgeable, willing parties in an arm's length transaction on the measurement date.

When available, the fair value of a financial instrument is based on quoted market prices in an active market for that instrument. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions on an arm's length basis. If a quoted market price is not available or if a market for a financial instrument is not active, the fair value is determined by using valuation techniques. Valuation techniques include net present value techniques, discounted cash flow methods, comparison to similar instruments for which market observable prices exist.

Where discounted cash flow techniques are used, estimated future cash flows are based on management's best estimates and the discount rate is a market-related rate at the reporting date for an instrument with similar terms and conditions.

The fair value of derivatives that are not exchange traded is estimated at the amount that the Bank would receive or pay to terminate the contract at the reporting date, taking into account current market conditions and the current creditworthiness of the counterparty.

Gains and losses on subsequent measurement

Gains and losses arising from changes in the fair value of the 'financial instruments at fair value through profit or loss category' are included in the statement of income in the period in which they arise. Gains and losses arising from changes in the fair value of available for sale financial assets are recognised in statement of comprehensive income, until the financial asset is derecognised or impaired, at which time the cumulative gain or loss previously recognised in statement of comprehensive income is recognised in the statement of income.

3. Significant accounting policies *(continued)*

(e) Financial instruments *(continued)*

Impairment

Financial assets are reviewed at each reporting date to determine whether there is objective evidence of impairment. If any such evidence exists, the asset's recoverable amount is estimated. Impairment loss is the difference between the net carrying value of an asset and its recoverable amount. Any such impairment loss is recognised in the statement of income. The recoverable amount of loans and advances is calculated as the present value of the expected future cash flows, discounted at the instrument's original effective interest rate. Short-term balances are not discounted.

The Bank considers evidence of impairment for loans and advances and held-to-maturity investment securities at both a specific asset and collective level. All individually significant loans and advances and held-to-maturity investment securities are assessed for specific impairment. All individually significant loans and advances and held-to-maturity investment securities found not to be specifically impaired are then collectively assessed for any impairment that has been incurred but not yet identified. Loans and advances and held-to-maturity investment securities that are not individually significant are collectively assessed for impairment by grouping together loans and advances and held-to-maturity investment securities with similar risk characteristics. The impairment of loans and advances is further explained in note 29 of these financial statements.

If in a subsequent period the amount of an impairment loss decreases and the decrease can be linked objectively to an event occurring after the write down, the write down or allowance is reversed through the statement of income.

In the case of equity investments classified as available-for-sale, a significant or prolonged decline in the fair value of the security below its cost is considered in determining whether the assets are impaired. If any such evidence exists for available-for-sale investments, the cumulative loss is measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that investment previously recognised in statement of comprehensive income, and is removed from statement of comprehensive income and recognised in the statement of income.

Impairment losses recognised in the statement of income on equity instruments are not reversed through the statement of income and are reversed through the cumulative changes in fair value under statement of comprehensive income.

3. Significant accounting policies *(continued)*

(e) Financial instruments *(continued)*

Offsetting

Financial assets and liabilities are offset and the net amount is reported in the statement of financial position only when the Bank has a legally enforceable right to set off the recognised amounts and the transactions are intended to be settled on a net basis.

Income and expenses are presented on a net basis only when permitted by the accounting standards, or for gains and losses arising from a group of similar transactions such as in the Bank’s trading activity.

(f) Impairment of non-financial assets

The carrying amounts of the Bank's non - financial assets are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated. The reduction in value is recognised in the statement of income.

(g) Property and equipment

Property and equipment is stated at cost less accumulated depreciation and impairment losses, if any. Cost includes expenditures that are directly attributable to the acquisition of the asset. The cost of replacing an item of property and equipment is recognised in the carrying value of the item if it is probable that the future economic benefits embodied within the part will flow to the Bank and its cost can be measured reliably. The day-to-day servicing of property and equipment is recognised in the statement of income as incurred. Depreciation is charged on a straight-line basis so as to write off the assets over their estimated useful lives as follows:

Leasehold property	- over the unexpired term of the lease
Vehicles	- 5 years
Equipments and furniture	- 3-5 years
Heavy equipment	- 10 years

Useful lives and depreciation rates are re-assessed at each reporting date. Property 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.

3. Significant accounting policies *(continued)*

(h) Intangible assets

Intangible assets that are acquired by the Bank are stated at cost less accumulated amortisation and accumulated impairment losses, if any. Costs of the intangible asset represent the costs incurred to acquire and bring to use the specific intangible asset. Amortisation is charged to the statement of income on a straight line basis over the estimated useful lives of intangible assets from the date that they are available for use. The Bank's intangible assets comprise of software costs which are amortised over a period of 3 years.

(i) Accounting for purchase and sale of financial assets

All purchases and sales of financial assets are recognised on the trade date, i.e. the date that the Bank commits to purchase or sell the financial asset. Purchases or sales of financial assets are those that require delivery of assets within the time frame generally established by regulation or convention in the market place.

(j) Foreign currencies

Transactions in foreign currencies are translated into UAE Dirham at spot exchange rate ruling at the date of the transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated into UAE Dirham at spot exchange rate ruling on the reporting date. The resulting gains or losses, together with gains and losses on spot foreign exchange transactions, are recognised in the statement of income. The foreign currency gains and losses on monetary items is the difference between amortised cost in the functional currency at the beginning of the period, adjusted for effective interest and payments during the period, and the amortised cost in foreign currency translated at spot exchange rate at the end of the period. Non-monetary assets and liabilities denominated in foreign currencies, which are stated at historical cost, are translated at the foreign exchange rate ruling at the date of the transaction.

Notional principal amount of forward exchange contracts are translated at spot exchange rate ruling at the reporting date.

(k) Retirement benefits

The Bank contributes to the UAE Nationals Pension and Social Security Scheme for UAE nationals as per the requirements of the Government of the United Arab Emirates. The Bank also makes contributions to the HSBC International Staff Retirement Benefit Scheme for all international staff.

3. Significant accounting policies *(continued)*

(k) Retirement benefits *(continued)*

For locally recruited employees (non UAE nationals), end of service benefits are calculated and paid in accordance with the UAE Federal Labour Law. The Bank's net obligation in respect of such end of service benefits is the amount of future benefits that employees have earned in return for their service in current and prior periods. The obligation is calculated by a qualified actuary using the projected unit credit method (using an emerging cash flow model) allowing for assumed future experience. The discount rate used is the inter-bank offer rate for 7 years AED interest rate swap. Actuarial differences are recognised in the statement of comprehensive income.

(l) Share Awards

Restricted Share Awards and Achievement Share Awards are granted to certain executives of the Bank. These awards confer the right to own a specified number of shares of HSBC Holdings plc upon completion of a minimum period of service from the date of the award. In some cases the fair value of the employees' services received in exchange for the equity instrument granted (determined by reference to the fair value of the equity instrument granted) is paid upfront to HSBC Holdings Plc. The shares are recorded as an asset in the Bank's books, which will be set off at the end of the employee vesting period.

When an inducement is awarded to an employee subject to completion of a specified period of service before the inducement vests, the expense is recognised on a straight line basis over the period to vesting.

(m) Derivatives

Classification

The Bank enters into derivative financial instruments including futures, forwards, swaps and options in the foreign exchange and capital markets. Derivative financial instruments that do not qualify for hedge accounting are classified as "FVPL – financial assets held for trading" financial instruments.

Measurement

In the normal course of business, the fair value of a derivative on initial recognition is the transaction price. Subsequent to their initial recognition, derivative financial instruments are stated at fair values. Fair values are generally obtained by reference to quoted market prices in active markets, or by using valuation techniques when an active market does not exist.

3. Significant accounting policies *(continued)*

(m) Derivatives *(continued)*

Measurement *(continued)*

Derivative financial instruments with positive market values (unrealised gains) are included in assets and derivative financial instruments with negative market values (unrealised losses) are included in liabilities.

Gains and losses on subsequent measurement

The gains or losses from derivative financial instruments classified as held for trading are included in net trading income.

Embedded derivatives

Certain derivatives embedded in other financial instruments, such as conversion option in convertible bond, are treated as separate derivatives when their economic characteristics and risks are not closely related to those of the host contract and the host contract is not carried at fair value through profit or loss. These embedded derivatives are measured at fair value with changes in the fair value recognised in the statement of income.

(n) Hedging instruments

When derivatives are designated as hedges, the Bank classifies them as either:

- fair value hedges which hedge the change in the fair value of recognised assets or liabilities; or

- cash flow hedges which hedge the exposure to variability in highly probable future cash flows attributable to a recognised asset or liability or a forecast transaction.

Hedge accounting is applied to derivatives designated as hedging instruments in a fair value or cash flow hedge provided certain criteria are met.

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.

3. Significant accounting policies *(continued)*

(n) Hedging instruments *(continued)*

Hedge accounting *(continued)*

The Bank also requires a documented assessment, both at hedge inception and on an ongoing basis, of whether or not the 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 hedges

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

Cash flow hedges

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

Hedge effectiveness testing

To qualify for hedge accounting, IAS 39 requires that at the inception of the hedge and throughout its life, each hedge must be expected to be highly effective (prospective effectiveness). Actual effectiveness (retrospective effectiveness) must also be demonstrated on an ongoing basis.

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

For fair value hedge relationships, the Bank uses the cumulative dollar offset method or regression analysis as effectiveness testing methodologies. For cash flow hedge relationships, the Bank utilizes the change in variable cash flow method or the cumulative dollar offset method, using the hypothetical derivative approach.

For prospective effectiveness, the hedging instrument must be expected to be highly effective in achieving 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, the changes in fair value or cash flows must offset each other in the range of 80 per cent to 125 per cent for the hedge to be deemed effective.

3. Significant accounting policies *(continued)*

(n) Hedging instruments *(continued)*

Discontinuation of hedge accounting

The hedge accounting is discontinued when a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting. At that point of time, any cumulative gain or loss on the hedging instrument that has been recognised in statement of comprehensive income remains in the statement of comprehensive income until the forecast transaction occurs. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in the statement of comprehensive income is immediately transferred to the statement of income.

Hedges that do not qualify for hedge accounting

For hedges which do not qualify for hedge accounting, any gains or losses arising from changes in the fair value of the hedging instrument are taken directly to the statement of income for the period.

(o) Deposits

All money market and customer deposits are initially recognised at cost, being the fair value of the consideration received. After initial recognition, all interest bearing deposits, other than liabilities classified as fair value through profit or loss ("FVPL"), are subsequently measured at amortised cost using the effective interest method. Amortised cost is calculated by taking into account any discount or premium on settlement. For liabilities carried at amortised cost (which are not part of a hedging relationship), any gain or loss is recognised in the statement of income when the liability is derecognised or impaired.

Liabilities which are classified as FVPL are subsequently measured at fair value, and any gain or loss arising from a change in fair value is included in the statement of income in the period in which it arises.

(p) Operating lease payments

Payments made under operating leases are recognised in the statement of income on a straight-line basis over the term of the lease.

3. Significant accounting policies *(continued)*

(q) Cash and cash equivalents

For the purpose of cash flow statement, cash and cash equivalents consist of cash and balances with the Central Bank, items in course of collection from other banks, liquid investments, loans and advances to banks with original maturity of less than three months, which are subject to insignificant risk of changes in their fair value, and are used by the Bank in the management of its short term committments.

(r) Provisions

A provision is recognised in the statement of financial position when the Bank has a legal or constructive obligation as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation.

(s) Key accounting estimates and judgements

The preparation of financial statements requires management to make certain estimates and assumptions that affect the reported amount of financial assets and liabilities and the resultant allowances for impairment and fair values. In particular, considerable judgement by management is required in the estimation of the amount and timing of future cash flows when determining the level of allowances required for impaired loans and receivables as well as allowances for impairment of unquoted investment securities. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Significant items where the use of estimates and judgements are required are outlined below:

Allowances for impairment of loans and receivables

The Bank reviews its loan portfolio to assess impairment on a regular basis. In determining whether an impairment loss should be recorded in the statement of income, the Bank makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the contractual future cash flows from a loan or homogenous group of loans. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss.

3. Significant accounting policies *(continued)*

(s) Key accounting estimates and judgements *(continued)*

Impairment of available for sale investment securities

The Bank determines that available-for-sale investment securities are impaired when there has been a significant or prolonged decline in the fair value below their cost. This determination of what is significant or prolonged requires judgement. In making this judgement, the Bank evaluates factors such as the credit rating and the financial performance of the issuer.

Income taxes

Significant estimates are required in determining the provision for income taxes. There are many transactions and calculations for which the ultimate tax determination is uncertain during the ordinary course of business. Where the final tax outcome of these matters is different from the amounts that were initially recorded, such differences will impact the income tax and deferred tax provisions in the period in which such determination is made.

4. Interest income and expense

	2010	2009
	AED'000	AED'000
Interest income		
Loans and advances to banks	**73,341**	87,805
Loans and advances to customers	**3,300,484**	4,095,215
Investments	**198,331**	241,227
Others	**10,299**	21,864
Total	**3,582,455**	4,446,111
Interest expense		
Deposits by banks	**(301,168)**	(131,693)
Customer accounts	**(637,232)**	(956,411)
Debt securities in issue	**(174,550)**	(221,089)
Others	**(4,347)**	(47,937)
Total	**(1,117,297)**	(1,357,130)
Net interest income	**2,465,158**	3,088,981

5. Fees and commission income and expense

	2010	2009
	AED'000	AED'000
Fees and commission income		
Personal banking customer fees	**479,136**	531,911
Corporate banking related fees	**574,260**	531,248
Investment banking fees	**358,984**	345,226
Total	**1,412,380**	1,408,385
Fees and commission expense		
Personal banking customer fees	**(59,499)**	(66,486)
Corporate banking related fees	**(43,207)**	(37,909)
Investment banking fees	**(48,798)**	(44,019)
Total	**(151,504)**	(148,414)
Net fees and commission income	**1,260,876**	1,259,971

6. Net trading income

	2010	2009
	AED'000	AED'000
Foreign exchange	**627,462**	721,605
Derivatives and other securities	**52,396**	47,768
Interest income on trading assets	**37,839**	69,201
Total	**717,697**	838,574

7. Other operating income

	2010	2009
	AED'000	AED'000
Recovery of operational / support cost	**259,048**	237,003
Gain on disposal of property, equipment and investments	**7,863**	6
Loss on sale of loans and advances	**-**	(5,260)
Gain on buy back of debt securities in issue	**2,286**	223,272
Dividend income	**867**	1,570
Others	**11,161**	2,776
Total	**281,225**	459,367

8. Administrative expenses

	2010	2009
	AED'000	AED'000
Staff costs		
- wages and salaries	**833,840**	799,388
- share awards (note 28)	**52,580**	52,325
- pension costs	**46,213**	44,087
- other costs	**279,829**	225,480
	1,212,462	1,121,280
Premises and equipment (excluding depreciation)	**157,121**	144,695
Others	**730,099**	769,562
Total	**2,099,682**	2,035,537

HSBC Bank Middle East Limited - UAE Operations

Notes to the financial statements *(continued)*

9. Tax expense

	2010	2009
	AED'000	AED'000
Current tax	**101,554**	497,138
Prior year tax	**77,242**	978
Deferred tax	**65,702**	(501,780)
	(62,335)	-
Charge for the year	**182,163**	(3,664)
Accounting profit	**1,125,546**	(39,678)
Tax at the applicable rate of 20%	**225,109**	(7,936)
Exempt income in respect of Jebel Ali and Ras Al Khaimah Branches	**(52,402)**	(66,468)
Impact of permanent disallowances	**(5,451)**	69,762
Prior year adjustment	**14,907**	978
	182,163	(3,664)

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.

10. Cash and balances with the Central Bank

	2010	2009
	AED'000	AED'000
Cash in hand	**609,879**	468,247
Statutory reserves	**5,060,888**	5,142,753
	5,670,767	5,611,000

11. Loans and advances to banks

	2010	2009
	AED'000	AED'000
Loans and advances to banks	**10,631,437**	15,557,591
Allowance for impairment losses (note 11.1)	**(92)**	(92)
	10,631,345	15,557,499

11.1 Allowance for impairment losses

	2010 AED'000	2009 AED'000
Balance as at 1 January	**92**	92
Charge for the year	**-**	-
Balance as at 31 December	**92**	92

12. Loans and advances to customers

	2010 AED'000	2009 AED'000
Overdrafts	**7,025,431**	7,336,090
Credit cards	**2,234,581**	2,997,007
Term lending	**32,875,323**	32,009,799
Bills discounted	**5,891,622**	2,602,488
Others	**6,306,577**	7,679,722
	54,333,534	52,625,106
Less: Allowance for impairment losses (note 12.1)	**3,444,208**	3,161,307
	50,889,326	49,463,799

12.1 Allowance for impairment losses

	2010 AED'000	2009 AED'000
Balance as at 1 January	**3,161,307**	826,390
Charge for the year	**2,888,765**	3,687,576
Released during the year	**(1,354,420)**	(47,300)
Net charge for the year	**1,534,345**	3,640,276
Write off during the year	**(1,186,060)**	(1,305,359)
Other movement	**(65,384)**	-
Balance as at 31 December	**3,444,208**	3,161,307

13. Financial Investments

	2010 AED'000	2009 AED'000
Fair value through profit and loss:		
Debt securities	**1,385,456**	618,589
Available for sale		
Debt securities		
- Quoted	**3,101,812**	3,170,177
- Un-quoted	**19,984,343**	15,682,610
	23,086,155	18,852,787
Equities		
- listed (note 13.1)	**13,714**	24,932
- unlisted	**1,837**	2,458
	15,551	27,390
	23,101,706	18,880,177
	24,487,162	19,498,766

13.1 The listed shares represent investments in the equity shares of HSBC Holdings plc, held by the Bank for distribution to employees, under share award schemes, on completion of the vesting period. The accounting policy for share awards is set out in note 3(i).

During the current year, Nil (2009: AED 14.4 million) is transferred as impairment loss from statement of comprehensive income to statement of income due to significant decline in the fair value of shares.

14. Property and equipment

	Land and buildings AED'000	Leasehold improvements AED'000	Vehicles, equipment, fixtures and fittings AED'000	Capital work in progress AED'000	Total AED'000
2010					
Cost at 1 January 2010	33,719	171,154	237,887	15,955	458,715
Additions	-	-	22,499	36,676	59,175
Disposals	-	(429)	(599)	-	(1,028)
Transfers	-	25,602	-	(25,602)	-
Reclassified as asset held for sale	(33,719)				(33,719)
Cost at 31 December 2010	**-**	**196,327**	**259,787**	**27,029**	**483,143**
Accumulated depreciation at 1 January 2010	955	74,092	157,559	-	232,606
Charge for the year	280	19,454	30,706	-	50,440
Disposals	-	-	(287)	-	(287)
Impairment taken to statement of income	18,682	-	-	-	18,682
Reclassified as asset held for sale	(19,917)	-	-	-	(19,917)
Accumulated depreciation at 31 December 2010	**-**	**93,546**	**187,978**	**-**	**281,524**
Net book value at 31 December 2010	**-**	**102,781**	**71,809**	**27,029**	**201,619**
2009					
Cost at 1 January 2009	-	150,926	215,232	9,071	375,229
Additions	33,719	24,154	25,781	6,884	90,538
Disposals	-	(3,926)	(3,126)	-	(7,052)
Cost at 31 December 2009	33,719	171,154	237,887	15,955	458,715
Accumulated depreciation at 1 January 2009	-	64,378	128,007	-	192,385
Charge for the year	955	12,783	30,658	-	44,396
Disposals	-	(3,069)	(1,106)	-	(4,175)
Accumulated depreciation at 31 December 2009	955	74,092	157,559	-	232,606
Net book value at 31 December 2009	32,764	97,062	80,328	15,955	226,109

15. Intangible assets

	Intangibles	Capital Work in progress	Total
	AED'000	AED'000	AED'000
2010			
Cost at 1 January 2010	**98,668**	**16,180**	**114,848**
Additions	**2,034**	**19,025**	**21,059**
Transfers	**23,792**	**(23,792)**	**-**
Cost at 31 December 2010	**124,494**	**11,413**	**135,907**
Accumulated amortisation at 1 January 2010	**64,591**	**-**	**64,591**
Charge for the year	**23,674**	**-**	**23,674**
Accumulated amortisation at 31 December 2010	**88,265**	**-**	**88,265**
Net book value at 31 December 2010	**36,229**	**11,413**	**47,642**
2009			
Cost at 1 January 2009	73,835	12,531	86,366
Additions	20,469	8,013	28,482
Transfers	4,364	(4,364)	-
Cost at 31 December 2009	98,668	16,180	114,848
Accumulated amortisation at 1 January 2009	41,219	-	41,219
Charge for the year	23,372	-	23,372
Accumulated amortisation at 31 December 2009	64,591	-	64,591
Net book value at 31 December 2009	34,077	16,180	50,257

16. Deferred tax asset

	2010 AED'000	2009 AED'000
Deferred tax is attributable to the following:		
Recognised in statement of income during the year		
Other liabilities	**43,948**	27,904
Allowance for impairment losses	**559,208**	578,619
	603,156	606,523
Recognised in statement of comprehensive income		
Available for sale investment reserve	**(13,821)**	(13,882)
Cash flow hedge reserve	**12,513**	3,398
	(1,308)	(10,484)
Total	**601,848**	596,039

17. Other assets

	2010 AED'000	2009 AED'000
Interest receivable	**292,212**	391,272
Prepaid expenses	**63,761**	65,863
Fair value of derivatives (note 26)	**3,070,776**	2,344,604
Customer receivables under acceptances	**2,614,018**	1,907,584
Items in course of collection from other banks	**-**	82
Other receivables	**341,948**	669,660
Total	**6,382,715**	5,379,065

18. Customer accounts

	2010 AED'000	2009 AED'000
Current accounts	**26,892,302**	25,212,639
Saving accounts	**4,482,542**	4,015,469
Call deposits	**4,910,340**	5,441,630
Term deposits	**22,345,202**	22,214,361
Money market term deposits	**1,509,765**	2,844,281
Others	**87,720**	119,479
Total	**60,227,871**	59,847,859

19. Debt securities in issue

Debt securities in issue represent the issue of floating and fixed rate notes of AED 10,327 million (2009: AED 11,329 million) under the Bank's Euro Medium Term Note (EMTN) programme and 3 year Certificate of Deposits ("CD's") of Nil (2009: AED 500 million, based on fixed margin of 30bps plus yield quoted by the UAE Central Bank on 6 month CDs).

20. Subordinated loan from head office

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.

21. Other liabilities

	2010	2009
	AED'000	AED'000
Interest payable and deferred income	**541,824**	482,855
Banker's drafts	**69,388**	150,506
Current taxation (refer note 21.1)	**351,879**	497,138
Fair value of derivatives (note 26)	**3,056,123**	2,311,065
Obligations under acceptances	**2,614,018**	1,907,584
Marginal deposits	**1,018,456**	1,233,094
Items in course of transmission to other banks	**106,091**	-
Other liabilities and provisions	**1,330,938**	1,293,506
Total	**9,088,717**	7,875,748

21.1 Current taxation

	2010	2009
	AED'000	AED'000
At 1 January	**497,138**	552,882
Charged for the year (note 9)	**101,554**	497,138
Prior year charges	**77,242**	978
Tax paid	**(324,055)**	(553,860)
At 31 December	**351,879**	497,138

22. Provisions for liabilities and charges

	Provision for pension and post retirement obligations AED'000	Provision for contingent liabilities and commitments AED'000	Total AED'000
At 1 January 2009	156,943	14,725	171,668
Charge for the year	36,245	1,778	38,023
Provisions utilised	(16,861)	-	(16,861)
Adjustment to provision arising from loss on actuarial valuation	(29,934)	-	(29,934)
At 31 December 2009	146,393	16,503	162,896
Charge for the year	**32,273**	**8,101**	**40,374**
Provisions utilised	**(23,070)**	**(16,425)**	**(39,495)**
Adjustment to provision arising from gain on actuarial valuation	**23,278**	**-**	**23,278**
At 31 December 2010	**178,874**	**8,179**	**187,053**

Assumptions used for determining provisions for retirement benefits are:

	2010	2009
Salary growth rate	**4.00%**	4.00%
Discount rate	**4.26%**	4.80%
Resignation rate	**15.00%**	10.60%
Termination rate	**5.00%**	1.20%

23. Contingent liabilities and commitments

	2010 AED'000	2009 AED'000
Credit related		
Contingent liabilities:		
Guarantees (contract amounts)	**23,371,574**	23,081,302

23. Contingent liabilities and commitments *(continued)*

Credit related *(continued)*

	2010	2009
	AED'000	AED'000
Commitments		
Documentary credits and short-term trade related transactions	**2,184,696**	1,604,487
Undrawn formal standby facilities, credit lines and other commitments to lend:		
- 1 year and under	**32,669,496**	38,579,416
- over 1 year	**1,851,434**	1,961,301

Contingent liabilities and commitments are credit-related instruments which include letters of credit, guarantees and commitments to extend credit. The contractual amounts represent the amounts at risk should the contract be fully drawn upon and the client defaults. Since a significant portion of the guarantees and commitments are expected to expire without being drawn upon, the total of the contract amounts is not representative of future liquidity requirements.

Operating lease commitments

	2010	2009
	AED'000	AED'000
Leasehold land and buildings under non-cancellable operating leases		
- within 1 year	**57,524**	51,458
- between 1 and 5 years	**210,750**	170,202
- over 5 years	**95,901**	88,672
	364,175	310,332

During the current year AED 82,545,581 (2009: AED 77,659,577) was recognised as rental expense in the statement of income in respect of operating leases.

Capital commitments

	2010	2009
	AED'000	AED'000
Expenditure contracted for	**20,430**	32,931
Expenditure authorised but not contracted for	**15,263**	8,500
	35,693	41,431

24. Head office funds

Allocated capital and unremitted profits

Allocated capital consists of interest free funds contributed by head office. During the current year Nil (2009: AED 4,591 million) of profits was remitted to the head office.

Legal reserve

In accordance with Article 82 of Union Law No. 10 of 1980, a minimum of 10% of the net profit after tax for the year is to be allocated to a legal reserve, which is non-distributable. Transfers to this reserve are required to be made until the legal reserve equals 50% of the allocated capital.

25. Cash and cash equivalents

	2010	2009
	AED'000	AED'000
Cash in hand	**609,879**	468,247
Items in the course of collection from other banks	**-**	82
Loans and advances to banks maturing within 3 months	**10,264,095**	15,122,313
Central Bank certificates of deposit maturing within 3 months	**5,110,065**	7,202,357
Total	**15,984,039**	22,792,999

26. Derivatives

In the ordinary course of business the Bank enters into various types of transactions that involve financial instruments. A derivative financial instrument is a financial contract between two parties where payments are dependent upon movements in the price of an underlying financial instrument, reference rate or index. Derivative financial instruments include forwards, futures, swaps and options.

The table below shows the positive and negative fair values of derivative financial instruments, which are equivalent to the market values, together with the notional amounts analysed by the term to maturity. The notional amount is the amount of a derivative’s underlying asset, reference rate or index and is the basis upon which changes in the value of derivatives are measured. The notional amounts indicate the volume of transactions outstanding at year end and are neither indicative of the market risk nor credit risk.

26. Derivatives *(continued)*

31 December 2010				***Notional amounts by term to maturity***			
	Positive fair value AED'000	**Negative fair value AED'000**	**Notional amount AED'000**	**Within 3 months AED'000**	**3-12 months AED'000**	**1-5 years AED'000**	**Over 5 years AED'000**
Derivatives held for trading:							
Interest rate contracts	1,485,351	1,561,086	93,838,772	181,459	11,173,291	65,944,394	16,539,628
Foreign exchange contracts	1,327,525	1,196,627	137,616,714	69,040,443	48,914,220	16,437,045	3,225,006
Foreign exchange options	45,839	46,131	17,331,107	3,895,525	12,814,310	621,272	-
Equity options	63,970	63,970	2,737,607	1,172,141	1,521,396	44,070	-
Credit derivatives	148,091	129,821	9,654,395	-	1,044,459	8,369,060	240,876
Derivatives held as cash flow hedges:							
Interest rate contracts	-	58,488	1,836,250	-	-	1,836,250	-
	3,070,776	**3,056,123**	**263,014,845**	**74,289,568**	**75,467,676**	**93,252,091**	**20,005,510**

31 December 2009				*Notional amounts by term to maturity*			
	Positive fair value AED'000	Negative fair value AED'000	Notional amount AED'000	Within 3 months AED'000	3-12 months AED'000	1-5 years AED'000	Over 5 years AED'000
Derivatives held for trading:							
Interest rate contracts	897,318	963,425	67,137,715	1,777,185	11,657,865	37,962,331	15,740,334
Foreign exchange contracts	1,122,814	1,012,412	120,664,310	63,812,069	40,841,268	12,721,652	3,289,321
Foreign exchange options	122,379	122,379	10,439,112	3,374,333	5,356,172	1,708,607	-
Equity options	56,034	56,034	2,448,056	-	-	2,448,056	-
Credit derivatives	146,059	132,066	7,556,124	-	-	7,556,124	-
Derivatives held as cash flow hedges:							
Interest rate contracts	-	24,749	918,125	-	-	918,125	-
	2,344,604	2,311,065	209,163,442	68,963,587	57,855,305	63,314,895	19,029,655

26. Derivatives *(continued)*

Derivative product types

Forwards and futures are contractual agreements to either buy or sell a specified currency, commodity or financial instrument at a specific price and date in the future. Forwards are customised contracts transacted in the over-the-counter market. Futures are transacted in standardised amounts on regulated exchanges and are subject to daily cash margin requirements. Forward rate agreements are effectively tailor-made interest rate futures, which fix a forward rate of interest on a notional loan, for an agreed period of time starting on a specified future date.

Swaps are contractual agreements between two parties to exchange interest or foreign currency differentials based on a specific notional amount. For interest rate swaps, counterparties generally exchange fixed and floating rate interest payments based on a notional value in a single currency. For cross-currency swaps, notional amounts are exchanged in different currencies. For cross-currency interest rate swaps, notional amounts and fixed and floating interest payments are exchanged in different currencies.

Options are contractual agreements that confer the right, but not the obligation, to either buy or sell a specific amount of a currency, commodity or financial instrument at a fixed price, either at a fixed future date or at any time within a specified period.

Derivative related credit risk

Credit risk in respect of derivative financial instruments arises from the potential for a counterparty to default on its contractual obligations and is equivalent to the positive fair value of instruments that are favourable to the Bank.

Derivatives held or issued for trading purposes

Most of the Bank's derivative trading activities relates to sales, positioning and arbitrage. Sales activities involve offering products to customers to enable them to transfer, modify or reduce current and expected risks. Positioning involves managing risk positions with the expectation of profiting from favourable movements in prices, rates or indices. Arbitrage involves identifying and profiting from price differentials between markets or products.

Derivatives held or issued for hedging purposes

The Bank has adopted a comprehensive system for the measurement and management of risk. Part of the risk management process involves managing the Bank's exposure to fluctuations in foreign exchange rates (currency risk) and interest rates through asset and liability management activities.

26. Derivatives *(continued)*

Derivatives held or issued for hedging purposes *(continued)*

It is the Bank's policy to reduce its exposure to currency and interest rate risks to acceptable levels as determined by the HSBC Group Head Office and their Board of Directors, within the guidelines issued by the UAE Central Bank. The HSBC Group Head Office has established levels of currency risk by setting limits on counterparty and currency position exposures. Positions are monitored on a daily basis and hedging strategies are used to ensure positions are maintained within established limits. The HSBC Group Head Office has established levels of interest rate risk by setting limits on the interest rate gaps for stipulated periods. Asset and liability interest rate gaps are reviewed on a daily/weekly/monthly basis and hedging strategies are used to reduce the interest rate gaps to within the limits established by the HSBC Group Head Office and their Board of Directors.

As part of asset and liability management, the Bank uses derivatives for hedging purposes in order to reduce its own exposure to interest rate and currency risks. This is achieved by hedging specific transactions as well as strategic hedging against overall exposures. For interest rate risk this is carried out by monitoring the duration of assets and liabilities using simulations to estimate the level of interest rate risk and entering into interest rate swaps to hedge a proportion of the interest rate exposure. Since strategic hedging does not qualify for special hedge accounting, related derivatives are accounted as trading instruments.

The Bank uses forward foreign exchange contracts and currency swaps to hedge against specifically identified currency risks. In addition, the Bank uses interest rate swaps to hedge against the fair value risk arising from specifically identified fixed rate financial instruments. The Bank also uses interest rate swaps to hedge against the cash flow risks arising on certain floating rate assets and liabilities. In all such cases the hedging relationship and objective, including details of the hedged item and hedging instrument, are formally documented and the transactions are accounted for either as fair value hedges or cash flow hedges.

The table below shows a summary of effectively hedged items, the nature of the risk being hedged, the hedging instrument and its fair value.

Description of hedged item	Hedged item notional value AED'000	Hedged risk	Hedging instrument	Positive / (negative) fair value during the year AED'000
Floating interest rate pool of assets				
2010	1,836,250	Cash flow	Interest rate swaps	(58,488)
2009	918,125	Cash flow	Interest rate swaps	(24,749)

27. Related party transactions

Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial or operational decisions. In the case of the Bank, related parties, as defined in International Accounting Standard No. 24, include directors and officers of the Bank, and companies of whom they are principal owners and key management personnel. Banking transactions are entered into with related parties on agreed terms and conditions on an arms length basis.

The outstanding as at the reporting date and average balances during the year in respect of related parties, HSBC group entities, included in the statement of financial position are as follows:

	2010 Outstanding AED'000	**2010 Average AED'000**	2009 Outstanding AED'000	2009 Average AED'000
Loans and advances to customers	**815,000**	**755,000**	695,000	716,766
Loans and advances to banks	**4,576,122**	**4,333,059**	4,089,996	4,903,798
Customer accounts	**239,695**	**259,637**	279,579	281,389
Deposits by banks	**2,119,872**	**2,555,093**	2,990,314	5,022,062
Subordinate loan from head office	**2,754,375**	**2,754,375**	2,754,375	1,377,188
Other assets (interest receivable and other income)	**181,490**	**189,750**	198,010	153,215
Other liabilities (interest payable and other charges)	**185,663**	**167,880**	150,097	110,758
Irrevocable commitments and contingencies	**1,540,065**	**1,614,489**	1,688,913	1,727,844
Exchange rate, interest rate, equity and other contracts (principal amounts only)	**150,408,655**	**132,356,798**	114,304,941	108,385,974
	=========	=========	=========	=========

The income and expenses in respect of related parties included in the statement of income are as follows:

	2010 AED'000	2009 AED'000
Interest income	**56,665**	46,238
Interest expense	**298,010**	119,950
Fees and commissions income	**101,420**	157,195
Fees and commissions expense	**84,261**	71,194
Other operating income	**259,048**	237,003
Other administrative expenses	**422,816**	457,297
International Staff Retirement Benefit Scheme charges	**15,725**	7,842
	=======	=======
Key management personnel		
Salaries, wages and other benefits	**6,161**	7,515
Retirement benefits	**75**	-
Share awards	**175**	-
	=======	=======

28. Share awards

The Bank granted Restricted Share Awards and Achievement Share Awards to certain executives during the period 2003 to 2010. 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 cost of the shares is determined by HSBC Holdings plc and is paid by the Bank upfront in some cases. The liability for the awards is accrued over the vesting period.

The details of the awards granted to date are set out in the following table:

Grant date	Vesting conditions	Total value	Amortised in 2010	Amortised in 2009
		AED'000	AED'000	AED'000
2006*	Three years of service	8,355	-	853
2007**	Three years of service	10,297	858	3,411
2008	Three years of service	10,107	3,369	3,369
2009	Three years of service	21,070	7,023	5,267
2010	Three years of service	13,429	6,154	-
		--------	--------	--------
		63,258	17,404	12,900
		=====	=====	=====

* The awards were vested / settled in March 2009.

** The awards were vested / settled in March 2010.

29. Financial risk management

Introduction and overview

All of the Bank’s activities involve analysis, evaluation, acceptance and management of some degree of risk or combination of risks. The most important types of risk are credit risk, market risk, liquidity risk and operational risk. Market risk includes foreign exchange and interest rate risk.

Risk management framework

The risk management framework is established by the HSBC Holdings plc (‘the Group’) which sets out the well established risk governance and ownership structure to ensure oversight of and accountability for, effective management of risk at regional, customer group and operating entity levels. However, the primary responsibility for managing risk rest with the Board of Directors of the Group and Chief Executive Officer of the Bank.

29. Financial risk management *(continued)*

Risk management framework *(continued)*

The Board of Directors has the responsibility to cascade the Group's risk management policies which are designed to support the formulation of risk appetite, guide employees and establish procedures for monitoring and controlling risk with timely and reliable reporting to the Board. The Group regularly reviews and updates its risk management policies and systems to reflect changes in markets, products and emerging best practice which are then cascaded to the Bank.

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

a) Credit risk

Credit risk is the risk of financial loss if a customer or counterparty of the Bank fails to meet an obligation under a contract. It arises principally from lending, trade finance, treasury and leasing activities but also from certain off-balance sheet products such as guarantees. The Bank has Group's standards, policies and procedures dedicated to control and monitor risk from all such activities.

The Group is responsible for the formulation of high-level credit policies. It also reviews the application of the Group's universal facility grading system.

The Group manages centrally exposures to sovereign entities, banks and other financial institutions. The Group's credit and settlement risk limits to counterparties in these sectors are approved and managed by Group Risk to optimize the use of credit availability and avoid excessive risk concentration.

Cross-border risk is controlled through the imposition of country limits, which are determined by taking into account economic and political factors, and local business knowledge, with sub-limits by maturity and type of business. Transactions with counterparties in higher risk countries are considered on a case-by-case basis.

The Bank's local management is responsible for:

- implementing credit policies, procedures and lending guidelines that conform to Group standards;
- monitoring credit processes which includes delegated approval authorities and credit procedures;
- monitoring quality and performance of the credit portfolio;
- monitoring and controlling all credit risks;
- managing risk concentrations by market sector, geography and product;
- managing exposures by customer and retail product segments through local systems; and
- frequent and intensive review and reporting of problem exposures in order to accelerate remedial action.

29. Financial risk management *(continued)*

a) Credit risk *(continued)*

Special attention is paid to manage loans with potential problems. Where deemed appropriate, specialist units are established to provide intensive management and control to maximize recoveries of doubtful debts.

Periodic risk based audits of credit processes and portfolios are undertaken by Group Internal Audit. Audit includes consideration of the adequacy and clarity of credit policy/procedure manuals; an in-depth analysis of a representative sample of accounts; an overview of homogeneous portfolios of similar assets to assess the quality of the loan book and other exposures; the adequacy of impairment calculations and checking that the Group and local standards and policies are adhered to in the approval and management of credit facilities.

Collateral and credit enhancements

Loans and advances

Where appropriate, the Bank is required to implement guidelines on the acceptability of specific classes of collateral or credit risk mitigation, and determine valuation parameters. Such parameters are expected to be conservative, reviewed regularly and be supported by empirical evidence. Security structures and legal covenants are subject to regular review to ensure that they continue to fulfil their intended purpose and remain in line with local market practice. While collateral is important in terms of mitigating credit risk, it is the Group’s policy to establish that loans are within the customer’s capacity to repay rather than to over rely on security. In certain cases, depending on the customer’s standing and the type of product, facilities may be unsecured. The principal collateral types are as follows:

- in the personal sector, mortgages over residential properties;
- in the commercial and industrial sector, charges over business assets such as premises, stock and debtors;
- in the commercial real estate sector, charges over the properties being financed; and
- in the financial sector, charges over financial instruments such as debt securities and equities in support of trading facilities.

Other securities

Collateral held as security for financial assets other than loans and advances is determined by the structure of the instrument. Debt securities, treasury and other eligible bills are generally unsecured with the exception of asset backed securities and similar instruments, which are secured by pools of financial assets.

29. Financial risk management *(continued)*

a) Credit risk *(continued)*

Credit quality

The credit quality of the portfolio of loans and advances at 31 December 2010 can be assessed by reference to the Bank's standard credit grading system. The Bank's rating process for credit facilities is designed to highlight exposures requiring greater management attention based on a higher probability of default and potential loss. Management particularly focuses on facilities to those borrowers and portfolio segments classified below satisfactory grades. Amendments to risk grades, where necessary, are required to be undertaken promptly. Management also regularly evaluates the adequacy of the established allowances for impaired loans by conducting a detailed review of the loan portfolio, comparing performance and delinquency statistics with historical trends and assessing the impact of current economic conditions. The following information is based on that system:

	2010		2009	
	Loans and advances to customers AED'000	**Loans and advances to banks AED'000**	Loans and advances to customers AED'000	Loans and advances to banks AED'000
Gross loans and advances				
- neither past due nor impaired	45,307,689	10,631,345	44,858,983	15,557,499
- past due but not impaired	3,321,578	-	3,891,516	-
- impaired	5,704,267	92	3,874,607	92
	54,333,534	**10,631,437**	52,625,106	15,557,591

The credit quality with reference to the standard credit rating system is assessed as follows:

Quality classification	**Whole sale lending and derivatives**	**Retail lending**
Strong	CRR1 to CRR 2	EL 1 to EL 2
Good	CRR3	EL 3
Medium	CRR 4 to CRR 5	EL 4 to EL 5
Sub-standard	CRR6 to CRR 8	EL 6
Impaired	CRR9 to CRR 10	EL 7 to EL 10

29. Financial risk management *(continued)*

a) Credit risk *(continued)*

Credit quality *(continued)*

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 close 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 the recovery processes.

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

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

Impaired exposures have been assessed, individually or collectively, as impaired.

The credit quality of loans and advances balances at reporting date is set out below:

	Loans and advances to customers		**Loans and advances to Banks**	
	2010	2009	**2010**	2009
	AED'000	AED'000	**AED'000**	AED'000
Strong	**12,652,137**	13,744,819	**10,619,193**	11,979,018
Good	**10,524,001**	7,142,460	**144**	3,575,705
Medium	**20,282,450**	22,692,819	**11,614**	2,653
Sub-standard	**5,170,679**	5,170,401	**394**	123
Impaired	**5,704,267**	3,874,607	**92**	92
Less: Allowance for impairment losses	**(3,444,208)**	(3,161,307)	**(92)**	(92)
	50,889,326	49,463,799	**10,631,345**	15,557,499

29. Financial risk management *(continued)*

a) Credit risk *(continued)*

Credit quality *(continued)*

Loans and advances which were past due but not impaired

Loans and advances which were past due at reporting date but not impaired were as follows:

	2010	2009
	AED'000	AED'000
Past due upto 29 days	**2,205,121**	2,498,001
Past due 30-59 days	**102,774**	239,488
Past due 60-89 days	**139,444**	567,489
	2,447,339	3,304,978
Past due 90-179 days	**499,350**	141,777
Past due over 180 days but less than 1 year	**374,889**	444,761
Past due more than 1 year	**-**	-
	3,321,578	3,891,516

29. Financial risk management *(continued)*

a) Credit risk *(continued)*

Debt securities and other bills by rating agency designation

The following table presents an analysis of debt securities by rating agency designation at year end, based on Standard and Poor's ('S&P') ratings or their equivalent:

31 December:	**2010**	2009
	AED'000	AED'000
AAA	**3,901,237**	3,796,164
AA- to AA+	**216,453**	166,283
A- to A+	**324,380**	149,247
Lower than A-	**280,558**	259,644
Unrated	**19,748,983**	15,100,038
Total	**24,471,611**	19,471,376
Of which issued by:		
- governments and central banks	**19,695,439**	14,747,748
- corporates and banks	**4,776,172**	4,723,628
Total	**24,471,611**	19,471,376
Of which classified as:		
- available for sale securities	**23,086,155**	18,852,787
- Fair value through profit or loss	**1,385,456**	618,589
Total	**24,471,611**	19,471,376

Debt securities with short-term ratings are reported against the long-term rating of the issuer of the short-term debt securities. If major rating agencies have different ratings for the same debt securities, the securities are reported against the lower rating.

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 loans assessed collectively. Losses expected from future events are not recognised.

29. Financial risk management *(continued)*

a) Credit risk *(continued)*

Impairment of loans and advances *(continued)*

Individually assessed loans

At each reporting date, the Bank assesses on a case-by-case basis whether there is any objective evidence that a loan is impaired. This procedure is applied to all accounts that are considered individually significant. In determining impairment losses on these loans, the following factors are considered:

- the Bank's aggregate exposure to the customer;
- the viability of the customer's business model and 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 mitigates) and likelihood of successful repossession;
- the likely deduction of any costs involved in recovery of amounts outstanding;
- the ability of the borrower to obtain, and make payments in, the currency of the loan if not local currency; and
- where available, the secondary market price for the debt.

Impairment loss is calculated by discounting the expected future cash flows of a loan at its original effective interest rate, and comparing the resultant present value with the loan’s current carrying value. Any loss is charged in the statement of income. The carrying amount of impaired loans on the statement of financial position is reduced through the use of an allowance account. Interest on impaired assets continues to be recognised through the unwinding of the discount.

Collectively assessed loans

Impairment is determined on a collective basis in two different scenarios:

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

29. Financial risk management *(continued)*

a) Credit risk *(continued)*

Impairment of loans and advances *(continued)*

Collectively assessed loans (continued)

Incurred but not yet identified.

Individually assessed loans for which no evidence of loss has been identified are grouped together according to their credit risk characteristics for the purpose of calculating an estimated collective loss. This arises from individual loan impairment at the reporting date which will only be specifically identified in the future.

The collective impairment loss is determined after taking into account:

- historical loss experience in portfolios of similar 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 specific allowance against the individual loan; and
- management's judgement as to whether current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

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

Homogeneous group of loans

For homogeneous groups of loans that are not considered individually significant, the Bank utilises a roll rate methodology. This methodology employs a statistical analysis of historical trends of the probability of default and the amount of consequential loss, assessed at each time period for which the customer’s contractual payments are overdue. 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 value of the portfolio.

Other historical data and current economic conditions are also evaluated when calculating the appropriate level of allowance required to cover inherent loss.

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

29. Financial risk management *(continued)*

a) Credit risk *(continued)*

Loan write-offs

Loans (and the related impairment allowances) are normally charged off, either partially or in full, when there is no realistic prospect of recovery of these amounts and when the proceeds from the realisation of security have been received. Unsecured personal facilities are normally charged off between 150 and 210 days overdue. There are no cases where the charge-off period exceeds 360 days except where certain personal accounts are still deemed collectible beyond this point. In the case of bankruptcy, charge-off occurs at the time of notification.

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 statement of income.

Renegotiated loans

Loans that have been individually identified as impaired and whose terms have been subsequently renegotiated are treated as new loans and all unamortised fees and costs are taken to the statement of income with immediate effect. However, even after renegotiation, the loans are not upgraded and remain in the same category till the satisfactory performance for a certain period subsequent to renegotiation.

Cross-border exposures

In relevant cases, impairment allowances will include an element in respect of cross-border exposures to countries assessed by management to be vulnerable to foreign currency payment restrictions. This assessment includes analysis of both economic and political factors existing at the time. Economic factors include the level of external indebtedness, the debt service burden and access to external sources of funds to meet the debtor country's financing requirements. Political factors taken into account include the stability of the country and its government, threats to security and the quality and independence of the legal system.

Non-performing loans

For individually assessed accounts, loans are designated as non-performing as soon as there is objective evidence that an impairment loss has been incurred. Objective evidence of impairment includes observable data such as when contractual payments of principal or interest are 90 days overdue. Portfolios of homogeneous loans, representing retail lending, are designated as non-performing if facilities are 90 days or more overdue.

29. Financial risk management *(continued)*

a) Credit risk *(continued)*

Impairment allowance

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

Movement in allowance accounts for total loans and advances:

	2010		2009	
	Individually assessed AED'000	**Collectively assessed AED'000**	Individually assessed AED'000	Collectively assessed AED'000
At 1 January	**1,327,544**	**1,833,763**	194,406	631,984
Charge for the year	**1,276,965**	**1,611,800**	1,167,739	2,621,882
Amounts written off	**(19,267)**	**(1,166,793)**	(18,543)	(1,286,816)
Release of provisions	**(158,418)**	**(1,196,002)**	(16,058)	(133,287)
Other movement	**(65,384)**	-	-	-
At 31 December	**2,361,440**	**1,082,768**	1,327,544	1,833,763

Impairment allowances against loans and advances to customers:

	2010 %age	2009 %age
Total impairment allowances to gross lending		
Individually assessed impairment allowances	**4.35**	2.52
Collectively assessed impairment allowances	**1.99**	3.48

	2010 AED'000	2009 AED'000
Balances as at 31 December		
Non-performing loans	**5,704,267**	3,874,607
Impairment allowances	**3,444,208**	3,161,307
Gross loans and advances	**54,333,534**	52,625,106
Impairment allowances as a %age of non-performing loans	**60.38**	**81.59**

29. Financial risk management *(continued)*

a) Credit risk *(continued)*

Collateral and other credit enhancements obtained

The Bank has assets obtained by taking control of collateral accepted as security, or through other credit enhancements amounting to AED 2,533,109 thousand (2009: AED 3,165,758 thousand).

Renegotiated loans

Restructuring activity is designed to manage customer relationships, maximise collection opportunities and avoid foreclosure or repossession, if possible. Following restructuring, an overdue consumer account will normally be reset from delinquent to current status, subject to satisfactory performance till certain period subsequent to renegotiation. Restructuring policies and practices are based on indicators or criteria which, in the judgement of local management, evidence the probability that payment will continue. These policies are reviewed and their application varies depending upon the nature of the market, the product and the availability of empirically based data. Where empirical evidence indicates an increased propensity to default on restructured accounts, the use of roll rate methodologies for the calculation of impairment allowances results in the increased default propensity being reflected in impairment allowances.

Renegotiated loans that would otherwise be past due or impaired as at 31 December 2010 amounted to AED 2,801,761 thousand (2009: AED 438,417 thousand).

Concentration of exposures

The Bank provides a diverse range of financial services in the United Arab Emirates. As a result, its portfolio of financial instruments with credit risk is highly diversified with no exposures to individual industries or economic groupings totalling more than 10 per cent 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 2010 and 31 December 2009 was concentrated mainly in Europe and the Middle East.

29. Financial risk management *(continued)*

a) Credit risk *(continued)*

Concentration of exposures *(continued)*

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

	Loans and Advances to customers	
	2010	2009
	AED'000	AED'000
Personal lending	**12,344,627**	15,169,557
Commercial and industrial	**22,486,993**	17,693,155
Commercial real estate and construction	**5,868,745**	6,120,115
Financial institutions	**822,249**	1,414,820
Government	**3,883,604**	4,543,267
Other market sectors	**8,927,316**	7,684,192
	54,333,534	52,625,106
Less: Allowance for impairment losses	**(3,444,208)**	(3,161,307)
	50,889,326	49,463,799

29. Financial risk management *(continued)*

a) Credit risk *(continued)*

Concentration of exposures *(continued)*

The details of Bank's geographical concentration of exposure are as follows:

	Assets		
	Banks	**Non-banks**	**Total**
	AED'000	**AED'000**	**AED'000**
At 31 December 2010			
United Arab Emirates	24,700,724	50,955,319	75,656,043
Other GCC countries	3,808,519	1,534,052	5,342,571
Others	6,634,761	6,966,220	13,600,981
	35,144,004	**59,455,591**	**94,599,595**
At 31 December 2009			
United Arab Emirates	20,491,508	50,452,927	70,944,435
Other GCC countries	6,183,006	1,265,053	7,448,059
Others	9,203,608	5,472,333	14,675,941
	35,878,122	57,190,313	93,068,435

29. Financial risk management *(continued)*

b) Liquidity risk

Liquidity risk is the risk that the Bank will encounter difficulty in meeting obligations associated with its financial liabilities that are settled by delivery of cash or another financial asset. This risk arises from mismatches in the timing of cash flows. Funding risk (a form of liquidity risk) arises when the necessary liquidity to fund illiquid asset positions cannot be obtained at the expected terms and when required.

The Bank's objective of liquidity and funding management is to ensure that all foreseeable funding commitments and deposit withdrawals can be met when due, and that wholesale market access is co-ordinated and disciplined. To this end, the Bank maintains a diversified and stable funding base comprising core retail and corporate customer deposits and institutional balances, augmented by wholesale funding and portfolios of highly liquid assets which are diversified by currency and maturity, in order to be able to respond quickly and smoothly to unforeseen liquidity requirements.

The management of liquidity and funding is primarily carried out in accordance with practice and limits set by the Group. These limits vary by local financial unit to take account of the depth and liquidity of the market in which the entity operates. It is the Group's general policy that each banking entity should be self-sufficient with regard to funding its own operations. Exceptions are permitted to facilitate the efficient funding of certain short-term treasury requirements however, which are funded under strict internal and regulatory guidelines and limits.

These internal and regulatory limits and guidelines serve to place formal limitations on the transfer of resources between Group entities and are necessary to reflect the broad range of currencies, markets and time zones within which the Group operates.

The Group's policy is to require operating entities to maintain a strong liquidity position and to manage the liquidity profile of their assets, liabilities and commitments so that cash flows are appropriately balanced and all funding obligations are met when due.

The Group's liquidity and funding management process requires:

- projecting cash flows by major currency and considering the level of liquid assets necessary in relation thereto;
- monitoring statement of financial position liquidity ratios against internal and regulatory requirements;
- maintaining a diverse range of funding sources with adequate back-up facilities;
- managing the concentration and profile of debt maturities; and
- maintaining debt financing plans;

29. Financial risk management *(continued)*

b) Liquidity risk *(continued)*

- monitoring depositor concentration in order to avoid undue reliance on large individual depositors and ensure a satisfactory overall funding mix; and
- maintaining liquidity and funding contingency plans. These plans identify early indicators of stress conditions and describe actions to be taken in the event of difficulties arising from systemic or other crises while minimizing adverse long-term implications for the business.

Current accounts and savings deposits payable on demand or at short notice form a significant part of the Bank's funding. The Bank places considerable importance on the stability of these deposits.

The Bank would meet unexpected net cash outflows by selling securities and accessing additional funding sources such as inter-bank or asset-backed markets.

The maturity profile of the financial assets and liabilities at the reporting date is based on contractual repayment arrangements and is determined on the basis of the remaining period at the reporting date to the final maturity dates. The maturity profile is monitored by management to ensure adequate liquidity is maintained.

29. Financial risk management *(continued)*

b) Liquidity risk *(continued)*

The maturity profile of the financial assets and liabilities as at 31 December 2010 were as follows:

31 December 2010

	Upto 3 months AED'000	3 to 12 months AED'000	1 to 5 years AED'000	Over 5 years AED'000	No fixed maturity AED'000	Total AED'000
Financial assets						
Cash and balances with the Central Bank	5,670,767	-	-	-	-	5,670,767
Loans and advances to banks	10,264,095	-	367,250	-	-	10,631,345
Loans and advances to customers	22,233,226	8,423,070	13,357,848	6,875,182	-	50,889,326
Investments	5,286,878	17,366,748	1,591,450	240,249	1,837	24,487,162
Other assets	2,479,264	421,566	5,400	-	3,412,724	6,318,954
Total	**45,934,230**	**26,211,384**	**15,321,948**	**7,115,431**	**3,414,561**	**97,997,554**
Financial liabilities						
Deposits by banks	6,213,167	46,380	1,101,897	-	-	7,361,444
Customer accounts	54,667,502	4,738,967	821,402	-	-	60,227,871
Debt securities in issue	428,442	3,906,885	5,991,797	-	-	10,327,124
Subordinated loan from head office	-	-	-	2,754,375	-	2,754,375
Other liabilities	3,186,846	421,566	5,400	-	5,474,905	9,088,717
Total	**64,495,957**	**9,113,798**	**7,920,496**	**2,754,375**	**5,474,905**	**89,759,531**
On balance sheet gap	**(18,561,727)**	**17,097,586**	**7,401,452**	**4,361,056**	**(2,060,344)**	**8,238,023**

29. Financial risk management *(continued)*

b) Liquidity risk *(continued)*

31 December 2009

	Upto 3 months AED'000	3 to 12 months AED'000	1 to 5 years AED'000	Over 5 years AED'000	No fixed maturity AED'000	Total AED'000
Financial assets						
Cash and balances with the Central Bank	5,611,000	-	-	-	-	5,611,000
Loans and advances to banks	15,122,313	435,186	-	-	-	15,557,499
Loans and advances to customers	25,811,465	9,106,967	12,306,250	2,239,117	-	49,463,799
Investments	7,300,870	7,360,214	4,835,224	-	2,458	19,498,766
Other assets	1,801,590	483,987	13,360	-	3,014,265	5,313,202
Total assets	55,647,238	17,386,354	17,154,834	2,239,117	3,016,723	95,444,266
Financial liabilities						
Deposits by banks	4,660,783	45,641	1,111,728	-	-	5,818,152
Customer accounts	55,025,015	3,717,161	1,028,250	77,433	-	59,847,859
Debt securities in issue	-	6,586,099	5,243,383	-	-	11,829,482
Subordinated loan from head office	-	-	-	2,754,375	-	2,754,375
Other liabilities	3,588,011	506,109	26,550	-	3,755,078	7,875,748
Total	63,273,809	10,855,010	7,409,911	2,831,808	3,755,078	88,125,616
On balance sheet gap	(7,626,571)	6,531,344	9,744,923	(592,691)	(738,355)	7,318,650

29. Financial risk management *(continued)*

b) Liquidity risk *(continued)*

The contractual maturity profile of liabilities as at 31 December 2010 were as follows:

31 December 2010	**Carrying value AED'000**	**Upto 3 months AED'000**	**3 to 12 months AED'000**	**1 to 5 years AED'000**	**Over 5 years AED'000**	**No fixed maturity AED'000**	**Total AED'000**
Deposits by banks	7,361,444	6,337,738	87,866	1,314,219	-	-	7,739,823
Customer accounts	60,227,871	54,884,694	4,945,641	984,233	-	-	60,814,568
Debt securities in issue	10,327,124	455,099	3,999,898	6,424,463	-	-	10,879,460
Subordinated loan from head office	2,754,375	48,775	146,324	780,397	4,705,368	-	5,680,864
Other liabilities	9,088,717		421,566	5,400	-	5,474,905	5,901,871
Total	**89,759,531**	**61,726,306**	**9,601,295**	**9,508,712**	**4,705,368**	**5,474,905**	**91,016,586**
Guarantees and off balance sheet commitments	**60,077,200**	**42,845,911**	**15,423,840**	**1,774,752**	**32,697**	**-**	**60,077,200**
31 December 2009							
Deposits by banks	5,818,152	4,700,665	69,441	1,233,657	-	-	6,003,763
Customer accounts	59,847,859	55,186,235	3,783,392	1,144,697	97,580	-	60,211,904
Debt securities in issue	11,829,482	60,099	6,766,396	5,669,602	-	-	12,496,097
Subordinated loan from head office	2,754,375	50,715	152,144	811,436	4,782,964	-	5,797,259
Other liabilities	7,875,748	3,588,011	506,109	26,550	-	3,755,078	7,875,748
Total	88,125,616	63,585,725	11,277,482	8,885,942	4,880,544	3,755,078	92,384,771
Guarantees and off balance sheet commitments	65,226,506	31,497,651	10,790,793	15,032,415	7,905,647	-	65,226,506

29. Financial risk management *(continued)*

b) Liquidity risk *(continued)*

The Bank emphasises the importance of core customer deposits as a source of funds to finance lending to customers. This is achieved by placing limits, 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 (previously referred to as the 'advances to deposits' ratio).

Advances to core funding ratio limits 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. The classification of a deposit as 'core' includes consideration of the size of the deposit balance, the pricing, the type of customer and the deposit's behavioural characteristics. Due to the distinction between core and non-core deposits, the Bank's measure of advances to deposits will be more restrictive than that which could be inferred from the financial statements.

The advances to core funding ratio at the reporting date and during the reporting period was as follows:

	2010	2009
	AED '000	AED '000
At 31 December	**104.00%**	100.59%
Average for the year	**100.85%**	110.45%
Minimum for the year	**95.36%**	100.59%
Maximum for the year	**104.78%**	121.65%

c) Market risk

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

The objective of market risk management is to manage and control market risk exposures in order to optimise return on risk while maintaining a market profile consistent with the Bank's status as a premier provider of financial products and services.

Each operating entity is required to assess the market risks which arise on each product in its business and to transfer these risks to either its local Global Markets unit for management, or to separate books managed under the auspices of the local Assets and Libilities Commitee ('ALCO'). The aim is to ensure that all market risks are consolidated within operations which have the necessary skills, tools, management and governance to professionally manage such risks.

29. Financial risk management *(continued)*

c) Market risk *(continued)*

Value at risk (VAR)

One of the principal tools used by the Bank to monitor and limit market risk exposure is 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 (for the Bank, 99 per cent). The Bank calculates VAR daily and the methodology is predominantly based on historical simulation. The historical simulation model derives plausible future scenarios from historical market rates time series, taking account of inter-relationships between different markets and rates, for example between interest rates and foreign exchange rates. Potential movements in market prices are calculated with reference to market data from the last two years.

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

a) the use of historic data as a proxy for estimating future events may not encompass all potential events, particularly those which are extreme in nature;

b) the use of a one-day holding period assumes that all positions can be liquidated or hedged in one day. This may not fully reflect the market risk arising from times of severe illiquidity, when a one-day holding period may be insufficient to liquidate or hedge all positions fully;

c) the use of a 99 per cent confidence level, by definition, does not take into account losses that might occur beyond this level of confidence; and

d) VAR is calculated on the basis of exposures outstanding at the close of business and therefore does not necessarily reflect intra-day exposures.

The Bank recognises these limitations by augmenting its VAR limits with other position and sensitivity limit structures. Additionally, the Bank applies a wide range of stress testing, both on individual portfolios and on Bank's consolidated positions. The Bank's stress-testing regime provides senior management with an assessment of the financial impact of identified extreme events on the market risk exposures of the Bank.

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

	Portfolio	
Risk type	Trading	Non trading
Foreign exchange	VAR	VAR
Interest rate	VAR	VAR
Credit spread	Sensitivity	Sensitivity

29. Financial risk management *(continued)*

c) Market risk *(continued)*

Value at risk (VAR) *(continued)*

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

Value at risk	**2010** **AED'000**	2009 AED'000
As at 31 December	**11,553**	11,694
Average for the year	**33,646**	12,163
Minimum during the year	**9,385**	8,169
Maximum during the year	**48,637**	20,790

Fair value and price verification control

Where certain financial instruments are carried at fair values, it is the Bank's policy that the valuation and the related price verification processes are subject to independent testing. Financial instruments which are accounted for on a fair value basis include assets held in the trading portfolio, financial instruments designated at fair value, obligations related to securities sold short, all derivative financial instruments and available for sale securities.

The determination of fair values is therefore a significant element in the reporting of the Bank’s Global Markets activities.

All significant valuation policies and any changes thereto, must be approved by Senior Finance Management. The Bank’s governance of financial reporting requires that Financial Control departments are independent of the risk-taking businesses, with the Finance functions having ultimate responsibility for the determination of fair values included in the financial statements, and for ensuring that the Group’s policies and relevant accounting standards are adhered to. Senior management are required to assess the resourcing and expertise of Finance functions on a regular basis to ensure that the Bank’s financial control and price verification processes are properly staffed to support the required control infrastructure.

29. Financial risk management *(continued)*

c) Market risk *(continued)*

Fair value and price verification control *(continued)*

Trading

Market risk in trading portfolios is monitored and controlled at both portfolio and position levels using a complementary set of techniques, such as VAR and present value of a basis point, together with stress and sensitivity testing and concentration limits. These techniques quantify the impact on capital of defined market movements.

Other controls include restricting individual operations to trading within a list of permissible instruments authorised for each site by Group Traded Credit and Risk, and enforcing rigorous new product approval procedures. In particular, trading in the more complex derivative products is concentrated based on the Group policies with appropriate levels of product expertise and robust control systems.

The Bank's policy on hedging is to manage economic risk in the most appropriate way regardless as to whether hedge accounting is available, within limits regarding the potential volatility of reported earnings. Trading VAR is further analysed below by risk type, by positions taken with trading intent:

Total trading VAR by risk type

	Foreign exchange Trading AED'000	**Interest rate Trading AED'000**	**Spread Trading AED'000**	**Total Trading AED'000**
At 31 December 2010	**7,084**	**9,777**	**3,649**	**5,571**
At 31 December 2009	14,809	16,141	-	5,429
Average				
2010	**14,857**	**12,451**	**4,668**	**10,997**
2009	8,428	7,757	-	6,280
Minimum				
2010	**6,965**	**7,342**	**2,009**	**5,376**
2009	1,857	1,815	-	3,475
Maximum				
2010	**21,174**	**17,482**	**20,166**	**20,052**
2009	22,664	17,479	-	12,771

29. Financial risk management *(continued)*

c) Market risk *(continued)*

Fair value and price verification control *(continued)*

Non-trading

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

Market 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 optionality in certain product areas, for example, mortgage prepayments, and from behavioural assumptions regarding the economic duration of liabilities which are contractually repayable on demand, for example, current accounts. This prospective change in future net interest income from non-trading portfolios will be reflected in the current realisable value of these positions should they be sold or closed prior to maturity. In order to manage this risk optimally, market risk in non-trading portfolios is transferred to Global Markets or to separate books managed under the auspices of the local ALCO.

The transfer of market risk to trading books managed by Global Markets or ALCO is usually achieved by a series of internal deals between the business units and these trading books. When the behavioural characteristics of a product differ from its contractual characteristics, the behavioural characteristics are assessed to determine the true underlying interest rate risk. Local ALCO's regularly monitor all such behavioural assumptions and interest rate risk positions to ensure they comply with interest rate risk limits established by the Group.

As noted above, in certain cases, the non-linear characteristics of products cannot be adequately captured by the risk transfer process. For example, both the flow from customer deposit accounts to more attractive investment products and the precise repayment levels of mortgages will vary at different interest rate levels. In such circumstances simulation modelling is used to identify the impact of varying scenarios on valuations and net interest income.

29. Financial risk management *(continued)*

c) Market risk *(continued)*

Net interest income

Future net interest income is affected by movements in interest rates. A principal part of the Bank's management of market risk in non-trading portfolios is to monitor the sensitivity of projected net interest income under varying interest rate scenarios (simulation modelling). The Bank aims, through its management of market risk in non-trading portfolios, to mitigate the impact of prospective interest rate movements which could reduce future net interest income, whilst balancing the cost of such hedging activities on the current net revenue stream. For simulation modelling, businesses use a combination of scenarios relevant to local businesses and local markets as well as standard scenarios required to be used across the Group.

The Bank's core exposure to changes in its net interest income arising from movements in interest rates falls into two areas: core deposit franchises and Global Markets.

The major drivers of the changes shown in the projected effect of interest rate moves are set out below.

- Reinvestment rates - for the purpose of the sensitivity projections, it has been assumed maturing interest earning assets and interest bearing liabilities replenish at the prevailing market rates and on similar terms.

- The projected movements from rate changes are computed assuming simultaneous change in customer rates.

- Economic environment - the projected effect of interest rate moves assumes no significant changes in the existing economic environment, interest rate and exchange rate policies of the regions.

It can be seen from the above that projecting the movement in net interest income from prospective changes in interest rates is a complex interaction of structural and managed exposures. In a rising rate environment, the most critical exposures are those managed within Global Markets.

Additionally, the Bank considers a principal risk to future net interest income to be a general flattening of yield curves at a low level of interest rates, as this reduces the value of the deposit franchise and limits the opportunities within Global Markets.

29. Financial risk management *(continued)*

c) Market risk *(continued)*

Net interest income *(continued)*

The Bank monitors the sensitivity of reserves to interest rate movements on a monthly basis by assessing the expected reduction in valuation of available-for-sale portfolios and cash flow hedges due to parallel movements of plus or minus 100bps in all yield curves. The table below describes the sensitivity to these movements at 31 December 2010 and 2009 and the maximum and minimum month figures during the year then ended:

	At 31 December AED'000	**Maximum impact AED'000**	**Minimum impact AED'000**
2010			
+ 100 basis point parallel move in all yield curves	(181,592)	(183,644)	(58,602)
As a percentage of Head Office funds at 31 December 2010	-2.03%	-2.05%	-0.65%
- 100 basis point parallel move all in yield curves	181,592	183,644	58,602
As a percentage of Head Office funds at 31 December 2010	2.03%	2.05%	0.65%
2009			
+ 100 basis point parallel move in all yield curves	(67,759)	(74,601)	(15,117)
As a percentage of Head Office funds at 31 December 2009	-0.84%	-0.92%	-0.19%
- 100 basis point parallel move all in yield curves	67,759	74,601	15,117
As a percentage of Head Office funds at 31 December 2009	0.84%	0.92%	0.19%

d) Currency risk

The Bank had a net long position of AED 153.1 million as at 31 December 2010 (2009: Net long position of AED 344.1 million) in foreign currency.

29. Financial risk management *(continued)*

e) Operational risk

Operational risk is the risk of loss arising from fraud, unauthorised activities, error, omission, inefficiency, systems failure or external events. It is inherent to every business organisation and covers a wide spectrum of issues.

The Group manages this risk through a controls-based environment in which processes are documented, authorisation is independent and transactions are reconciled and monitored. This is supported by an independent programme of periodic reviews undertaken by Internal Audit, and by monitoring external operational risk events, which ensure that the group stays in line with best practice and takes account of lessons learned from publicised operational failures within the financial services industry.

The Group has codified its operational risk management process by issuing a high level standard. This explains how the Group manages operational risk by identifying, assessing, monitoring, controlling and mitigating the risk, rectifying operational risk events, and implementing any additional procedures required for compliance with local regulatory requirements. The processes undertaken to manage operational risk are determined by reference to the scale and nature of each Group operation. The Group standard covers the following:

- Operational risk management responsibility is assigned at senior management level within the business operation;

- Information systems are used to record the identification and assessment of operational risks and generate appropriate, regular management reporting;

- Operational risks are identified by assessments covering operational risks facing each business and risks inherent in processes, activities and products. Risk assessment incorporates a regular review of identified risks to monitor significant changes;

- Operational risk loss data is collected and reported to senior management. Aggregate operational risk losses are recorded and details of incidents above a materiality threshold are reported to the Group Audit Committee and the Risk Management Meeting; and

- Risk mitigation, including insurance, is considered where this is cost-effective.

Local management is responsible for implementing the Group standard on operational risk throughout their operations and, where deficiencies are evident, rectifying them within a reasonable timeframe.

29. Financial risk management *(continued)*

e) Operational risk *(continued)*

The Group maintains and tests contingency facilities to support operations in the event of disasters. Additional reviews and tests are conducted in the event that any Group office is affected by a business disruption event to incorporate lessons learned in the operational recovery from those circumstances.

f) 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 increase the returns for the shareholders; and

- Comply with regulatory capital requirements set by the Central Bank of the UAE.

The Bank's regulatory capital adequacy ratio, set by the Central Bank of the UAE at a minimum level of 12% (2009: 11%), the banks regulatory capital is analysed into two tiers:

- Tier 1 capital, which includes ordinary share capital and retained earnings(excluding current year profit); and

- Tier 2 capital, which includes collective impairment provision and subordinated facilities.

	2010	**2009**
	AED'000	**AED'000**
Tier 1 capital		
Allocated capital	**4,495,255**	4,495,255
Legal reserve	**843,937**	843,937
Other reserves	**(3,035)**	68,530
Unremitted profits	**2,686,300**	2,722,314
Total	**8,022,457**	8,130,036
Less: deductions		
Goodwill and intangibles	**(47,643)**	(34,078)
Own shares held	**(13,714)**	(24,932)
Current year loss	**-**	(36,014)
	7,961,100	8,035,012

29. Financial risk management *(continued)*

f) Capital management *(continued)*

	2010 AED'000	2009 AED'000
Tier 2 Capital		-
Undisclosed reserves - General provision	**635,362**	898,931
Subordinated loan from head office	**2,754,375**	2,754,375
Total capital base (a)	**11,350,837**	11,688,318
Risk weighted assets (b)	88,547,644	71,914,472
Capital adequacy ratio (%) [(a)/(b)*100]	**12.82%**	**16.25%**

The Bank has complied with all externally imposed capital requirements throughout the year.

There have been no material changes in the Bank's management of capital during the year, except that in 2009, the Central Bank advised that the capital adequacy ratio should be increased to 11% analysed into two Tiers, of which Tier 1 capital adequacy must not be less than 7% by 30 September 2009 and 12% analysed into two tiers of which Tier 1 capital adequacy ratio must not be less than 8% by 30 June 2010. Accordingly, the Bank has complied with its capital adequacy calculation in accordance with Basel II Standardised Approach for credit, market and operational risks.

Capital allocation

The Bank also internally assesses its capital requirements taking into consideration growth requirements and business plans, and quantifies its Regulatory as well as Risk/Economic Capital requirements.

30. Financial assets and liabilities

Fair value information

Based on the valuation methodologies outlined below, the analysis and fair values of all on-and-off balance-sheet financial instruments as at 31 December 2010 are given below.

30. Financial assets and liabilities *(continued)*

Fair value information *(continued)*

Loans and advances to customers

The fair value of loans and advances to customers is principally estimated as being equal to the net present value of future scheduled repayments discounted at current market rates less allowance for impairment losses.

Other on-balance sheet financial instruments

The fair values of all other on-balance sheet financial instruments are considered to approximate their book values as they are either short term in nature or carried in the financial statements at fair value.

Off-balance sheet financial instruments

No fair value adjustment is made with respect to credit related off-balance sheet financial instruments as the related future income streams materially reflect contractual fees and commissions actually charged as at the balance sheet date for agreements of similar credit standing and maturity.

The fair values of exchange rate contracts and interest rate contracts are based on quoted mid market prices.

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 principal accounting policies in the notes to the financial statements describe how the classes of financial instruments are measured, and how income and expenses, including fair value gains and losses, are recognised. The following table analyses the financial assets and liabilities in the statement of financial position by the class of financial instrument to which they are assigned, and therefore by the measurement basis.

30. Financial assets and liabilities *(continued)*

Analysis of financial assets and liabilities by measurement basis(continued)

2010	Held for trading	Loans and receivables	Available-for-sale securities	Financial assets and liabilities at amortised cost	Derivatives designated as cash flow hedging instruments	Total	Fair value
	AED'000	AED'000	AED'000	AED'000	AED'000	AED'000	AED'000
ASSETS							
Cash and balances with the Central Bank	-	-	-	5,670,767	-	5,670,767	5,670,767
Loans and advances to banks	-	10,631,345	-	-	-	10,631,345	10,641,360
Loans and advances to customers	51,442	50,837,884	-	-	-	50,889,326	51,000,484
Financial investments	1,385,456	-	23,101,706	-	-	24,487,162	24,487,162
Other assets	3,070,776	-	-	3,248,178	-	6,318,954	6,318,954
Total financial assets	**4,507,674**	**61,469,229**	**23,101,706**	**8,918,945**	**-**	**97,997,554**	**98,118,727**
LIABILITIES							
Deposits by banks	-	-	-	7,361,444	-	7,361,444	7,300,088
Customer accounts	-	-	-	60,227,871	-	60,227,871	60,233,398
Debt securities in issue	-	-	-	10,327,124	-	10,327,124	10,278,252
Subordinated loan from head office	-	-	-	2,754,375	-	2,754,375	2,754,375
Other liabilities	2,997,635	-	-	5,926,503	58,488	8,982,626	8,982,626
Total financial liabilities	**2,997,635**	**-**	**-**	**86,597,317**	**58,488**	**89,653,440**	**89,548,739**

30. Financial assets and liabilities *(continued)*

Analysis of financial assets and liabilities by measurement basis(continued)

2009	Held for trading	Loans and receivables	Available- for-sale securities	Financial assets and liabilities at amortised cost	Derivatives designated as cash flow hedging instruments	Total	Fair value
	AED'000	AED'000	AED'000	AED'000	AED'000	AED'000	AED'000
ASSETS							
Cash and balances with the Central Bank	-	-	-	5,611,000	-	5,611,000	5,611,000
Loans and advances to banks	-	15,557,499	-	-	-	15,557,499	16,616,992
Loans and advances to customers	26,650	49,437,149	-	-	-	49,463,799	47,885,529
Financial investments	618,589	-	18,880,177	-	-	19,498,766	19,498,766
Other assets	2,344,604	-	-	2,968,598	-	5,313,202	5,313,120
Total financial assets	2,989,843	64,994,648	18,880,177	8,579,598	-	95,444,266	94,925,407
LIABILITIES							
Deposits by banks	-	-	-	5,818,152	-	5,818,152	6,919,136
Customer accounts	-	-	-	59,847,859	-	59,847,859	59,766,880
Debt securities in issue	-	-	-	11,829,482	-	11,829,482	11,502,888
Subordinated loan from head office	-	-	-	2,754,375	-	2,754,375	2,754,375
Other liabilities	2,294,074	-	-	5,564,683	16,991	7,875,748	7,875,748
Total financial liabilities	2,294,074	-	-	85,814,551	16,991	88,125,616	88,819,027

30. Financial assets and liabilities *(continued)*

Analysis of financial assets and liabilities by fair value hierarchy

The Bank measures fair values using the following fair value hierarchy that reflects the significance of the inputs used in making the measurements:

Level 1: Quoted market price (unadjusted) in an active market for an identical instrument. A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry, group, pricing service or regulatory agency, and those prices represent actual and regularly recurring market transactions on an arm's length basis.

Level 2: Valuation techniques based on observable input, either directly (i.e., as prices) or indirectly (i.e., derived from prices). This category includes instruments valued using: quoted market prices in active markets for similar instruments; quoted prices for identical or similar instruments; or other valuation techniques where all significant inputs are directly or indirectly observable from market data.

Level 3: Valuation techniques using significant unobservable inputs. This category includes all instruments where the valuation technique includes inputs based on unobservable data and the unobservable inputs have a significant effect on the instrument’s valuation. This category includes instruments that are valued based on quoted prices for similar instruments where significant unobservable adjustments or assumptions are required to reflect differences between the instruments.

30. Financial assets and liabilities *(continued)*

Analysis of financial assets and liabilities by fair value hierarchy *(continued)*

2010	Level 1	Level 2	Level 3	Total
	AED'000	AED'000	AED'000	AED'000
Financials assets valued at fair value				
Trading assets	-	1,385,456	-	1,385,456
Available for sale - Debt securities	-	23,086,155	-	23,086,155
Equities	13,714	1,837	-	15,551
Derivative financial assets:				
Interest rate contracts	-	1,485,351	-	1,485,351
Foreign exchange contracts	-	1,318,509	9,016	1,327,525
Foreign exchange options	-	45,839	-	45,839
Equity options	-	63,970	-	63,970
Credit derivatives	-	148,091	-	148,091
Total	**13,714**	**27,535,208**	**9,016**	**27,557,938**
Financials liabilities valued at fair value				
Trading liabilities	-	447,139	-	447,139
Derivative financial liabilities:				
Interest rate contracts	-	1,619,574	-	1,619,574
Foreign exchange contracts	-	1,196,627	-	1,196,627
Foreign exchange options	-	43,626	2,505	46,131
Equity options	-	27,778	36,192	63,970
Credit derivatives	-	129,821	-	129,821
Total	**-**	**3,464,565**	**38,697**	**3,503,262**

30. Financial assets and liabilities *(continued)*

Analysis of financial assets and liabilities by fair value hierarchy *(continued)*

2009	**Level 1**	**Level 2**	**Level 3**	**Total**
	AED'000	**AED'000**	**AED'000**	**AED'000**
Financials assets valued at fair value				
Trading assets	-	618,589	-	618,589
Available for sale - Debt securities	-	18,852,787	-	18,852,787
Equities	24,932	2,458	-	27,390
	-	-	-	
Derivative financial assets:	-	-	-	
Interest rate contracts	-	897,318	-	897,318
Foreign exchange contracts	-	1,075,274	47,540	1,122,814
Foreign exchange options	-	122,379	-	122,379
Equity options	-	51,644	4,390	56,034
Credit derivatives	-	146,059	-	146,059
Total	24,932	21,766,508	51,930	21,843,370
Financials liabilities valued at fair value				
Derivative financial liabilities:				
Interest rate contracts	-	963,425	-	963,425
Foreign exchange contracts	-	1,012,412	-	1,012,412
Foreign exchange options	-	121,241	1,138	122,379
Equity options	-	45,449	10,585	56,034
Credit derivatives	-	132,066	-	132,066
Total	-	2,274,593	11,723	2,286,316

30. Financial assets and liabilities *(continued)*

	Derivatives assets AED'000	Derivatives liabilities AED'000	Total AED'000
2010			
Opening balance	51,930	11,723	63,653
Total gains or (losses):			
in statement of income	(10,132)	(20,779)	(30,911)
Settlements - cash receipts/(payments)	-	-	-
Purchases	16,863	47,753	64,616
Transfers out of Level 3	(49,645)	-	(49,645)
Closing balance	**9,016**	**38,697**	**47,713**
2009			
Opening balance	31,841	2,806	34,647
Total gains or (losses):			
in statement of income	(19,159)	(1,524)	(20,683)
Settlements - cash receipts/(payments)	28,807	(143)	28,664
Purchases	35,227	10,584	45,811
Transfers out of Level 3	(24,786)	-	(24,786)
Closing balance	51,930	11,723	63,653

Transfers out of Level 3

During 2010, few derivative contracts were transferred out of level 3 of the fair value hierarchy as the unobservable risk was effectively hedged by entering into offsetting contracts or the significant inputs used in the fair value measurement, which were previously unobservable, became observable due to the decrease in the remaining maturity period.

Transfers in/out of Level 1 and Level 2

During the year, there were no transfers between Level 1 and Level 2 of the fair value hierarchy above. Further, there has been no change in the valuation techniques in relation to valuation of financial instruments during the year.

31. Events after the reporting date

These accounts were approved by the Management on 31 March 2011 and authorised for issue.

32. Comparative figures

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